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TRANSCRIPT OF PROCEEDINGS

PRODUCTIVITY COMMISSION

INQUIRY INTO PRICE REGULATION OF AIRPORT SERVICES

**PROF R.H. SNAPE, Deputy Chairman
DR N. BYRON, Commissioner**

TRANSCRIPT OF PROCEEDINGS

AT MELBOURNE ON MONDAY, 2 APRIL 2001, AT 9.08 AM

Continued from 26/3/01 in Sydney

PROF SNAPE: Welcome to this, the second day of the public hearings into the inquiry into prices regulation of airports - it's the first day in Melbourne, of course - conducted by the Productivity Commission. My name is Richard Snape and on my right is Dr Neil Byron. There are staff members present who will be pleased to give advice on procedures et cetera should it be required. The terms of the inquiry are specified in the terms of reference sent to the Commission late in December last year by the Assistant Treasurer. The Commission has circulated an issues paper that sets out what we perceived to be major issues. Copies of the terms of reference and of the issues paper are available just outside the entrance to the room.

We anticipate issuing a draft report in August while a final report is due with the Government in December. We plan to hold a second round of hearings after the draft report has been digested. The purpose of this inquiry is to examine whether new regulatory arrangements targeted at those charges for airport services or products where the airport operator has been identified as having the most potential to abuse market power are needed to ensure that the exercise of any such power may be appropriately counteracted. The Commission is to report on whether there is the need for prices regulation of airports and if so the appropriate form of any prices regulation, taking into account a number of principles that are set out in the terms of reference.

The public hearings provide the opportunity for interested parties to make oral presentations. Generally, this is in the form of speaking to written submissions, these being available on the Commission's website, as well as in hard copy. We note that we would like those written submissions and the oral evidence to be as much in the public domain as possible in accordance with the requirements of our act. We ask that any people who are making submissions to give very serious consideration to restricting anything in commercial-in-confidence to what is truly commercial-in-confidence, so we may in fact discharge our obligation to make this a public inquiry.

At the oral presentations, generally this is in the form of speaking to written submissions, these being available on the Commission's website, as I said, as well as in hard copy. The hearings also provide an opportunity for the Commission to seek clarifications and to pursue with participants matters of interest to the Commission. Transcripts of the hearings are sent to the relevant participants to check for accuracy of reporting. They are normally available on the Commission's website within a few days of the hearing. At the end of the scheduled hearings for today I shall invite any persons present to make unscheduled presentations should they wish to do so. I welcome and invite our first participant, Professor Peter Forsyth, who has given us a very helpful written submission, to speak to his submission. I do ask our participants to identify themselves for the purpose of the transcript.

PROF FORSYTH: Thank you. This is Peter Forsyth. I'm professor of economics at Monash University. Thank you for the opportunity to speak to my submission. What I've tried to do is provide a general overview of airport regulation. What the purpose of this is, is I think to, I guess provide the Commission with something of a

benchmark with which to assess the various other arguments that it will be hearing from a range of interested parties. What I tried to do is identify what I considered to be the most important issues and how they might be resolved. In some cases my submission is brief but that's of necessity. There are quite a lot of references there, both to some of the work that I've done and also to the literature in the field. So if you want to follow up on some of those arguments, you can.

I'd like to start briefly by mentioning the rationale of the price regulation. Price regulation of airports is different in some respects from price regulation of monopoly generally. The usual argument that you get in texts about regulation being there to promote efficiency can't really be used in the case of airports. Essentially, regulation has an efficiency cost and whilst it will have some efficiency benefits the former will outweigh the latter.

Basically, we have a situation where you have a body with monopoly or could have monopoly and with a lot of market power and it will use that market power. However, when it uses that market power it won't create too much of an efficiency loss in the traditional way and that's partly because it can operate a very efficient price structure. So the efficiency costs of monopoly, use of monopoly power, are relatively small. As against that, if we regulate, regulation is inherently going to be somewhat cost based. When it's cost based it promotes productive inefficiency and that can be quite expensive. So on balance the argument must be that you don't regulate airports in order to achieve efficiency gains. If you're going to be regulating airports it's essentially to achieve other objectives.

You'll note from my submission that I don't accept the countervailing power argument. It's sometimes argued that airlines are big companies and they have countervailing power which they can use to force airports to keep prices down. Along with most observers outside airports, I'm not convinced by this argument. Essentially, to run the countervailing power argument, the user has to have a good alternative to the product on offer, so if Ansett wants to fly into Melbourne, to have countervailing power it has to have a very good alternative that it can switch to fairly readily and that's usually not the case in Australia. It can be the case in Europe or in parts of the US but not in most parts of Australia.

When faced with large price increases, for example, when you see high prices at Kansai Airport, what airlines usually do is huff and puff and complain and then pay up. Fundamentally, in most cases, it's an awful lot easier for an airline to pass on a \$5 or \$10 price increase to passengers, particularly when they know that all their competitors are going to have to do the same thing rather than have a major fight at the airport. So ultimately if we're going to have price regulation it's presumably to achieve other objectives, such as keeping prices low or keeping profits at some level that is regarded as normal.

I have some comments about the New Zealand system and I could add also the Scottish arrangements. Essentially, I don't believe that the New Zealand airports are "unregulated" in a true sense. What there is there is a form of shadow regulation.

Ever since the airports have been privatised a couple of years or so ago there has been an inquiry into imposing price controls. Of course in the case of the Scottish airports, Turnhouse Airport knows that it could be regulated very easily because there's a regulatory structure in place. Other airports like Manchester, Stansted are regulated, so it would take no time at all for the CAA to impose regulation on the Scottish airports if it wanted to.

PROF SNAPE: Where is Turnhouse?

PROF FORSYTH: Edinburgh. So really what you've got in place in those places is a form of shadow regulation. The point about shadow regulation is that it may keep prices down but it will also have similar effects to actual regulation. If airports believe that high profitability will lead to direct regulation, then it is less keen to achieve high profitability which means that they're less keen to keep their costs at a minimum. Overall, I don't think you can read strong messages from, say, the New Zealand experience.

I have identified a number of issues that one might examine. I think one thing that one has to set out from the very beginning is where the efficiency problems at airports are likely to lie. I suggest that they are not likely to lie in terms of overall price levels. However, price structures can be quite important. In particular, with busy airports there are a range of other problems. Congestion may be a problem but it doesn't have to be, because you can have much more efficient slot systems. But then when you have slot systems there's a question of how efficient the slot allocation system is. Productive inefficiency or efficiency is a major issue which tends not to be given very much attention but certainly it will be an expensive form of inefficiency if it occurs. Then a final aspect of efficiency concerns efficiency in terms of investment programs, both at a single airport and also when you have a system of adding to airport capacity by building a new airport, such as may be in Sydney at some stage.

I've mentioned before that I regard regulation as costly. This depends on what sort of regulation it is. What you find in Australia, as indeed overseas, is that regulation tends to be somewhat cost based. When it's rather cost based it tends to weaken incentives for cost reduction. We have a system in Australia of CPI-X regulation in most jurisdictions. I don't think you can regard this as necessarily incentive regulation. There's often an identification of CPI-X with "incentive regulation". Rather I think one should look at CPI-X as being the format for regulation and the extent to which it is incentive based or cost based is a matter of what the regulators are doing. Indeed, in some instances in Australia, even within the airport area, there are examples of what are virtually 100 per cent cost plus regulation.

The alternative to cost based regulation is yardstick or benchmark regulation. You often find references to this and how it's desirable but regulators always avoid it. They avoid it simply because it's risky from the firm's perspective and therefore from their perspective. Regulators can be punished if an industry is too profitable - and one can quote various examples of that. So the safe thing for a regulator to do is to

rely heavily on cost and not too much on benchmarks. So there's a real problem of getting benchmark regulation accepted if that's what's wanted.

Let's have a look at some of the specific issues. I mentioned price structures. By and large I think price structures that we have for the non-busy airports, ie, all airports in Australia other than Sydney, are pretty good, and there's quite a lot of discussion of that; not necessarily in my paper but in the literature. With busy airports, prices don't serve as the major allocative function. What happens is that the slot allocation system bears much of that role but not all of it. Indeed price structures can matter and what we have in a number of busy airports, such as London and seems to be developing in Sydney, is a system where the price structure is inappropriate. What you need for a busy airport is a uniform price structure not a weight-based charge. Essentially you're trying to ration a small amount of capacity rather than to maximise the use of a lot of capacity, so you need a different price structure.

Price caps, the way that they're implemented, can encourage airports to do that. At the moment the structure of the price cap which the ACCC applies to Melbourne and Adelaide and so forth, encourages airports to do precisely the opposite. That's fine for Melbourne and Adelaide but it's the inappropriate structure of price cap for Sydney. Another issue is investment and I've got some discussion of investment both at the individual airport level and also when one's discussing issues about how you meld together price regulation with building new airports. I think what has happened is that the ACCC has recognised problems in investment and in quality and has tried to adapt to those maybe in a somewhat ad hoc method. It's important that it does recognise this. I think there are some issues that do need to be addressed and I've mentioned those. Then when one comes to new airports, how one links together old airports and new airports, how one regulates prices in that context, I think we have to recognise that actual regulated prices are not going to be the primary signal for investment and also they're not going to be the primary allocative device. It's going to be the slot system that's going to be the primary allocative device between the busy and the non-busy airport and so there is some discussion about that.

I have a few words to say about the dual till versus the single till and I must admit that I'm - as one notes there are a range of conflicting arguments. There seems to be an emerging consensus that it's not clear, either way, which is preferable on efficiency grounds, but there seems to be also an emerging consensus that the single till is relatively weaker at busy airports such as Sydney. I also have some comments about rents in non-aeronautical areas. I'm not convinced that all of the rents are locational rents, but one can test for that. There are ways that one can test for whether a high price is really due to locational rents. I think we have to remember with locational rents that they come about because of the inherent scarcity of space or land, not necessarily just a created scarcity, so that's something one must test for.

Just to finish off I'd like to make a few comments in general about some recommendations. By and large I think the regulation of non-busy airports in Australia has been fairly well designed, however, the real concern is that they will become too far cost based and to that extent they will promote productive

inefficiency. Greater reliance on benchmarks and less reliance on costs is essential, but how you achieve that is another matter. It's no good just to make various general statements about how greater reliance on benchmarks should be considered or is desirable, it really has to be built in to the regulatory system or else regulators will simply pay lip service to that. I don't think there is very much to be gained from switching away from the quasi dual till approach that we have in the non-busy airports; I'm not pro nor against that particularly.

One thing that I think does need to be revised, however, are the investment criteria and the link between additional capacity and higher regulated prices is inappropriate and I think there needs to be a more comprehensive evaluation, particularly of major investments though it may be possible to devise ways of making a simpler arrangement for less important investments. When one comes to busy airports such as Sydney there are additional efficiency problems. As I've mentioned, the price caps that work for Melbourne - perhaps work very well for Melbourne - aren't appropriate for Sydney and have to be redesigned. The second problem is that price regulation does need to be redesigned to take into account investment - it can. So far, certainly as evidenced by the ACCC's February draft report, it hasn't really taken the long-term investment issues into account and that, of course, is something which ideally should be resolved before privatisation.

Finally, the proposed halfway house between dual and single tills at Sydney Airport essentially represents cost plus regulation and should be replaced. The final comment is that one of the objectives we like to have for regulation is that of light-handed regulation; certainly I'd agree with that objective if it's possible. Unfortunately, I think in the case of airports, light-handed regulation is not feasible. If you're going to have light-handed regulation what that probably means is that you're going to be ignoring some of the important aspects such as the investment and quality aspects. There isn't a halfway house. If you're going to have regulation of airports, you're going to have fairly involved regulation, at least with respect to some aspects. Thank you.

PROF SNAPE: Thank you very much for that, Professor Forsyth. Could I ask if people can hear easily? Back row, is that fine? This is the first time we've used this as a hearing - well, it's the second time, I think. It's the first time I've used it as a hearing room and so we want to make sure that people can hear. We are trying to get amplification tomorrow, but it didn't quite work today. Let us know if you can't hear. As I said, we do like to make it public. Thank you very much for that, Peter, and could I start off by asking you to elaborate a little bit on this distinction between busy airports and non-busy airports or congested and uncongested airports, upon which distinction some of your recommendations rest. Some people might argue that that distinction is a little bit too black and white, that even what may appear to be a non-busy airport in general can be busy at certain times or it can be congested at certain times and it is a question of what is congested. We heard from the owners of Townsville Airport, for example, which generally one would regard as not being a congested airport, but nevertheless it was congested at certain times and with respect to certain facilities and particularly aprons et cetera.

So this sharp distinction between busy and non-busy or congested and non-congested doesn't really give recognition to different times of day, nor does it give recognition to different facilities, it appears to concentrate on the runway. But there are, of course, essentially linked, other aspects of an airport for which there is no substitution such as a taxiway. It also doesn't give any recognition to a transition from what might be called an uncongested airport to a congested airport and so if one is in fact talking about different types of regulation for a congested airport on one hand and uncongested on the other, one isn't addressing how one in fact moves, if that is occurring over time, from one to the other; nor does it give attention to what might be an uncongested airport at the moment, might be anticipated to be congested in the future and those who are making decisions today will in fact be making decisions with respect to that future pricing or regulation that might come into being when it becomes congested.

There are in fact a number of points there: one is congested, what; when; transition from one to the other and the fact that those who are making decisions in one situation will be looking ahead to when it comes into the other situation.

PROF FORSYTH: There are a number of issues there. You're perfectly right, you can't just put things into a definitely busy and congested airport as compared to a completely non-busy airport. It's really a matter of degree and it also is a question of how easy it is to solve the congestion problems. If, for example, a terminal is busy and congested, as long as the land and so forth is available it may be relatively straightforward to extend that terminal. So there can be short-term periods of congestion, busyness in particular parts of an airport system. Why I concentrate on runways is because they are the most difficult things to add capacity to. If you're thinking of a busy airport and the quintessential one is London at Heathrow, you can't just add runways to create more slots, it's just very unlikely that it will ever be possible. Indeed, even at Gatwick it may be not feasible to build a second runway.

Runways are the very difficult items of capacity to extend. The way that you do it usually is that you have to build a new airport and hence we have discussion of building a new airport for Sydney or greater use of Bankstown or something else. In other words, shifting to a new, completely new, site for some of the business. You might even argue that Sydney isn't a busy airport. Certainly busy at the peak, but not during the whole of the day. However, at least with Sydney it's now getting to the stage where additional capacity through building new facilities elsewhere is now an issue and so I think that's really a criterion of a busy airport. Why I make the distinction between busy and non-busy is that the sorts of issues that you've got to resolve are different. If you talk about Melbourne Airport, maybe there are some periods where it's a bit busy, but that's relatively minor compared to the sorts of allocation problems that you're facing at Sydney.

PROF SNAPE: You say because Sydney is congested and Melbourne isn't that the pricing principles for Sydney should be different from those of Melbourne. But if one says that Melbourne is in fact congested at certain times of day, doesn't that lead

one then to say that the pricing principles which you are recommending for Sydney should be applied to Melbourne for those times of day?

PROF FORSYTH: Yes, indeed, I mean, if that were a real problem. For example, if there was congestion at particular times then indeed the slot system might be one that might be appropriate and indeed, also the pricing at the peak should reflect that.

PROF SNAPE: How does one then move from a weight based one which was in fact the standard system and at Melbourne, how does one move then to a congestion type of pricing mechanism?

PROF FORSYTH: It's inherently very difficult if you're going to have a price regulatory system. It's inherently very difficult because the signals that you give in your price cap induce the regulated firm to do certain things with respect to prices and you can't really combine giving two different signals and that is indeed a problem of regulation.

PROF SNAPE: Well, it's an additional problem, as soon as one moves away from this rigid distinction between busy and non-busy airports which is what you've got - - -

PROF FORSYTH: Right. It may well be that Melbourne is a bit busy at certain times of the day. But overall I think you can regard it as a non-busy airport, particularly as they're saying that they won't need - sorry, that they will not be touching capacity for a long time to come. So that it's again a matter of balance. You could regulate Melbourne as an unbusy airport, you regulate Sydney as a busy airport because of the emphasis of the problem. Neither is perfect, but then that's the problem with regulation, you have to design your regulation to resolve a particular problem and it can't resolve two problems at once. So you just have to make a call on saying, "Look, at some stage or other a particular airport may be busy and that's essentially an airport where capacity constraints are really beginning to bite and where the efficiency aspects of those capacity constraints really require addressing."

PROF SNAPE: When you say that the airlines have no countervailing power, can one not think - I mean, they're purchasing many things from an airport and it may be that the airport needs the airlines, of course, and that the airlines need the airport. But are there not other aspects of the deal between an airport and an airline in which the airlines can exert monopoly power? This has certainly has been put to us by some of the airport participants that in dealing with airlines, as you say, very, very big, that they can negotiate with respect to their maintenance facilities, they can take them somewhere else, they can negotiate with the offices they have. There are a number of things that an airline can have on an airport or may not have on an airport and we're having it put fairly strongly to us by a number of airports that in fact with respect to the drawing in - in these - if you like to call them - ancillary facilities as to where they're going to be located and they in fact get tied into a package and once you've got that package there that it is argued by the airports that in fact the airlines have a great deal of countervailing power.

PROF FORSYTH: I'd certainly agree that they have some countervailing power in those services which are potentially contestable.

PROF SNAPE: Yes, but then tie it into a package.

PROF FORSYTH: I think you're arguing that the airlines want to break that package, aren't you, and switch away from let's say the airports' provision of certain services to others.

PROF SNAPE: Yes.

PROF FORSYTH: Well, certainly they could try that but they still can't - - -

PROF SNAPE: The airports are telling us that they in fact do that.

PROF FORSYTH: Yes, indeed but that's not where the airports are making a lot of money, these after all are the contestable services almost by definition. These are the ones where the airport can supply the service or some other groups could, and so they're likely to be the services for which the profit margins are lowest within the airport. Therefore, whilst the airport would be annoyed to lose some business in some particular area and indeed in the short run it may incur losses because of that, in the long term it's not too serious. After all, they still control the runway and the airline has to use the runway at the price that the airport chooses to charge.

DR BYRON: Could I just elaborate on that a little bit more. You seem to be portraying it in the sort of all or nothing - you know, Qantas pulls out of Sydney. But aren't there a lot of relatively small adjustments that could be made at the margin in terms of the number of flights per day, the size of aircraft, alternative routes?

PROF FORSYTH: Certainly, but the trouble is if they're going to be adjustments at the margin they're not really going to bite very strongly. So, I mean, what we're really talking about is the ability of an airline or a group of airlines to really challenge an airport's pricing policy. Sure, they can shift a few flights out or they can do this or that at the margin but that's really not going to make a big difference.

PROF SNAPE: I wonder in the context of Canberra Airport when Impulse was coming to deal with Canberra Airport, there were newspaper reports of substantial threats made by airlines to Canberra at that time and it would have seemed that Canberra Airport took those very seriously.

PROF FORSYTH: Suppose Qantas refuses to use Canberra, I mean, that would be the absolute gift to Ansett, to Impulse and whoever. I mean, really, what kind of a threat is that. It's the biggest joke you can imagine.

PROF SNAPE: Correct me if I'm wrong but Canberra Airport did not treat it as a joke.

PROF FORSYTH: Well, naturally they would have to say that they're treating that seriously. Do you know whether Canberra Airport did what it did because it was so afraid of losing, say, Qantas, and Ansett and the other airlines not making up the services, which they certainly would, or was it because they thought twice about this proposal? After all, when you think about it, building some additional facilities in order to accommodate another airline when you've already got enough capacity, you'd need to have a lot of extra business coming from that to make that worthwhile. My guess is that Canberra Airport assessed the profitability of that proposal and decided it wasn't going to go ahead with it. Offhand I wouldn't have expected it to be worthwhile to be spending a lot of money on such a proposal. I suspect it was just their interest in achieving a profit which made them act as they did, though of course it may have looked as if airline threats may have induced them to do that.

PROF SNAPE: When you speak about an airline could be a very profitable airline - - -

DR BYRON: Airport.

PROF SNAPE: Airport, I'm sorry. This is a distinction that I'd better keep clear in my mind - could be a very profitable airport and that therefore one sees the future regulation designed around distributional matters, as you were saying. Could you not argue that the privatised airports, in fact in the sale price, that that has been taken into account already, that they're likely to be very profitable?

PROF FORSYTH: The sale price reflects the regulation or otherwise that is expected to be put into place. So if we promise that a particular airport was not to be regulated at all then people would expect it to be able to earn very high profits and they would factor that into the sale price. As it turns out, in all privatisations that I've known of, there's either been an explicit regulatory arrangement with clear cut guidelines as to what prices will be allowed, or an implicit arrangement and that's conditioned the price at which the airport has sold at.

PROF SNAPE: If you see it as distributional, is this distributional essentially between the airport and the airline?

PROF FORSYTH: It can be between the airport and the airline, or it can be between the airport and the passengers. If it's a non-busy airport, it's essentially between the airport and the passengers because in a competitive airline market, higher airport charges will be added to airfares. Where you've got a busy airport where the capacity is restricted and the capacity is in short supply, then additional airport charges will go, at least to some extent, to the airline. So it's a question of shifting between airline and airport in that context, such as Sydney.

DR BYRON: Just coming back to that previous point, if a government had said at a time of privatisation that you should expect to only ever achieve normal returns of

capital, I imagine that the bid prices would be certainly a lot lower than they actually were. Would you agree with that?

PROF FORSYTH: Whatever the profit expectations are will determine the bid price.

DR BYRON: They were actually bidding the capitalised value of a stream of anticipated future revenues.

PROF FORSYTH: Exactly. Yes, and that's critical in the case of Sydney which really needs to be resolved before it's privatised. Exactly what form of regulation and at what level will determine what Sydney is worth.

DR BYRON: I guess what's troubling me is that a lot of the airports, both regulated and unregulated, don't seem to correspond in practice with what our sort of textbook models of monopoly behaviour would predict. Then I find myself arguing, are there different sorts of models of behaviour of the airport owner that might better coincide with what we seem to observe in practice. For example, rather than focusing on the very inelastic demand of airlines for airport services, I wonder if perhaps in the case of an airport that was uncongested, had lots of excess capacity, declining unit costs, might the airport owner decide to pursue higher profits by increasing volumes, throughput, shifting the demand curve, if you like, rather than just continually forcing up prices until we get to a point that only one aircraft from Brunei arrives once a month because you've got an extremely high price and a very low quantity. The airports seem to be behaving as though they're pursuing profit maximisation by increasing throughput at current prices rather than increasing prices.

PROF FORSYTH: But that's presumably under regulation, price cap regulation. So under price cap regulation, they can't increase their prices basically. So they can increase their profits by either going for complementary services which they can - - -

DR BYRON: Outside the cap.

PROF FORSYTH: Yes. So hence we see the fuel levy which comes in immediately after privatisation. We see the taxi levies being discussed and attempted implementation of taxi levies and so on. Sure, you can do that but you also go to increase - certainly you'd try to increase the usage of the airport to the extent that you can, yes.

DR BYRON: I guess we don't have very many examples in Australia of large RPT airports that are unregulated. The only ones I can think of at the moment are Cairns, Mount Isa perhaps. Perhaps the owners of Avalon, for example, might see that as a potential substitute to Melbourne. Are there any examples from elsewhere in the world of private airport owners which appear to have a monopoly position but choose to pursue growth in volume rather than just increasing prices?

PROF FORSYTH: The problem is they're all regulated, either formally or informally. For example, BAA theoretically could do what it likes at Glasgow or Edinburgh airports. But of course they know very well that their other airports are price regulated. They know that Manchester is regulated and that if they got out of line that would probably be an immediate signal for regulation. So they're essentially going to behave as though they were regulated, something like Manchester is regulated.

PROF SNAPE: But isn't that the problem in the sense of when one is trying to speak about unregulated airports in Australia, for example, or if it were to be unregulated that there's no really no such counterfactual; that there would always be at least the Trade Practices Act in the background and there would always be, because of the political sensitivity of it, the threat of regulation. As you said, in New Zealand it's not a good counter example because there was always a threat of reregulation. Isn't this really the fact of the matter that there will always be a threat of regulation?

PROF FORSYTH: I think in practical terms there probably is, yes. So it's really a matter of saying - well, you could try to lock a situation into zero regulation by committing - by, let's say, excluding airports from potential litigation and so on if you really wanted to have zero regulation. That's of course not what the New Zealanders have done. They have said, "There are always these loopholes." Then it really becomes a matter of discussing the relative merits of having either an implicit system or an explicit system. So really what you're trying to do is work out whether you think perhaps the Trade Practices Act and the Federal Court might be better regulators than the ACCC, for example.

PROF SNAPE: Well, the threat of them.

PROF FORSYTH: The threat of them, yes.

PROF SNAPE: But with the ACCC, if you're relying on the Trade Practices Act you of course have still got the ACCC in there.

PROF FORSYTH: Yes, but I mean essentially it would perhaps go the Federal Court or wherever - maybe the High Court even. So really what your choice would be, would be a threat of an implicit system. Remember an implicit system of regulation has the same disincentive properties, so far as efficiency is concerned, as an explicit one.

PROF SNAPE: It may.

PROF FORSYTH: If the signals are that if an airport is highly profitable and that will trigger some form of intervention then that becomes profit regulation. I'm saying it's identical. There is always a risk, there's a possibility that you may get a high profit and it may not provoke regulation. But if there's a possibility or a probability that, say, high profitability will provoke regulation, then it's having similar economic

effects to regulation. Now, another issue that you've got to resolve is what would be the signals? Would high prices be the signals or would high profitability be the signals? What if an airport is highly efficient and achieves high profitability, would that provoke regulation? There's a problem there.

DR BYRON: I can't think of too many other industry sectors or firms where the government has a sort of implicit position that any organisation that generates high profits will therefore be targeted for price control. The way the economy works is that high profits are generally considered to be a good thing the company should aim for rather than try to avoid.

PROF FORSYTH: That's of course true in most of the rest of industry which doesn't have natural monopoly or locational monopoly characteristics. Most of the natural monopolies we've got we have already regulated, so the group that you're talking about, there aren't very many examples of.

DR BYRON: But that's why it's very important to be able to tell the difference between an organisation that's earning high profits because it's very well run and an organisation that is not particularly well run but happens to enjoy and exercise a great deal of monopoly.

PROF FORSYTH: That's certainly true, yes. But of course what we've done in the way that we regulate things is that most of those industries where there is a degree of natural monopoly or market power that could be exercised, we have explicitly regulated them in Australia. Most of the rest are subject to a reasonable degree of competition. You may well be able to find some examples that fall in between those two schools but there's not an awful lot of companies in that position.

PROF SNAPE: You've been looking at airports for a long time and you've been looking at them over a large part of the world also, but in Australia in the transition from legislative monopolies, if you like, under the FAC - very highly regulated, if you like, because they were all run together et cetera and the current system with privatisation, would you judge that - first of all, are they more efficient now than they used to be and is there more abuse of monopoly power now than there used to be, if any, in both circumstances of course?

PROF FORSYTH: Right. In terms of efficiency measurements I haven't seen any recent measures. I think one thing we have to remember is that the airports were set X factors that implied that they were able to get some efficiency improvements and certainly in some of them they seemed to be quite profitable within the price cap which is implying that they have been able to get some efficiency improvements over the last two or three years.

PROF SNAPE: Which is quite profitable?

PROF FORSYTH: Well, moderately profitable.

PROF SNAPE: That's not the story we're getting from the airports.

PROF FORSYTH: I know Brisbane is saying lots of things and so forth. Indeed, one can see why - one of the factors that enters in is the fact that the price cap doesn't really make allowance for demand swings which other proposed systems do or other systems in operation do.

PROF SNAPE: But just on which are profitable airports, I mean, if one looks at the figures that the airports are giving us, none of them are profitable.

PROF FORSYTH: I don't want to enter that debate.

PROF SNAPE: But you have, in the sense you just said that a number of them are profitable.

PROF FORSYTH: Yes, I'd regard them as profitable. I'm not saying that airports are necessarily earning very high profits in every year, particularly when there's a downturn in tourism which affects airports such as Brisbane and so forth. I'm not saying that it's highly profitable right at the moment or the last couple of years but what you did ask me was whether airports are achieving efficiencies.

PROF SNAPE: Efficiencies and the abuse of monopoly power, if any.

PROF FORSYTH: As we know they are price capped.

PROF SNAPE: I was looking at the Australian airports over the time, both before and after privatisation, whether there had been any abuse of monopoly power over that whole period or any change in that over the period - if any.

PROF FORSYTH: Right. What we have in place is a system of price caps which were based on existing prices, including an X factor which varied from airport to airport which implied that there would be some productivity gains over the next few years of 3, 4, 5 per cent roughly. So effectively if you regard there as being abuse of monopoly power now then presumably there was in the past because they're roughly the same prices.

PROF SNAPE: Price is only one dimension of that. You've spoken about the quality of the service and so on as well. Also people speak about cost padding and gold plating and all of that sort of thing.

PROF FORSYTH: Exactly. So if there was gold plating and cost padding before then it hasn't been eliminated, but maybe it is being.

PROF SNAPE: It's a question of whether gold plating was put in.

PROF FORSYTH: It may well have been.

PROF SNAPE: So you wouldn't see any difference of behaviour.

PROF FORSYTH: We've only seen a couple of years - two or three years - of privatisation and it may take time if there is gold plating for that gold plating to be removed. Clearly if there was a lot of cost padding and it was being removed then we would expect to see substantial increases in profitability. I mean, I don't know that over the last three years you've seen a big change. Well, one of the reasons is that prices have been capped, also quality is being monitored. There have been some examples of relatively minor uses of market power, such as fuel levies and taxi levies and those sorts of things. In the scheme of things they're not big deals. So I mean the extent of the use of market power hasn't changed very much in the last few years, as indeed you would not expect it to do in a short period since privatisation.

I think what you'd really need to do to see whether there was a lot of cost padding and so forth is to explore productivity of airports in 10 years' time and compare that to the pre-privatisation situation.

PROF SNAPE: Could I then tie that up with the locational rents that you were talking about and as you said, you can distinguish between locational rents and exercise of monopoly power or, if you like, monopoly rents according to whether there's created scarcity. Is there any evidence in any of these activities that the airlines are undertaking, the airports are undertaking - airports, I mean - that there has been created scarcity?

PROF FORSYTH: What I'm doing is I'm suggesting to you that you can check this out. I haven't been able to check it out but what I'm saying is, one shouldn't accept these arguments one way or the other uncritically but there are ways of testing this. If there are locational rents then that's because of an inherent scarcity of land or space. Of course, certainly there are locational rents in airports: the shop that's closest to the gate is a more attractive location than the shop that's way down the end of the terminal. So there are different locational rents there. The carpark that's closest to the gate is certainly more attractive than the carpark that you have to walk a long way to. There are ways of getting a feel for things. A locational rent is determined by what the market was prepared to pay. A shop in Collins Street has to pay a rent which is determined by the market.

The landlord in Collins Street can get a price which is determined by the market. The landlord doesn't simply choose the price that it will charge by reference to some benchmark, such as the price of land in Pitt Street in Sydney; whether that definitely proves - it may be that they were underpricing all the time anyway. But these sorts of aspects are ways of testing whether there are genuine locational rents or the extent to which there is use of genuine locational rents and the extent to which there's been a bit of piggy-backing onto other market power.

PROF SNAPE: Again I was asking really of your experience of airports whether you have perceived this - - -

PROF FORSYTH: Sometimes when you go to an airport which is out in the country, where a cow is happily grazing close by and you pay a fortune for parking, you wonder whether that's entirely locational rent.

PROF SNAPE: I'm not sure where that takes us into regulation actually.

PROF FORSYTH: That's a good question. Just because there are some non-locational rents being earned doesn't mean to say that everyone has to rush in and regulate them. Indeed I think there is a problem with what's been suggested for Sydney Airport, namely that a range of services be declared, as it were, or notified and any above normal profit be creamed off back into reducing aeronautical charges. First of all, whether that's a real problem or not, a bit of, market power being used in ancillary services, and then the real problem I think is whether the regulation, particularly as proposed in the ACCC's February document, is going to make things worse because it's pure cost based regulation effectively.

PROF SNAPE: Yes, we have had a number of comments on that particular proposal, as you might expect, and not just from Sydney Airport either. Could I just ask you for an interpretation of a word actually on page 24. It's a word that you used again in your introduction today when you said - you were referring to charges and you say:

A Ramsey price structure is precisely what is not wanted -

this is at a congested airport -

rather uniform prices for all movements.

What did you mean by "uniform"?

PROF FORSYTH: As far as it's possible the same price for every movement. So if what you're trying to do is ration scarce runway capacity, everyone pays the same price. That of course does not apply to terminals and other things.

PROF SNAPE: But you meant the same price at the same time of day.

PROF FORSYTH: Yes. At the same time of day it may be different at different times of the day.

PROF SNAPE: That was not at all clear from the written or from what you - - -

PROF FORSYTH: I see. What I was doing, I was characterising it as against a weight-based charge.

PROF SNAPE: Yes, but just reading it, it could have been read as a comparison between differentiated charges and the uniform charge. What you're saying is a

different system of differentiated charges is what you are saying, so that everyone would pay the same at the same time of day.

PROF FORSYTH: Yes.

PROF SNAPE: Although presumably if a small plane takes up more airspace, as it tends to do - - -

PROF FORSYTH: Arguably it could be - - -

PROF SNAPE: - - - because they come in slower and they have to be let more - it should in fact perhaps go inversely to weight at any point of time.

PROF FORSYTH: Well, what you would then do is have a charge based on runway occupancy.

PROF SNAPE: So that's what you meant in that.

PROF FORSYTH: Yes.

PROF SNAPE: Thanks for that elaboration.

DR BYRON: Could I just elaborate on - I was just wondering on that point whether you had given any thought to a two-part pricing system with a fee for the use of the airspace and a fee for the use of the ground, the runway and the ground charges could still be weight based but the fee for the use of the airspace overhead the airport is where you wouldn't actually want the uniform charging.

PROF FORSYTH: When you say the ground charges being for the use of the runway or for the use of other facilities?

DR BYRON: Basically the runway and taxiways.

PROF FORSYTH: The trouble is if the runway is the constraint then that is what you want to have the uniform price for.

PROF SNAPE: I think what it would be here - I think it was floated quickly in our issues paper, would be to say that you buy for a fixed charge the right to a certain time for a year or five years or whatever it is, okay, and that's the opportunity cost of that airspace. You then say, that actually landing you're going to incur an additional marginal cost which is the wear and tear on the landing and the use of other facilities for which there is a separable marginal cost and opportunity cost. So what one is saying is then a fixed cost to get you there, whether you use it or not. If you do use it you incur an additional marginal cost which is just like your telephone.

PROF FORSYTH: Yes. I have no objections to that. It's most likely that that marginal cost will be very small relative to the first one and so it may not be worth bothering about and that's been the usual story with airports, but as with lots of stories that often get said, we should check them. It may be that it's more significant than we think and there might be a case for doing it that way but it's certainly a possibility.

PROF SNAPE: That would fit in, in fact, with your general principle.

PROF FORSYTH: Yes.

PROF SNAPE: Subject to the caveat you put on it, it's the cost of the regulation et cetera if you are regulating or if you're not regulating, the cost of implementing it that way.

PROF FORSYTH: Of course this is part of your problem with regulation. Regulation - your price cap - must be relatively simple. It can be a little bit more complicated than we've got at the moment. Hamburg actually has a more complicated formula which has some advantages but it's got to be relatively simple. So achieving precise structures in pricing can be fairly difficult within a price regulatory environment.

PROF SNAPE: You might or might not be interested in the draft report on telecoms which was released last week which in fact had a draft recommendation with respect to the regulation that the regulation should in fact permit multi-part pricing of the sort that we're just talking about rather than to be structured so that it couldn't be allowed.

PROF FORSYTH: Yes. I think that's something that has to be taken into account in the design of the regulation. The problem though always is to get regulatory structures which give incentives to do various things. One of the good things about the current system as has been recognised in the literature for the last 20 years is that there is an incentive in a fairly simple price cap to have something like a weight based charge and that's consistent and, as it were, encouraged by the way in which the price cap is implemented; that's a good thing. Perhaps that's come about partly by accident, partly by design but when you start trying to finesse the price structure rather more, it becomes very difficult to have both the simple regulatory structure and achieve those rather precise objectives.

DR BYRON: On your concerns, when you were wrapping up your oral presentation this morning about investment criteria for new investments, did I understand you correctly in saying that we need to think somewhat differently about marginal adjustments to capacity as opposed to a whole new airport?

PROF FORSYTH: I guess in principle you don't have to but where there's a difference is this: if you're talking about a marginal adjustment to capacity - and I don't really see that if you're going to increase capacity there should be any change

necessarily in price; if you're going to improve the quality by extending the runway at Adelaide or something else like that, a benefit for the airlines, that's fine that that should be reflected in price, subject to the evaluation of that investment and the willingness to pay and so forth. If you're talking about an investment in additional capacity, let's say, at Adelaide Airport, wherever, it can be done within the existing price regulatory arrangements and so it may not provide any major problems. Where you do get problems is how, you give incentives to either another company or Sydney Airport to invest in Badgerys Creek or Bankstown, knowing that Badgerys Creek is a lot further away, may have very high initial development costs and so on, and how you balance the price regulatory structures of the two airports is going to be quite a complicated business.

DR BYRON: Given the locational disadvantage of Badgerys Creek and the difference between the cost of constructing a greenfields, as opposed to what we have at Kingsford Smith, one would assume that the landing fees at a hypothetical Badgerys would have to be higher to break even but lower to be commercially acceptable to the airlines.

PROF FORSYTH: That's part of your problem and I think you can resolve it but I don't know if it has been resolved or I don't know that the way in which it is to be resolved has been very clearly enunciated as yet. Of course, a lot of the burden will be assumed by the slot allocation mechanism. That's effectively what happens at London where you have a slot allocation mechanism. The shadow price of slots or the value of slots goes up over time and that induces airlines to use less preferred airports, such as Stansted.

DR BYRON: Are slots tradable in the UK?

PROF FORSYTH: Sort of; sort of not. Basically not freely tradeable.

PROF SNAPE: Not on the top of the table but they are under the table.

PROF FORSYTH: Yes.

DR BYRON: Coming back to the sort of marginal capacity additions which I thought you were opposed to in uncongested airports, if the capacity addition is something like new aprons to accommodate a new entrant or more overnight parking space or something at Townsville or Canberra, if the regulator is basically saying to the airport operator, "We will allow you charges that enable you to make X per cent return on that investment or 8 per cent or something," and the airport operator thinks, "Well, if I put another storey on my carpark I could make 15 per cent or whatever," isn't there likely to be a continuing divergence of investment towards the unregulated assets and away from the regulated assets, that the airport owner will then have an incentive to always invest in the unregulated non-aero than in the regulated aero?

PROF FORSYTH: Right. That's quite an important issue. I mean, it depends on whether you regard that, say carparking, as piggy-backing onto market power. If you

think that, then that is a concern because you would have - well, I'm not so sure that it's that much of a concern because you don't want to add too much - if you think there's market power piggy-backing onto the aeronautical monopoly then you don't want to invest too much because you'll provide too much capacity and drop the price. On the other hand if you don't think there's very much market power it's a fairly contestable operation, then if you can get 15 per cent it should be invested in because it sounds like there's demand for carparking there and that doesn't stop you from investing in aprons or wherever. You can borrow more and invest in aprons if that's worthwhile as well, but I don't know that it's either one or the other.

What I'm suggesting in there is that I'm not so much opposed to investment in capacity except that the normal arrangements with the regulated industry are that you don't get a price increase if you simply increase capacity to meet further demand. Telstra doesn't get a price increase if demand increases. So there seems to be a peculiarity in the way that the investment rules work. To be sure, if what the airport is doing is providing additional facilities to improve the quality - and assuming that's what the airlines want - then that makes sense to allow them a price increase. But simply as the airport grows, every time it puts in a bit more capacity to be able to put prices up, I mean, that's suggesting that the bigger it gets the higher the price should be, that seems to go against the general feeling that at least at individual sites for airports there is, if anything, scale economies.

Where it also ties in - and this may be some of the problem - is that the price at which the airport was initially privatised at and regulated at may have been too low and below, as it were, replacement cost or the cost of adding to additional capacity, then you do have some problems and you do have to make specific allowance for perhaps higher prices for additional capacity if essentially you underprice the existing capacity.

PROF SNAPE: I guess one of the sentences that you just said pinpointed another problem under the regulation, when you said, "if in fact the airlines want it", and of course that tends to suggest there's going to be a homogeneous product supplied to the airlines, and we see quite clearly from Adelaide that that's not what the airlines want.

PROF FORSYTH: Exactly. If there is a situation where the users want it and the airport is willing to provide for it, there usually isn't much of a problem. Of course where problems arise is where some users want it, some others don't want it. That can be a real problem and realistically that's where the regulator does have to make an evaluation to find out whether on balance some particular proposal is worthwhile.

PROF SNAPE: But there's another problem with regulation, as you were pointing out.

PROF FORSYTH: Indeed, yes, and that shows the difficulty of achieving a light-handed regulation. I mean, you recognise there are problems with investment

that when you start addressing them, you start becoming fairly detailed in terms of your regulation.

PROF SNAPE: In the three draft reports that the Commission released last week, there was also one on prices surveillance which Neil is very involved in. Also a third one was on Part IIIA. The recommendations which overlapped in this case between those two was in fact a recommendation that some of the price monitoring provisions of the current Price Surveillance Act could be transferred into the Trade Practices Act and the price surveillance, or rather I should say price monitoring, could be an alternative, a sort of a halfway house, with respect to declaration in fact. So a greater focus in these two reports was put on price monitoring rather than formal regulation. Now, have you contemplated price monitoring as an option for airports?

PROF FORSYTH: Can I ask you what you regard as the critical difference between the two because there certainly seems to be a degree of disagreement as to what that difference is?

PROF SNAPE: I'll bounce that to Neil.

DR BYRON: The difference that I make is that price control, price regulation, is an attempt to actually influence or set parameters, variables, prices, fees, profits or something like that; monitoring I see as simply observing, reporting, collating, but not attempting to control, those key managerial variables, so that a firm that was being monitored would be required to make certain information available to the regulator or to the public, but nobody attempts to interfere with what they actually do.

PROF FORSYTH: Right.

PROF SNAPE: Except as you would immediately point out, as a sort of a shadow.

PROF FORSYTH: Well, I mean, the next question is what happens if the price-monitored firm - is it under any constraints? What will happen if various things happen? Is it completely free to charge whatever it likes and no-one will step in or what are the rules of the game?

DR BYRON: I guess there's an implied threat as in Scotland and New Zealand, in your cases. The regulator, in the event of being uncertain whether the problem was really serious enough that it warranted the full boots and all heavy-handed regulation but didn't want to let them off totally scot-free, so to speak, would as an intermediate point say, "Well, we will monitor some features of your activities for the next three years but if at any time it becomes clear from that monitoring that it really is a very serious problem then the regulator or the government will take the appropriate action. It's what you do in the meantime while waiting for clarification, whether it's a serious problem or a non-problem.

PROF FORSYTH: I've never quite worked out why you'd bother monitoring. I mean, I can look up prices on the Web if I want to. I can look up the profitability in

the annual report. Is there something that monitoring is providing me with additional information?

DR BYRON: That's something yet to be fleshed out perhaps. Perhaps the monitoring would provide the regulator with some information that is not currently published.

PROF FORSYTH: Right. Well, there might be some case for getting additional information if that's regarded as important. It all depends upon what the implicit threat is and I don't know that one can regard an implicit threat to do something unspecified, if certain triggers unspecified are met. I mean, is it a profits trigger, is it a price trigger and so forth.

PROF SNAPE: I think maybe another way to look at it is to think about an industry which is being declared or under Part IIIA or similar in the past or which has been regulated and which one is thinking, "Well, should this be regulated?" and rather than take the regulation off completely it's a sort of halfway house to see how things are going to work.

PROF FORSYTH: Yes, but also adds to uncertainty because you don't know what behaviour will trigger regulation and what won't. You don't really know what price you can charge.

PROF SNAPE: Yes, I take the point. My question was, have you really contemplated it?

PROF FORSYTH: I haven't because I've never been persuaded of the merits of price surveillance or monitoring, except perhaps in providing a bit more information but I've not been particularly persuaded by price monitoring.

DR BYRON: I think it's particularly in that information sense that we're talking where the regulator or the NCC, in the case of a IIIA declaration, simply feels that there is not quite enough information to decide whether it's full regulation or none whatsoever.

PROF SNAPE: Okay. I've got a couple more - I'm not sure how Neil is going with his list - but I think that on CPI-X regulation when it was first introduced or first proposed in Britain - I think it was first proposed by Stephen Littlechild and others back in that time - it was proposed as an interim measure in recognition that it would converge over time to a rate of return regulation in the way that it was applied. Would you agree then with what a number of people have said is that CPI-X will inevitably converge to a rate of return regulation? I think you've more or less said that already, but over time in the way that it will be applied, the way the X will be set over time.

PROF FORSYTH: I think I'd express it slightly differently. I think when CPI-X regulation was proposed it was seen as an interim approach in telecommunications.

Particularly there was a belief that telecommunications would be a lot more competitive in most of the areas than it is now. I think they thought by now everything would be competitive and so you wouldn't need any form of regulation. However, it was proposed as a form of incentive compatible regulation and to that extent it started off in that way. I think that very soon essentially when the price cap gets revised it soon became a lot more cost based. So even though I wouldn't say it will become - first of all, I think CPI-X is a format, and a format for regulation could be very incentive based, based on yardsticks, benchmarks and so forth with very little attention to the firm's cost, or it could be very cost based. It's just a question of how you implement it.

Meanwhile, rate of return is another format which tends to be very cost based - almost inevitably is pretty cost based. You can have very long regulatory periods so it can become less cost based. But nonetheless that is a format which is a bit different from CPI-X regulation but in terms of their real content they can become very similar. We've seen that move towards the CPI-X regulation being implemented in a way that the content is not that different from rate of return regulation. There is still some difference: the period of setting prices, plus the possibility of efficiency carry-overs means that there is a difference but certainly they're becoming rather similar and I think there are reasons why regulators are very unwilling to move to a fairly strong benchmark approach. Indeed, you mentioned Stephen Littlechild. He was the first regulator to be, as it were, forced to essentially give up the desirable properties of CPI-X regulation, relying on benchmarks. Essentially when the electricity industry became so profitable he was forced by political forces to review and revise the price cap. So, I mean, that was a classic example of political forces pushing regulators to move to more of a cost base.

DR BYRON: A number of the smaller airports have pointed out to us that the fees that airlines have to pay to Airservices Australia for air navigation charges, terminal navigation, whatever, are actually a lot higher than what the airport is paid. I was just wondering if you've looked at that at all. I mean, we're not inquiring into Airservices Australia's charges but it would seem to me that those charges have similar properties to landing fees in a sense of, they don't necessarily determine routes and capacity and frequency and so on, but it might greatly influence - if the airline is buying a package of services at each end, some of which are provided by the airport and some are provided by Air Services Australia, reducing the charges of one of those two, unilaterally may not make a terribly big difference to the behaviour of the airline in terms of frequency and so on, particularly if it's the smaller of the two.

PROF FORSYTH: It may not make a big difference, no, but that's no reason why a charge shouldn't be reduced, if there's a case for it to be reduced. I mean, to turn that on its head, if you say something like that you might say, "It doesn't really matter, you can charge whatever you like because it's only a little bit of the total cost."

DR BYRON: The importance of being unimportant.

PROF FORSYTH: Yes. So, I mean, you can't necessarily say that.

DR BYRON: The downside of that inelasticity of demand for airport services would also imply to me that an airport that was actually trying to chase tails, as they say, isn't likely to attract anybody, simply by offering a 50 per cent discount on landing fees. Even a 100 per cent discount on landing fees is not going to induce an airline to operate from A to B if the airline isn't convinced that's there's the passenger volume and the yields and so on to make it worthwhile.

PROF FORSYTH: Most certainly. Just because, let's say, Alice Springs is offering discounts, you don't re-route your Melbourne to Sydney flights to Alice Springs in order to take advantage of lower prices at Alice Springs than at Melbourne. Yes, there is some degree of competition between airports, for example, in getting a new start-up airline to come to you and so forth. Of course that competition is stronger in Europe because airports are a lot closer to one another. I think the Easy Jet example is a nice one that - Luton offered Easy Jet a low price to come to Luton. I think they had a three-year contract or something like that. Immediately after that contract ended they put the prices up very substantially. So certainly they're prepared to offer airport charge holidays for a while to get business but those holidays are limited in time. Of course that's only for a limited amount, for the sort of - well, there's not that much business that the Australian airports are competing between each other for.

PROF SNAPE: If Sydney put up its prices - this is hypothetical, of course - and leave the ring fence on one side, so we're talking about outside the ring fence at Sydney. If they put up their prices up to the marginal opportunity cost of land, they really put their prices up a huge amount which would - - -

PROF FORSYTH: The market clearing price, are you suggesting?

PROF SNAPE: Yes, to a market clearing price for the slots, and so that was an enormous hike in their prices. Would that indicate that they had market power?

PROF FORSYTH: That of itself isn't necessarily an indication of market power.

PROF SNAPE: So the fact that Sydney have put prices up - proposed to put prices up significantly - is not an indication that they have market power?

PROF FORSYTH: Not necessarily, no. It could be that something is underpriced and then you raise it closer to the market clearing price and that neither says that there is or isn't market power involved. One thing, however, is that the response may tell us whether there's much countervailing power in the case of the airlines. If there's so much countervailing power in the case of airlines, why do they accept it? I mean, they just tell Sydney Airport to lower its charges again, if it's so great.

PROF SNAPE: In that case it is just a redistribution of rent - - -

PROF FORSYTH: It is just a redistribution of rent case there, yes.

PROF SNAPE: And in that case it's simply between the airlines and the airport.

PROF FORSYTH: Yes, indeed.

PROF SNAPE: Because the passengers will be charged the price - you don't get discounts into Sydney very easily.

PROF FORSYTH: It's not quite so simple because if - are we supposing that the price structure changes as well?

PROF SNAPE: I'm talking about the price structure on the yield management of the planes, within the planes.

PROF FORSYTH: Right. If Sydney wanted to charge a price which efficiently allocated its capacity, it would not necessarily achieve more revenue if it included a change in price structure. The current price structure is the quasi-Ramsey structure, designed to extract revenue, as it were. If it moved to a uniform charge - - -

PROF SNAPE: In the sense that you were trying to - - -

PROF FORSYTH: Yes, in the sense that I've mentioned - may end up with less money, less revenue - that's possible - because it will be dropping the price. I mean, it will be charging a lot more for some users and rather less for others and on balance may end up with less.

PROF SNAPE: I'm not quite sure I follow that one, because if it is congested, if it is a congested airport, and if it is able to be a perfectly discriminating monopolist - - -

PROF FORSYTH: Sorry, I was assuming if it doesn't discriminate, it simply says, "Right, we have limited capacity. We are just going to charge a market clearing price and not use our ability to discriminate."

PROF SNAPE: A single price?

PROF FORSYTH: A single price.

PROF SNAPE: Well in that case, yes.

PROF FORSYTH: It could end up with less, and that single price can have implications for the smaller aircraft. For example, they may be priced out and therefore certain routes may become more expensive, the thrust of it is rent sharing between the airport and airlines, but we can't assume that there won't be any impacts on passengers as well.

PROF SNAPE: No, I think probably we won't explore all the injustices of that. But I think it is sometimes given in evidence, rightly or wrongly, that prices do matter in that, as I understand it, Kansai Airport doesn't have any planes smaller than a 747 or equivalent landing there.

PROF FORSYTH: Price structures matter, yes. Certainly if they wanted to get small planes in they could have a price structure that preserves the price level but nonetheless has low prices for small planes. Indeed, I'd be a bit concerned that they haven't structured their prices very sensibly if that's the case, because if you can get a few extras in, even at the lower price, particularly when you've got heaps of excess capacity, you would have tried to - - -

PROF SNAPE: Not at Kansai.

PROF FORSYTH: Okay.

PROF SNAPE: No, I'm sorry, I meant Narita.

PROF FORSYTH: Narita. Well, that's a busy airport - not Kansai.

PROF SNAPE: No, Narita is what I meant, I'm sorry. You mentioned Kansai earlier in your presentation and it was from that that I picked it up, but Narita is what I meant. I'm not sure if you've looked at some other submissions, but there's a submission from the Motor Trades Association of Australia Superannuation Fund, which is a large investor in a couple of airports, as you would know. That submission appears to say that, if there is to be regulation, it should be of a sort of single till, which strikes one initially as being a bit unusual coming from an airport. But the sort of single till that they are describing there is in fact a till that would cover all the airport's activities but instead of, as at Heathrow, if you like, landing charges going down because of the profitability of the retailing, this in fact would say in a sense that what is contestable is that the retailing could charge what it is able to and that's limited by competition from downtown et cetera but that the landing charges could then go up and that you'd have a single till covering the whole thing - this is my understanding of their submission - that in fact you could charge more for the landing.

PROF FORSYTH: I'm still not - I can't quite get what the thrust of that proposal is.

PROF SNAPE: I understand that the thrust of it is the retailing would not in fact drive the aeronautical charges down. If anything I think you could say that the aeronautical charges could push the retailing charges down.

PROF FORSYTH: Is there some overall cap, though, and is that overall cap to be adjusted upwards?

PROF SNAPE: It would appear so, but you haven't looked at this?

PROF FORSYTH: I haven't looked at that particular submission.

PROF SNAPE: If you're able to sometime and would like to comment on it, we would value a comment.

PROF FORSYTH: It sounds quite interesting, yes.

PROF SNAPE: My understanding may not be correct. We'll ask them later in the week.

PROF FORSYTH: Yes.

PROF SNAPE: It was written by Access Economics in Canberra. I think that's just about got my list. Let me just check. You do say that demand for airport services is highly inelastic. Do you know of any recent empirical work on price elasticities for particular airports? If so, perhaps you could let us know.

PROF FORSYTH: No. I'm aware of various studies that were done a few years back but I haven't seen any recent studies, no.

PROF SNAPE: Good.

PROF FORSYTH: Thank you.

PROF SNAPE: Thank you very much, Peter. That's been a very helpful submission and a very helpful discussion. We had one participant drop out this morning and so that means that we can have a morning tea, and morning tea I believe is available just next door, behind the back wall there. We'll resume at 11 o'clock with Sydney Airports Corporation. Thank you very much.

PROF SNAPE: We resume our hearings and we welcome Sydney Airports Corporation Ltd, from whom we have a draft report. Is it still a draft report, or a draft submission?

MR HUSE: In fact, the submission is in final form and was in late on Thursday, I think.

PROF SNAPE: Good, thank you. I'd invite the Sydney Airports representatives now to identify themselves, each of you, I'm afraid, so that the voices get on the tape, and if you could state your positions please.

MR HUSE: Thank you very much and good morning. My name is Don Huse. I'm chief financial officer.

MR FITZGERALD: My name is Steven Fitzgerald. I'm the manager Economics, Sydney Airports Corporation.

MR HOUSTON: My name is Greg Houston. I'm a director of National Economic Research Associates in Sydney here advising and assisting Sydney Airports Corporation.

MS HODGE: My name is Clair Hodge, Sydney Airports Corporation Ltd, deputy legal counsel.

MR SKEHILL: Stephen Skehill, special counsel, Mallesons Stephen Jaques, solicitors to Sydney Airports Corporation.

PROF SNAPE: Thank you very much. So we've got lawyers and non-lawyers, have we? I hope my comment about barristers was not recorded before. Who will be leading and speaking to the submission?

MR HUSE: I'll be leading and speaking to the submission but I do have some friends at court here, if you'll excuse the expression, and so we'll all be speaking in terms of the dialogue with the questions and answers, Mr Chairman.

PROF SNAPE: Thank you very much, Mr Huse. Off we go.

MR HUSE: Thank you. Certainly Sydney Airports Corporation is very pleased to be able to participate in this process. We have lodged a substantial submission, and what I will be doing is really drawing on significant elements of our submission and in particular addressing the executive summary, which of course highlights the substance of our case. Just working through the points that we develop, clearly the inquiries being undertaken by the Productivity Commission will collectively consider regulatory issues of critical public policy importance, and we note that there are already three issues on your agenda in terms of your current considerations. Our submission addresses all of those. I think for us the future performance of Australia's airports, certainly in our view, has the potential to enhance or to hinder the economic

growth of Australia. We in our submission make the case that, frankly, complete economic deregulation of Australian airports will deliver the greatest net benefits.

Let us just reflect for a moment at the outset on Sydney Airport's contribution both present and future. If we take a current snapshot of the port, it reveals a high quality facility handling in excess of 23 million passengers per annum, more than 500,000 tonnes of freight per annum, valued in excess of \$21 billion. We have aircraft on-time performance that, frankly, is the envy of comparable US and European ports. Indeed, this environment has been created in the last couple of years, when we've invested in excess of \$800 million, and this investment was very much made with the Sydney 2000 Olympic Games providing the focal point and indeed, I guess, the critical path for us in terms of completing the expansion and the upgrade.

Frankly, our goal is to have a comparably favourable snapshot five, 10, 20 years down the track, with the airport continuing to play a critical role in the development and growth of Sydney, the development and growth of New South Wales and the development and growth of Australia. As an alternative scenario, however: if we were to look ahead five, 10, 20 years and indeed look back on 2000-01 with nostalgia and ask, "Where did it all go wrong?" Indeed, this is the question currently being asked by people in California in relation to their electricity industry and by the British in relation to their once mighty, world-leading railway system. We wish to avoid those outcomes, and hence the importance of the Commission's current deliberations.

We consider the question: what is the environment necessary to deliver maximum benefits? The ability of Sydney Airport to keep pace with the expected rate of future growth and change will depend heavily on having the right economic environment. That environment must be capable of attracting investors and innovative managers and must encourage the development of and the investment in new facilities, new services, and must provide the right incentives for the maintenance and upgrade of existing facilities and services to deliver the quality standards demanded by an increasingly discerning airline customer base and passenger customer base. That environment must also create confidence that services will be provided at an efficient price, that is to say, a fair price that does not result in demand being inefficiently stifled.

The merits of an environment that delivers all of the above is unlikely to be in dispute in the course of the Productivity Commission's inquiries. Indeed, these goals are wholly consistent with the aspirations of the Commonwealth in its pricing policies established prior to the privatisation and corporatisation of airports. The likely areas of difference between interested parties is in the design and delivery of an optimal framework to create this outcome.

It's the net costs of regulation that need to be considered. Our submission we believe demonstrates that there has been a disconnect between the Commonwealth aspirations, the final design and the ACCC implementation of the airport regulatory

system. Rather than delivering the intended light-handed commercial outcomes-focused environment, the reality has been a detailed and intrusive regime that frankly discourages negotiated outcomes by encouraging regulatory gaming.

It is our view that airports are different and should be deregulated. There is prima facie evidence that prices at most major airports are below efficient levels. By "efficient" I refer to long-run incremental costs in relation to most airports. At Sydney Airport, current aeronautical returns are below zero, and that's demonstrated in the returns which we made to the ACCC on an annual basis. This not only signifies prices well below average cost but, with increasing incremental costs, prices are a long way below long-run incremental costs. Further, with the current congestion issues, short-run marginal cost is likely to be significantly higher than a long-run incremental cost. Therefore two questions arise: firstly, are higher prices inefficient and, secondly, would deregulated airports increase prices very significantly, that is to say, beyond efficient costs?

Our submission calls upon the Productivity Commission and subsequently the government to consider the market structure of major airports and the significant differences between airports and other regulated businesses such as electricity, gas and telecommunications. SACL believes - that is to say, Sydney Airports believes - that this analysis will reveal only very small economic and social risks associated with a full economic deregulation of airports. When balanced against the substantial risks that regulation may retard investment and innovation and the social and economic costs of this, the case for complete deregulation becomes compelling.

Airports are not vertically integrated. Airports do not compete with their customers' core business, that is to say, they are not vertically integrated. In industries with significant degrees of vertical integration, a full set of terms and conditions of access may be important determinants of the ability of access-seekers to compete with the infrastructure provider in downstream markets. In the case of airports there are no incentives for an airport to restrict access to their facilities and services or to provide an inappropriate level of service.

Accordingly, most terms and conditions are optimally determined through commercial negotiations. The residual concern is related to the price of access and the incentive an airport may have to price access at a level higher than the efficient level. We consider the likely price motives of unregulated airports. In our view airport companies have the same value maximisation objective as other companies. Major airports also generally accept they have a degree of market power in some of the services and facilities they provide. It does not necessarily follow, however, that in the absence of regulatory prohibition on airport companies best value enhancement strategy that this would involve abusing its market power by raising prices above efficient levels.

The success of major airports and their airline customers are inextricably linked. Airlines provide airports with potential for revenue growth through adding additional incremental aeronautical services, from increasing the level of optional

services such as heavy maintenance and on-airport freight handling and additional office administration functions and by jointly developing new products and services for passengers such as international arrival lounges and online services. Airlines do have a degree of choice in where they deploy new capacity or commence new services. These choices are clearly influenced by many factors, airport charges being a relatively minor one, particularly, we would add, at current Australian levels.

The final reasons that an airport will not necessarily seek to misuse market power is the potential for reregulation. This risk that will always exist when governments have the power to legislate is likely to temper any unreasonable behaviour. In our view airlines have significant countervailing market power and I was interested in comments which were raised earlier today. Electricity and gas and telecommunications industries have a large number of relatively small customers. The ability and incentives for these customers to influence pricing outcomes may be limited, although vocal user groups and large customers have a degree of political and market influence. Airport revenues by contrast are generated by a relatively small number of very large customers and I think we'd emphasise that these customers are many times larger than the airports that are servicing them by most measures and these customers are sophisticated, resourced and organised.

One of the courses of conduct open to airlines and which has been used by the airlines to date is to exert commercial pressure on airports to give airlines a particular commercial outcome using litigation as a tool. Gentlemen, I guess this is an area where commercial reality is really quite profound. Litigation can be very expensive. It can be very time consuming and indeed, for substantial periods of time debts outstanding from the airlines can be unpaid. If I can just draw on my own personal experience in another jurisdiction which has been referred to this morning, that is to say New Zealand where I was chief executive of an airport company, we had a situation there where we were in the courts with the airlines. It was a process that left us, at the end of the day, with more than eight, almost nine months' aeronautical revenue outstanding where we were in breach of our banking covenants and where the company was in a very stressed situation. That is the level of countervailing power that can be exercised using commercial mechanisms.

PROF SNAPE: You didn't seize a plane?

MR HUSE: We didn't seize a plane. We had to, under the act that was in place for us, allow planes to land in any event.

PROF SNAPE: But having landed, it could have been seized until the debt was paid?

MR HUSE: No, in the event our legal advice was that couldn't be done, we'd be acting in a way which would be outside the law. So we're left with the very difficult situation where the court is a sort of de facto regulator, you might say, in that jurisdiction and the power of the airlines to withhold payments was exercised by them. The discretion available to airlines to divert individual flights between airports

can have a significant impact on airport profitability. While this may require airlines adopting a suboptimal route structure in the short term, the commercial cost to airlines is likely to be modest. Another thought on countervailing power which we just emphasise here again in light of comments made earlier, we believe the margin is extremely important. Indeed, it's at the margin where airports are profitable, particularly anyway while aeronautical services perform at low, zero or even negative profitability such is the case pending the ACCC's decision at Sydney Airports Corporation.

A further level of countervailing power is the influence of airlines politically and in the media. Airport management and shareholders are likely to be sensitive to criticism and the influence of airlines will allow them to lobby for reregulation. Certainly, gentlemen, we take the view that there is very real countervailing power which empirically can be demonstrated as being exercised by the airlines. Congestion, capacity are both critically important considerations. Congestion is a two-sided issue. First, the market power of an operator of a capacity constrained airport such as Sydney may appear greater because there are limits to the extent growth can be achieved by attracting new operations. However, the efficient price, that is to say the marginal cost or incremental cost of expansion of a congested facility is likely to be significantly higher than at an uncongested airport, resulting in less concern about higher prices within reason.

We have written extensively on efficient pricing at Sydney Airport in our aeronautical pricing proposal process currently under consideration by the ACCC. This analysis concludes that the significant price increase proposed will improve efficiency but is likely to remain well below the optimally efficient market clearing price or the incremental cost of expansion of capacity on another site. Where continued investment on a current site can alleviate choke points, a deregulated environment will provide the best incentives for Sydney Airports to develop and proceed with innovative investment solutions.

Innovative solutions to capacity on a constrained site will often be at a higher unit cost than solutions on an unconstrained site. A regulated investment environment requires the regulator to second-guess the airport operator in terms of the best investment solution, particularly when incumbent customers seek to delay investment or reduce the regulated price by arguing that innovative investments are inefficient due to higher unit cost selective benchmarks. There would be understandable concern on the part of airlines about the ability of the operator of a capacity constrained airport to extract economic rents from airline customers. However, empirical evidence suggests that airlines currently capture significant economic rents through pricing airfares from capacity constrained airports above efficient levels.

As a result high airport prices may only have a distributional impact which is a second order issue in terms of efficiency. Second, Sydney Airport issues are clearly crucial. Economic efficiency objectives would see Sydney Airports pricing airport services at a point between marginal cost and customer valuations. A ceiling for such

prices is generally considered to be the incremental cost of new capacity. When demand exceeds supply at a price above incremental cost, new capacity should be added. In the case of new major airport capacity in the Sydney basin, the Commonwealth clearly has a role to play in determining timing and location. The government announced on 13 December last year that it would be premature to build a second major airport. It instead decided to support the development of Bankstown Airport as an overflow facility capable of handling small jets but not as large as B747s. Sydney Airport will continue to be subject to the same curfew and movement cap arrangements. The government announcement also stated that, and I quote:

It is confident that the commercial decisions by the airlines and our policy measures will ensure that Sydney Airport will be able to cope with the increasing air traffic until the end of the decade.

A further review of policy will take place in 2005. Subsequently, the government announced on 28 March this year that Sydney Airport will be privatised by way of 100 per cent trade sale in the second half of 2001 with Bankstown and the subsidiary airports to be privatised separately in the second half of 2002. The most important economic consequence of these decisions is that it establishes a very real cap on physical capacity for a substantial period of time. This focuses attention in the short to medium term on demand management rather than the expansion of supply. Accordingly, an efficient price of access will be determined by customer valuations rather than a cost-based approach that is favoured in many regulatory constructs.

The current administrative slot system allocates capacity, but there is little reason to believe that this system promotes efficient allocation. The grandfathering system whereby slots are held indefinitely by any party on the basis only of continued use creates significant potential for inefficient allocation. This includes slot banking by incumbents with an anti-competitive intent to restrict the access by or growth of competitors. A slot auction system has been suggested as an efficient means of determining user valuations and allocating scarce capacity. We understand that there would be significant administrative difficulties in establishing such a system due to complexities of establishing matching slots at the origin and destination ports. There is also the strength of airline associations such as the International Air Transport Association, IATA, which may create a disrupted process with airlines reaching prior agreement not to participate competitively.

SACL, that's to say Sydney Airports, does not believe a slot auction is necessary to achieve efficient prices. A deregulated environment would allow regular alterations to price level to achieve prices that closely mimic the outcome of an auction. This would reduce the value of slots to a level at which they would be freely exchanged. The issue raised by airlines in the Sydney Airport pricing context that the Commonwealth role in deciding the timing of new capacity negates the need for efficient pricing is simply wrong. In the short term we now know that a major new airport will not be available for 10 years, so efficient demand-based pricing has an important role to place in enhancing allocative efficiency.

In the 2005 study the government will likely look at the demand characteristics of Sydney Airport in determining whether or when a major new airport is required. If prices at that point are below efficient levels this will send signals that capacity is required more quickly than is efficient. This will lead to inefficiently early investment and new capacity, the costs of which will be borne by society at large in some form. It could be the travelling public through higher airfares or the Australian taxpayers in the event of a government investment or subsidy. The efficiency loss of building a \$4 billion facility say, three years too early would be around \$1 billion - and the maths of that is pretty simple.

The likely motivation of contrary positions is considered in our paper. We certainly recognise that some airlines and airline industry bodies are likely to run a scare campaign against full deregulation. This type of campaign is likely to be motivated in part by a genuine fear of the unknown in terms of an environment where a strong, commercial relationship will be paramount, rather than an environment where decisions are played out on a stage before a regulator. Another motive, however, may be a regulatory system that delays investment which may benefit incumbent airlines because it restricts the ability of competitors to enter the market or expand services thereby allowing incumbents to charge higher airfares. A third motive is simple rent seeking behaviour as evidenced in the so-called single till debate where airlines lay claim to revenues generated through competitive services provided by airports. This rent seeking is likely to be less successful in a deregulated environment. In our submission we do discuss a possible light-handed regulatory framework but very much in our view as a second-best outcome. In recognition of the potential for parties to seek a compromise between full economic deregulation and the current intrusive regulatory system, our submission outlines a possible light-handed regulatory system. While lacking the full incentive benefits of deregulation, a simple system involving a medium to long-term price path based on a set of objective service standards has significant benefits over the existing arrangements.

There are other required changes to legislation; we discuss these. Consistent with our comments above, this submission argues that neither the Prices Surveillance Act 1983 nor Part IIIA of the Trade Practices Act (1974) need apply to airports. This would also require changes to the Airports Act to remove section 192 which automatically applies Part IIIA under certain circumstances. The light-handed fall-back approach, however, utilises to some degree the existing section 192 and Part IIIA structures. Accordingly, this submission suggests improvements to these instruments in the event full deregulation is not embraced.

To conclude, based on our submission we believe the case for complete economic deregulation of Australian airports is compelling. Airports have a limited degree of market power which is substantially mitigated by the countervailing power of airline customers and strong incentives to develop commercial relationships to develop growth. The potential cost of imperfect regulation is extremely high, given the importance of efficient investment in new capacity and services. In the event total deregulation results in unexpected difficulties, the government always retains

the ability to reintroduce regulation. That's the end of our formal comments here this morning. With the team, we'd be very pleased to take questions, Mr Chairman.

PROF SNAPE: Thank you very much, Mr Huse, for that presentation and your submission. I see that your first best position is complete deregulation, indeed, even more complete deregulation than other aspects of the economy, insofar as you argue that Part IIIA shouldn't even apply. So that's an interesting view that airports should in fact be subject to even less regulation than the rest of the economy. I'm not sure if you have yet had time to look at the Commission's recommendations in its position paper which was on Part IIIA and on the Prices Surveillance Act which just came out last Thursday, but you may wish to contemplate whether the recommendations there would align with what you would like done with respect to Part IIIA and whether that revised Part IIIA or at least the suggested revisions that are there would in fact mean that you would then be prepared to have Part IIIA apply to you. But it's too early I think to ask for comment on that unless you've done your homework very quickly.

MR SKEHILL: Could I just say to you that I think if Part IIIA were to continue to apply, there are a number of positions in this submission that we would want to urge upon you, in addition to the things that you have put in your position paper on Part IIIA. The very great risk with Part IIIA is that it becomes de facto price control because every transaction gets pushed into arbitration. In this submission we have said a number of things to you about the need to make the "arbitrate negotiate" process more effective and to essentially force the development of mature commercial relationships so that arbitration becomes a true last case resort. At the moment, Part IIIA in some senses in contract to Part XIC doesn't fill that bill, and there's a number of things we suggest in this submission as worthy of consideration in Part IIIA, whether or not it applies to airports.

PROF SNAPE: I think in those three draft reports that came out, one of the thrusts of those is that there should be - if we're recommending what we would perceive as to be an improved generic IIIA but in fact that there should be a convergence of industry specific access and beyond access trade practices, regulations towards the generic; in other words, that there should be a very specific reason why there should be an industry specific set of regulations rather than the generic. In the telecoms draft report we list what are those specific characteristics of telecoms and to a significant extent it's to do with history and with the local loop and in networking that is associated with that. It was on that basis that we suggested that there should be a continuation of industry specific regulation with respect to those characteristics.

I'm not sure that I see in here any industry specific characteristics in your submission which in fact would warrant an industry specific set of access et cetera regulations.

MR FITZGERALD: Chairman, I think one of the issues that arises - and certainly I've only been able over the course of the weekend to have a very quick read of some summary points of the reports released last Thursday - but the point made in our submission is really that the thresholds to apply Part IIIA are not sufficient to avoid it

applying to airports in areas where there may not be net benefits. You certainly make the point that we appear to be arguing for less regulation than other areas of the economy. However, there are many areas of the economy where the threshold test for Part IIIA mean that in practice it will never apply to them. In terms of the detail of how that is done we'd be more than happy to discuss that with the Commission in the context of both this and the other inquiries, but it appears to us that the application of Part IIIA, as Stephen mentioned earlier, would lead in an otherwise deregulated airport environment to price control via IIIA potentially for the wrong reasons.

Some of those reasons may be the ones that are outlined in our opening remarks that an airline may not have difficulties with the terms of access per se but it may be in their interest to contest the addition of capacity for other reasons. In terms of the discussions of IIIA it doesn't appear that the system would be so streamlined as to prevent that sort of gaming occurring in an airport context. Therefore, our position is that the airport regulation is better without the application of IIIA to airports because the net benefits would favour that deregulated approach.

PROF SNAPE: I guess the point there is the application of the IIIA and your comments there are probably on the criteria for the application or for declaration and we'd welcome any comments that you might have on those criteria if you think that things would be caught in the net that shouldn't be caught in the net. Certainly in the three reports we've been very conscious of gaming and very conscious to try and reduce the opportunities for it by any parties. You'll notice quite a treatment of that in the telecoms one, as well as in the IIIA. You would also have noted what I mentioned earlier as the recommendations to bring the monitoring of prices and conditions from the existing Prices Surveillance Act amended into the Trade Practices Act and that gives a halfway house between declaration and all that it involves, and no regulation, albeit with problems which Professor Forsyth was mentioning this morning.

But it also could be regarded as not only a halfway house towards declaration but a halfway house out of declaration. Any comments that you have got in relation to that - and I'm not asking for them now, it's not appropriate since there's a massive amount of paper in those three volumes and I hope a massive amount of ideas as well - perhaps subsequently you may wish to comment and to review your own position as you have mentioned here in the light of those recommendations.

MR FITZGERALD: Chairman, perhaps we can make a more general comment about monitoring in terms of the reporting of regular information to a regulatory body of some kind because that is something we have considered as part of our preparation of our submission. We are not proposing necessarily in our deregulation position to cease reporting under the Airports Act in terms of providing additional information on an annual basis, breaking up a business into various components, and also to reporting quality of service monitoring type arrangements.

That type of monitoring, be it under Part IIIA or be it under some industry specific sort of regulation, I think brings the threat of reregulation into some sharper focus. I think while recognising the arguments made earlier that this may blunt some efficiency incentives because you may not act as efficiently as you might otherwise because you're going to be reporting higher profits, I think that's a relatively marginal argument. I think what would happen under monitoring is that in an otherwise deregulated environment that an airport company would be proactively trying to demonstrate the reasonableness of its approach through delivering quality outcomes and delivering investment outcomes and capacity outcomes. I think whether that is under some formal monitoring power or whether it's simply a result of the commercial pressures of a deregulated environment, I think that exists and would be accepted by airports as a normal part of their business relationship.

DR BYRON: In your introduction you said you think there's basically agreement from all parties on the goal, the eventual outcomes that are desired, and the question is really how do we get there. You've also said that the success of the airports and airlines are inextricably linked and mutually dependent. As a frequent user I'd suggest a seamless high quality service for the passenger. Door to door is basically what we're all after.

PROF SNAPE: At a fair price, to quote the submission.

DR BYRON: Yes, at a fair and reasonable price. As we all know the stated intention at the time of privatisation was that there would be movement towards commercial and negotiated outcomes and so on. Are you aware of instances anywhere, either within Australia or internationally where these sorts of collaborative rather than at each other's throats, type of relationships have worked with the airports and the airlines working together to provide the customer that good service at a reasonable price? Just one more point related to that - I guess the inverse - is whether the regulatory framework actually impedes that outcome which is the second part of the question.

MR FITZGERALD: I think Australia actually provides some very good examples of where that has happened. I think on a day-to-day basis, on a continual basis that happens at airports around Australia. I think through the delivery of services to passengers for the Sydney 2000 Games it was much applauded around the world from all of those experienced that and from airport colleagues et cetera. That certainly wouldn't have taken place without a strong degree of cooperation between all the partners on the airport. That includes airlines, it includes the government agencies and includes the airport. What I think we have been reasonably successful at achieving over the last two years with our airline customers is to separate the areas of dispute from the areas where we've worked together to provide services.

I think it is in this environment where the disagreements are made most stark, and in other environments, as a passenger going through Sydney Airport and the many comments we've received recently, it is a relatively seamless high quality service. So we've managed I think to quarantine to a large extent some of the

arguments down to ones of price and continue to work together. Looking overseas, I think one of the examples used this morning was the relationship between - I think it's Easy Jet and Luton Airport where they worked together to develop a product. I know there's various other airports in Europe where that's taken place, where secondary airports who are not regulated have worked with low cost carriers.

There is an analogy at Sydney with us working very cooperatively with Virgin and Impulse on their start-up, while we're under a regulatory structure we reached commercial agreements with both of those airlines for the development of terminal facilities and went cooperatively to the ACCC for the approval of those arrangements which was forthcoming. Turning to whether regulation helps or hinders, I believe the current form of regulation hinders. I think the artificial constructs in our relationship that have developed as a result of that are evidence that we are in a situation where we believe airlines are feeling it necessary as a matter of commercial pressure to talk reasonably openly about issues that are in dispute. We have detailed issues in what otherwise should be commercial arrangements left in dispute through to a regulator where I believe in any sort of less intrusive regulatory system they could be dealt with fairly readily up-front.

These go to issues of cost of capital. The operating costs, even the form of design of certain infrastructure is left on the table more or less as a negotiating tool in front of the regulator where both sides are really talking past one another to a regulator. I think that sort of relationship actually hinders the extension of those otherwise cooperative relationships through to deliver the best services to passengers in the longer term.

DR BYRON: Mr Huse also made the observation that the regulatory framework may actually retard investment and innovation. Could any of you give any examples of that sort of impact of the regulatory framework?

MR FITZGERALD: One of the issues that is apparent in Australian airports is that we're relatively young in this sort of regulatory setting. So we don't have the examples of sort of object failure that have existed in things like California Electricity and British Railtrack and others - power blackouts in other parts of the world, such as Auckland. So it is a relatively comfortable position for some to argue that this isn't there for a risk. We believe it's a reality and it's a growing reality. Sydney Airport undertook \$800 million worth of investment over two years; investment that was largely committed to deliver the Olympic Games and to develop the capacity that was seen as needed up to around 2003, 2004. However, that same set of circumstances applying now I believe would result in a very different process to achieve that sort of investment.

I think the current regulatory system faced with the same set of circumstances would result in a very different process and potentially a different outcome, particularly in terms of timing and perhaps quality and innovation, because we would have a regulator essentially setting very detailed measures in terms of the investment to be undertaken. I think we have come very close in certain areas to some failures

that could have had very important impacts: one is in relation to the domestic new entrants. At Sydney we took a commercial approach and we managed to secure agreement of both airlines. I understand in Melbourne Airport's case they had a different experience but I understand they're giving evidence to the Commission tomorrow and perhaps they can talk about that. That is a very real problem where you have issues that amount to a few cents per passenger potentially leading to no capacity for competitive new services.

I think those issues, as other airports reached their capacity points at various points in their airports, be it aprons, be it terminals, be it runways, they will look at investment against the other uses of the funds of their investors and potentially we will see a retarding of investment. As I sort of started off saying, I think we privatised airports in Australia are at a point where most airports had spare capacity and have had some spare capacity through this first regulatory period. Sydney Airport is in a different situation and had precommitted investment prior to corporatisation, so we haven't really seen the test cases on whether regulation is going to retard investment, but I think there's enough evidence to suggest that the current approach is far from ideal.

DR BYRON: In the opening remarks you conceded that Sydney Airport does have market power in some area. Could you elaborate a little on which areas?

MR FITZGERALD: Certainly. I think the primary area of market power in an airport such as Sydney at this point in time is in relation to the provision of runway services for large jets. I believe we have the only 747 or equivalent capable major runway within a reasonable distance of the Sydney CBD. So I think that at its head is where market power is derived or is at its greatest extent. I think from there on you get into less and less degrees of market power and it's just a continuum through to sort of perfect competition. I think our international terminal services have a degree of market power borne largely by their convenience rather than them not being at all competitive. There are choices for customers coming into Sydney internationally. They can come through other airports' international facilities and come to Sydney on domestic services. In that case our international terminal competes with the domestic terminals that are under long-term lease to the major incumbent airlines. However, they do generally have to use the same runway and taxiway system. So that I think is the runways where the main issue exists.

Other areas where market power may exist are the other areas where an airline or a passenger has no choice when coming to or leaving Sydney. Some of those - they're really ancillary to the runway system. It then becomes a market-by-market analysis of whether it's practicable to substitute other services such as refuelling. Most other services required by airlines are contestable at Sydney Airport. Ground handling is certainly highly contestable and not provided by the airport, through to our carparking and retailing facilities that are in our view highly competitive. They compete both on and off airport and I believe have no market power.

PROF SNAPE: They do get locational rents associated with the market power that you have on the runway, however.

MR FITZGERALD: We don't at present. I'd put it that we don't receive any locational rents, in fact, we don't receive the cost of providing those facilities at the present time in terms of runway and taxiway facilities.

PROF SNAPE: But you do get locational rents on parking and so on, and retailing?

MR FITZGERALD: Yes, there are locational rents. Given the scarce locality of those facilities, things such as car-parking are offered. There are others who get similar locational rents, such as the valet carparking of the domestic airlines that operate from a point slightly closer to terminals than our own carparks. So there are locational rents but they vary in size and scope.

MR HUSE: Just to add to that, those locational rents go out beyond our boundary as well, to other commercial parties who have their businesses adjacent to the port.

PROF SNAPE: Diminishing with distance?

MR HOUSTON: Yes. I mean, a good example is the two or three hotels that are located very near to the airport. Undoubtedly they derive some of their income because of their location. You can draw concentric circles around the airport and there are lots of parties that are present in those circles and enjoying various degrees of locational advantage.

PROF SNAPE: How do you allocate land to various uses? I was rather surprised to see recently that there's a surf discount warehouse shop occupying what to me seems to be a very valuable site and some land around that and I thought even some free parking associated with that warehouse, which I must recall next time I go there. How do you make decisions as to how to allocate land for various purposes?

MR HUSE: Can I just make some comments there? Steven, you may wish to come in as well. Airports, given their long-term nature, have very intricate planning processes which involve not only the airport and its advisers but also the other stakeholders and parties who operate on the port, and traditionally they are involved in what's known as a master planning process which will conclude with what is seen to be as a footprint for the court going forward one year, five years, 10 years and out as far as 20 years and even beyond, to the extent that amongst all the stakeholders on the port they certainly have a view of what's in the best interests of the port as a whole but they also have a view as to what's in their particular best interests as well.

So airports find themselves cast in the role, such as I would call it, as being the honest broker and in our particular case because we are so constrained by way of land area, we need to focus very much on the must haves that are on the port and those activities which could in fact go outside the boundaries. So the sum of it you have a 20-year master plan in process typically; that master plan would be reviewed again

typically every five years. It's a very, very inclusive process of all stakeholders, but within that you get to the situation that you've just described that you may be holding some land for a very important use five, 10, 15 years into the future but in the meantime you can use it for various short-term purposes which are commercially viable. So you do that in such a way that doesn't prejudice your ability to later on use it for the most important use for the port as a whole.

So there are quite a number of circumstances like that at Sydney Airport now and at most airports. Just finally to add to this, one is very, very concerned about putting in place assets which are essentially immovable and for an airport, for example, to start moving away from an on-ground carpark into a carpark building is actually quite a big step really for two reasons: (1) the cost of a high-rise carpark building is pretty expensive, but (2) the opportunity subsequently to use that area for another purpose which you may not originally have thought of becomes an opportunity in cost terms very, very high, so that's the process.

MR FITZGERALD: Could I add very briefly to that that what Don has outlined is really a method of achieving highest and best use over time of the areas available on the airport. One of the assumptions that goes into that process from the airport company's point of view is that the highest and best use will also result in profitable use for the airport company in order that we don't get distortions in those uses and there is certainly no reason that we can see that the highest and best use for society should not be the same as the highest and best use for the airport company. However, there is the potential for an imperfect regulatory regime to send signals to an airport company that it should be using a piece of land for something that is not a highest and best use simply because it delivers a more profitable use for the airport company which is otherwise prohibited from achieving reasonable returns from that. It's really the substitution of aeronautical and non-aeronautical in an imperfectly regulated aeronautical environment.

PROF SNAPE: Is it regulation then which is meaning that what I would imagine is very valuable land is being used for what seems to be a fairly low-grade discount warehouse?

MR FITZGERALD: I think the example you cite is more along the lines of Don's suggestion that this is a very valuable longer term site and the use that you observe now is a short-term moveable use. In fact we have many tenancies on the airport that are on very short-term leases with a view to keeping the flexibility to convert them to their end highest and best use when they are required and on an airport the size of Sydney Airport, being very small by Australian and international standards, my view is that the highest and best use of the very substantial proportion of the airport is for aeronautical purposes. The area you are referring to in the domestic precinct I would imagine its highest and best use at some point is future terminal development. Whether it becomes future terminal development or becomes an alternative non-aeronautical development will depend in part on the regulatory structure.

PROF SNAPE: How would the ACCC's draft determination affect the allocation of land?

MR FITZGERALD: One of the issues - and I might ask Greg to comment after an introduction - one of the issues the ACCC has in our view introduced a disincentive to the efficient allocation of resources is by notionally valuing aeronautical land at a CPI indexed historic cost counting back 80 years and coming up with an aeronautical land value of around \$70 per square metre when the observed market for land unrelated to airport use in the area is around 3 to 4 hundred dollars per square metre and certainly the value of land that has any sort of locational advantage is far greater than that. The other aspects of the regime that the ACCC has proposed is that to avoid the disincentive of using airport land for aeronautical purposes is that you could include in the rate base the purchases of other land off-airport in the event you relocate facilities. The net outcome of that is actually quite a strong incentive to the extent possible to locate aeronautical facilities off-airport, off the current airport site, because you would then see the acquired new aeronautical land going into the rate base at its acquired value and you would also realise the full potential value of the on-airport land in a non-aeronautical use. So to the extent that that distorts planning scenarios is yet to be fully tested, partly because we hope the ACCC reverses that view in their final decision.

MR HOUSTON: Perhaps another example is the carparking example. The ACCC has taken the view that the carpark should be sort of included in the till, if you like, and by itself that decision is not particularly meaningful until you combine that with their approach to valuing the land over which those carparks sit. By adopting their indexed historic costs approach to valuing land they deem above normal profits from carparking which essentially - I mean, we could have a debate about the price of carparks, to what extent it's a market power and to what extent it's locational rent. But I think it's pretty clear that that split, whether it's a hundred, zero, zero, a hundred or something in between, would not be anything like the split that is implicit in the ACCC's decision because the indexed historic cost doesn't even reflect today's value of the aeronautical land, let alone today's value of the non-aeronautical service which is carparking.

So the consequence of that decision, and taking the assumption that that decision would be repeated at the next regulatory review with the ACCC applying the same methodology, is for Sydney Airport to effectively try and take itself out of the carparking business, as defined currently by the ACCC, and do something alternative which essentially falls outside the till that's been defined. That could be anything from offering only valet parking instead of ordinary parking, knocking the carpark over and putting a hotel there, putting a McDonald's, a petrol station or what have you, or simply just lifting the barriers and leaving the carparks there for free, with the revenue that's lost from that recaptured through the aeronautical services — but I imagine a fair degree of chaos in terms of a rush to get to the airport each morning to be first to park your car there for a week if you're lucky enough to find a spot. So I think that's quite a nice example of all sorts of potential distortions that the decision the ACCC has currently set out would encourage.

PROF SNAPE: On page (v) of your - it was in what you referred to in your introductory remarks today and towards the bottom of that page you say:

Empirical evidence suggests that airlines currently capture significant economic rents through pricing airfares from capacity constrained airports above efficient levels.

What is the evidence that you have that the airlines are in fact charging prices for the seats on planes that are above efficient levels? It's that "above efficient levels" that I found very curious.

MR FITZGERALD: In that context really defining efficient as being the prices that you would observe in a full competitive market for airline services. I don't have with me the references but there have been some studies of airfares from congested airports and non-congested airports in the Transatlantic market which suggests that Heathrow Airport, while it has some of the lowest aeronautical charges, actually has or some of the highest airfares Transatlantic, and the differentials in airfares can be quite extreme.

PROF SNAPE: I can understand that and I can see that, and what you described to me there is that the airlines may be pricing efficiently; that is, who wants to go to Heathrow? People who will value Heathrow most. So the airlines therefore put up their prices for going into Heathrow so the people who buy the tickets are those who value Heathrow most. Those who don't can go to Stansted or Manchester or somewhere. That seems to me to be efficient pricing. It also means that if the airport itself is not pricing the slots into Heathrow at the market clearing level it tells me that the airlines are in fact clearing the market by their pricing and that you've got a transfer of rent from the airport to the airlines but not that there's any inefficiency.

The point that we've been making many times in our issues paper and elsewhere is there seems to be a great deal of squabbling about the distribution of rent. It doesn't mean it's unimportant but what we're trying to do is separate that from efficiency questions. This sentence said that this was inefficient. It does not seem to me that the argument, as here and as I've just elaborated upon, that is made implies any inefficiency at all. It would seem to me that it would be inefficient if the airlines in these circumstances weren't pricing the tickets at the value of going into Heathrow.

MR HOUSTON: You're absolutely right in the distinction that you make and we, NERA, have looked quite closely at the issue - quite detailed analysis of exactly who is using Sydney Airport for what at the moment, and that material has been submitted confidentially to the ACCC. Whether or not it can be available to the Commission is another question.

PROF SNAPE: If it could be we'd value it and treat it as confidential, of course.

MR HOUSTON: Just let me sort of summarise in broad terms some of the examples. I mean, first of all, Sydney Airport isn't exactly in the position that

Heathrow is where - in Heathrow, as I understand it, all slots are used all hours of the day, more or less.

PROF SNAPE: All available hours.

MR HOUSTON: Yes - well, I think it's almost all hours but whatever. Now, at Sydney Airport that's first of all not precisely the case. Not all hours are used up, in fact there's only four of the 16 or 18 that the airport is open. Secondly, if you look at the way in which those slots are used at the moment, there's on the face of it enormous scope to increase the potential efficiency of the use of those slots through things like not just simple time shifting by some peak pricing and getting some people to move from those four peak hours to the sort of off-peak hours or not so peak hours, but the allocation of routes and the size of planes that are operated on those routes. One of the best examples is the Sydney-Canberra route. I don't have the figures here, but if you look at the first few hours of each morning there's a disproportionate number of flights operating between Sydney and Canberra, given the size of Canberra, even taking into account that perhaps more people in Canberra want to wake up in the morning and jump on an aeroplane. There's an incredible number of flights between Sydney and Canberra relative to say Melbourne or Brisbane or Adelaide or wherever else, with very, very small planes. It's widely held that that in part is to do with the slot allocation regime, that the sort of Canberra-Sydney route is the holding route, the slot banking route while airlines sort of hold onto a slot while they find something more valuable to use it.

So just a relatively small reduction in the number and the frequency of flights to Canberra would, for example, open up the possibility of having more peak time flights between Sydney and Melbourne or Sydney and Brisbane, and it's worth setting that alongside the observation that one of the new entrants, Virgin Blue, doesn't have a service to Melbourne at the moment. One might surmise that an important reason for that is that there are effectively no slots available for the peak two hours in the morning and the peak two hours in the afternoon, which would clearly be a crucial part of your service offering, to open up a route to Melbourne. So one might imagine a reallocation of, just for example, Canberra-Sydney services for Melbourne-Sydney services could do a lot for competition on the Melbourne-Sydney route.

PROF SNAPE: I understand that, though that was not quite the context of the sentence. But I take the points that you're making. What sort of pricing mechanism then would you favour? You talk in page VI that you would:

Allow regular alterations in price level to achieve prices that closely mimic the outcome of an auction, so this would reduce the value of the slots to a level at which they could be freely exchanged. It would also capture the whole value of the slots for the airport.

So you would in fact envisage then an efficient form of pricing to be pricing the slots at their opportunity cost?

MR HOUSTON: First of all, you need to distinguish between the level of revenue and the structure of prices which recover that revenue, and most of the debate in the regulated context of the ACCC has been in the context of the level of total revenue. Let's just assume that that's been fixed and think about what would be the most efficient structure of prices to recover that revenue in that environment. Clearly, an efficient peak pricing system or an efficient price structure which might involve time differentiated prices as well as perhaps a reduction or an increase in the sort of uniformity of prices for the landing component of the thing. A more efficient structure needs to be or can only be developed in an iterative way by reference to the demand side reaction as you start to differentiate times of day or aircraft sizes and so on.

So I think the practical process which one needs to go through to arrive at an efficient pricing structure is one which - you can't just sort of get a computer model and come up with one overnight; it has to be developed over time. But as a matter of principle you would expect that to look like one where there were higher prices at times of the day when there were more people wanting slots, lower prices at times of the day where that wasn't a problem, and also a move away from the sort of emphasis on aircraft weight to one where there was a greater degree of uniformity, perhaps not complete uniformity, for the runway charge in particular.

PROF SNAPE: So why not just let the airlines sell their slots outside the ring fence?

MR HOUSTON: That's a good question.

PROF SNAPE: I mean, after all, you've just described a process in a socialist planning model in which you were trying to in fact work out the prices that would apply in a market if the market were allowed to operate. So why not allow the market to operate?

MR HOUSTON: I'd be a bit concerned if it was a socialist planning model, but - - -

PROF SNAPE: It sounded to me like the Oscar Langer type of stuff that was written about 70 years ago, 60 years ago.

MR HOUSTON: First of all, let me say there can be no argument against the point that airlines should be able to trade their slots freely and efficiently with each other in above-the-table transactions.

PROF SNAPE: With money?

MR HOUSTON: With money, absolutely, and that's not developed in here but neither is slot auctions either advocated or developed in here. The important thing to understand is, though, that the price of any slot, whether discovered by means of an auction or by means of simple bilateral over-the-counter trading, is inversely proportional to the price to use that slot. If you can imagine the airline demand curve

is 100, then the price for trading or a slot will be 100 minus whatever it cost to use it. If the cost of using it is 99, then the tradable price is \$1; if it's 50, then the price is 50. So even in a - - -

PROF SNAPE: In that point we get into, is it your dollar or their dollar?

MR HOUSTON: That's true, so there's no question that - - -

PROF SNAPE: But what you've described here is, as I understand it, to make sure it's your dollars rather than their dollars.

MR HOUSTON: That's right, but there's a whole lot of - what we're talking about here is the demand side, how to get demand side efficiency in the use of slots. There's a whole question which is left in that sort of observation of yours, the supply side and how to get all the supply side efficiencies that we've just been talking about. It's certainly not a question of indifference from the point of view of an airport operator whether the charges reflect the cost of adding more capacity or not. So while from the demand side, yes, you can argue it's a simple allocation of rents, and I think even that is too simplistic, because the structure of prices - it's not simply a question that it's 100 that's valued by the airline: does 50 go to the airport or 99? There's a lot of subtle and complex questions about the structure of prices, the balance between terminal charges, passenger charges, runway charges, flat charges, weight-based charges, time abuse charges.

I don't think simply auctioning of - if you're going to have an auction or allow tradability, you have to define very carefully what it is that's being traded, and I don't think you can underestimate the role of the person that's devising the structure of the prices, the usage fee, if you like. You can't underestimate the importance of that helping the process of getting efficiency on the demand side.

MR FITZGERALD: There's a couple of other points on that, one being the transparency of the costs of holding a slot are much greater if a runway is actually priced towards the value of the slot. At present the market structure of airlines at Sydney Airport is dominated overwhelmingly by two aligned groupings, and there would potentially be some resistance to free trading of slots by members of those alliances to competitors to those alliances, and I think the issue of pricing the runway does not overcome that problem because there is still an incentive for an airline alliance to continue to fly what is otherwise an unprofitable group with simply the motive of ensuring that that slot is not used elsewhere. However, that choice becomes very transparent and very open to the extent that they are making real cash losses on the route rather than simply holding an unpriced commodity that they haven't traded away.

PROF SNAPE: If it is saleable, then the opportunity cost of that becomes very clear.

MR FITZGERALD: It can become very clear, but it is not as direct a mechanism on the airline as a cash cost to them of operating that slot. So I think there is an issue of transparency. The other simple issue is that we should not be in any way embarrassed or concerned to the extent that we believe it is reasonable for any rents that may exist to actually go to the favour of the airport company, particularly in Sydney Airport's current position, where it is a publicly-owned business and rents therefore captured by Sydney Airports Corporation are distributed back through any sale or ongoing ownership through to the community, which is a reasonably efficient place for those rents to go rather than perhaps airline shareholders.

MR HOUSTON: Steven, without wanting to sort of jump down your throat, we need to be careful about the use of this term "rent". You know, there are locational rents, monopoly rents, all sorts of rents. What we're talking about here, or at least the Sydney Airport pricing proposal that's put before the ACCC, is simply to raise the total level of aeronautical revenues to that which would be involved in the costs of providing that airport facility. That, to be sure, involves the transfer of wealth - call it rent if you like - from one party to another part or from a number of parties. It does involve the transfer of economic value, but before you sort of conclude that it's not necessary to do that or there's no point in doing that, you have to really satisfy yourself that there's a good reason for the price of aeronautical capacity not to reflect its economic cost. I think that's actually quite a hard case to prove.

PROF SNAPE: What you're arguing I think is that, while there's been quite a bit of debate in the context of slot allocation as to who owns slots - and I don't just mean in Australia, I mean round the world - whose slots are they? You're saying that that question is really not just a matter with distributional implications but it has got efficiency implications as well. Is that what you're arguing?

MR HOUSTON: Sure. It has huge efficiency implications and we'll just explain some of the apparent misallocation of slots at the moment. That is due to a combination of underpricing of the right to use those slots at the moment as well as an administrative system that allows the users to hang onto them, whether they really need them; it's both of those things working together. If you addressed just one of those, then you've surely helped to solve the problem, but I think to address the problem properly you really need to address both of those aspects. No better example of the distortions from exactly the parallel situation as at Heathrow, where you've got airline takeovers that are driven by access to slots. Indeed, I guess the Hazelton example in Australia is a more local and more current example of exactly the same thing.

PROF SNAPE: Is that a slot question or a connecting question?

MR HOUSTON: That's a good question. A lot of popular comment in the press would suggest that slots have something to do with it, maybe not the whole story but at least some important part of it.

PROF SNAPE: I would have thought that as they look at the - is where they park - right beside the Ansett terminal, and that they link into Ansett. That would be quite a major factor, quite apart from the slots.

MR FITZGERALD: It's a question of degrees and the issue whether Hazelton as a stand alone business proposition, with its linkages then into Ansett, had the value that Ansett placed upon it. That's an empirical question that really only Ansett can finally answer. But I think there has been plenty of speculation both ways.

I think one of the other issues here is about new investment and whether, in a system where you have congestion - with the allocation decisions being made by the customers, in terms of trading the access rights if you like - where does the signal for new investment come from. In particular in this circumstance, where does the signal for expansion of major airport capacity in Sydney come from if the value of those slots is actually sitting on airline balance sheets? Who then decides that the efficient price has sort of risen above the long-run incremental cost of new capacity and that the capacity should actually now be enhanced?

I think while the government certainly will have a role in the decision to build a new airport, the pricing and economic signals for either the airport - the owner of Sydney Airports Corporation will have the first right of refusal on that second airport, or indeed a potential competitor to Sydney Airports Corporation. Where will they get those pricing signals to develop a new airport?

PROF SNAPE: Yes. In one part of your submission you state that the elasticity of demand is low but in another you discuss the fact that airlines do respond to price changes. Can you reconcile those two please?

MR FITZGERALD: Certainly. I think, chairman, you are possibly reading from a draft submission. I apologise for some - - -

PROF SNAPE: I apologise but that's what I had with me over the weekend.

MR FITZGERALD: Yes, apologise for some disconnect between us and the Commission's staff. But we certainly considered the same point in working through the draft. I believe they are reconcilable. The question is the degree.

PROF SNAPE: You're ready for the question in that case, aren't you.

MR FITZGERALD: Yes, we certainly asked ourselves the same question. We believe there is elasticity which will result in changes to price structure and level having an efficiency benefit on the market. However, is it recognised that the need for change in relative price level at least is quite significant - to get those changes to occur. It also will be an elasticity in terms of the use of various facilities by airlines. I probably haven't explained that very well but in terms of an individual passenger's elasticity, particularly in certain market segments, that is relatively low. However,

the ability of an airline to respond to price structure and price level changes by changing the size of aircraft and the timing of services is certainly apparent.

PROF SNAPE: I do apologise if that was a question which was overtaken. As you say, I was working from an earlier draft.

MR HOUSTON: I think the simple answer is just the distinction between the final market, which is an air travel market - aeronautical charges are a small proportion of that market and almost by definition it's hard to see big elasticities in there. But at the intermediate point, which is really where the customers directly of the airlines - there's significant scope for them to alter their scheduling, fleet sizing and those kind of decisions in order to improve the utilisation of capacity. So that's the distinction.

PROF SNAPE: I think I'm safe on the next one. You do mention some gaming - discusses gaming initiatives of airlines. Can you give some examples of this? Are you prepared to give some examples of this from your own experience?

MR FITZGERALD: Chairman, it's something we perhaps might come back to the Commission on in some more detail. I think the gaming that we have observed in the current pricing around Sydney Airport has been towards trying to delay the process of increasing price. We've certainly seen very publicly, in the Board of Airline Representatives' response to the ACCC's draft decision, what we would consider fairly thinly veiled threats of legal action against the regulator on the grounds of process. They may be genuine concerns but they may be in the realms of gaming. Certainly, in the context of some of the information requests and the information concerns of airlines, we don't believe on a measured view that the requests for the very, very fine detail, such as the number of particular newspaper publications that are read around airport management, is a - - -

PROF SNAPE: You had better explain that.

MR FITZGERALD: Well, there have been requests from airlines in consultation meetings for a breakdown of newspapers and publications and they have gone further and asked for the number of Sydney Morning Herald's purchased by the management and who reads them and why aren't they buying them themselves et cetera. So I mean, I think those sorts of questions are not going to the heart of the issue. I believe primarily they are trying to paint a particular picture about either management conduct or simply to delay a process. I think in a genuine commercial relationship in a deregulated environment I don't think you would be having those discussions.

DR BYRON: On - I think it's on page 36, at least of the draft that I was looking at - you've got a very interesting discussion on "the threat of reregulation as a disciplining device". There's also an earlier comment about:

Regulators often see high rates of return as evidence of monopoly profits.

You may have heard the earlier discussion this morning about how does a regulator or would-be regulator tell the difference between what's just a very profitable, well-run efficient company, and what's a company making big profits because it's abusing market power. If you have a fear that high profits might trigger regulation or reregulation, does that give an incentive to any firm to simply conceal its profits or inflate its costs, or gold plate or whatever? How do we deal with that problem of not wanting to distort incentives for the business to run as efficiently as possible?

MR FITZGERALD: My view is that it's a matter of degrees of risk. The risk of that kind of behaviour, where a firm would deliberately reduce its profits by adding costs or would try and hide its profits, I believe is far less than the risks of costs in a directly regulated setting, particularly the risks to efficient investment.

However, I believe it then becomes incumbent on the airport company, in its legitimate value maximising environment, to continue to portray itself as a very efficient, high quality company that is delivering very good outcomes that would not have otherwise been delivered in a regulated setting, and can certainly point in that environment to the significant benefits of deregulation, as a response to any claims that profits might be above a particular commentator's view of what a reasonable return on capital is for that type of business. I think the threat of regulation of itself is therefore, I agree, a form of regulation, but it is a light-handed form of regulation and those risks and costs I believe are much lower than the risks and costs associated with intrusive regulation.

DR BYRON: I was just thinking that even if your fees - landing charges, whatever - had been held constant in real terms, somebody might then say, "Oh yes, but you should have reduced your fees in real terms" - take advantage of productivity, technological changes and so on. I guess on thinking a bit about the discussion we had on these issues in the Prices Surveillance Act report, that in some cases the fact that prices haven't gone up doesn't tell us anything about whether or not monopoly power exists or is used.

Now, the important thing I guess is in terms of a New Zealand type of monitoring framework. The point that Professor Forsyth made earlier is, what would be the trigger for a regulator to say, "We now have prima facie evidence of abuse of market power and therefore we're going to come back in and reregulate you"?

MR HOUSTON: I mean, the classical figures are likely to be either some problems with the quality of service or reported rates of return which are deemed to be sort of excessive, however defined. They I think are the only really two things which - or they are the two most important things which would sort of operate in that environment, you know, for better or worse. I mean, clearly that may or may not create incentives for businesses to operate in ways which are sort of suboptimal, but at the end of the day you cannot - even in New Zealand you can't remove the threat of reregulation. I mean, even if you want to, you can't. So those issues will, by people who want to prosecute the case for some sort of curbing of what's believed to be market power will always focus on those issues and I don't think - that's just a

description of the way the world is. It may be good, it may be bad but that's what will happen.

DR BYRON: Where I'm coming from is that it seems that there's a fundamental choice between saying that airports have monopoly power and are therefore likely to use it, therefore, let's instigate a regulatory system immediately, or will you stand back and say, "As long as they don't abuse it, we won't regulate it but we reserve the right to regulate once we have that prima facie evidence of abuse of market power."

MR FITZGERALD: Behind the question is an assumption that there is market power and that it can and will be abused and I think the case we're setting out is that in a deregulated environment for many of the Australian airports and in particular Sydney in our case, in a deregulated environment we do not believe the profitability on its face would be so far above reasonable as to trigger any such concerns. In fact the benefits of deregulation would simply be that investment takes place at a realistic cost of capital which is decided by the airport in discussions with the customers and that on its face doesn't mean that you will be seeing very high rates of return over time. So first of all, it's a question about whether that's actually going to occur and then if it does occur, what is the trigger.

I think if we can move the debate in this area towards focusing on the best outcomes and that, I think, is incumbent on the industry players as much as anyone, then we, airports and airlines should actually over time be very comfortable with the result that with strong airport companies delivering good quality services and facilities in a timely manner to them and will not be calling necessarily for the reintroduction of regulation. It is those airline customers who would presumably be most vocal and their concerns I think over time if we look around at the international experience, in the US at the moment and generally coming out of the International Air Transport Association, their number one issue in the world is airport capacity. It's not airport pricing, it's airport capacity and I think if Australian airports in a deregulated environment are delivering quality capacity on time then they may - hopefully airlines will be able to look at that as a good result, even if airports are making higher returns than they are currently and I think that's - - -

PROF SNAPE: So I think what you're saying is that in your ideal, unregulated world you would want to ration the slots at peak times by using the price mechanism, by pricing them at what would be a market clearing level for various times of day.

DR BYRON: Rather than congestion.

PROF SNAPE: Yes.

DR BYRON: Congestion is the least preferred - - -

PROF SNAPE: That you would in fact want to - and you're saying that the elasticity of demand is fairly low and so that means that those prices would have to

go up a very long way from current levels to in fact secure that rationing solely by the pricing mechanism and yet that would not generate huge profits.

MR HOUSTON: I think that's not exactly what's being said. It's an empirical question, the answer to your observation, and which none of us in this room are really in a position to take a call on. Interestingly, if you look at Sydney Airport and compare the average passenger load of planes coming into it with other major airports around the world, it's very low. It's of the order of 50 per cent of what the average passenger load is in Singapore or Heathrow.

PROF SNAPE: Let's forget the ring fence and operate outside the ring fence.

MR HOUSTON: Even putting aside the ring fence it's still - so the calculations as put to you are outside the ring fence, it's very, very low. So it's an open question as to just how - you know, whether or not you have a facility which is truly congested in an economic sense where one is willing to allow the sort of economic signals to operate to the extent that they should. That's, I think, one of the sort of areas where the debate between Sydney Airport and the ACCC has, to my mind, gone off the rails a little bit. There is a lot of fear and a lot of discussion about this fear of congestion pricing and the implication that congestion rents arise from that and as a matter of public policy there may be a good reason to hold that fear. But the empirics at Sydney - I mean, to be sure there are four hours a day when there are no slots, but it's a long way to go from there to conclude that that situation couldn't be alleviated with some better pricing and whether or not - you know, it is an empirical question.

PROF SNAPE: Well, apply a bit of time - you get them coming in in larger planes by putting up the prices for a while and that alleviates it for a while but then down the track a bit further it really is going to become congested.

MR FITZGERALD: But we then have the potential for new capacity. I think one of the interesting parts of this debate has to be we're talking about potentially seeing very large returns at Sydney Airport but if we take a bit of a reality check on where we are, we're currently in negative territory. We're looking with our ACCC decision, our proposal was to move to something like a 6 per cent post-tax return, their draft decision has probably put us somewhere around 4 and that's with an 80 per cent increase in price. We then, I think, within the bounds of the reasonable have a significant amount of scope to both differentiate between the levels of price and also potentially to increase price without going to levels of return that look like they're any kind of abuse of market power or indeed, any type of true congestion rent.

I think we are at this stage a long way from that point. I think one of the advantages from a regulatory discussion point of view of being in such a poor return environment is that the type of price increments required to get to levels of return that would look monopolistic would in fact be mitigated by some of the commercial relationships and other things that are laid out in our submission. So in fact we would actually have to be pushing the envelope, if you like, over a long period of time to get into that sort of environment. Within that time frame we have a study

coming up in 2005 that will look at congestion and capacity issues. We potentially then have the horizon of the owner of the Sydney Airport building a new airport, or somebody else if that owner is giving signals that they'd prefer to capture congestion rents than build new capacity. Well, the government has announced that it will let someone else build that new capacity and you are then into an environment where you will have some genuine competition for major airport services in Sydney and the reason for regulation will have fallen away even further.

PROF SNAPE: The list that you give us on your proper submission on pages 59 and 60 of the refined definition of an airport service, could you just tell us the rationale for this classification of what should or should not be in?

MR SKEHILL: I suppose the first thing to say about the list is that it's exemplary rather than necessarily definitive. The problem with 192 at the moment is that the definition that it contains just leaves a fertile ground for argument as was shown in the Delta case. It seems to us that if 192 is to remain and, of course, our primary position is that it shouldn't, if 192 is to remain, if there is to be some automatic declaration of services for the purposes of Part IIIA then there should be as much specificity as possible about those services that are in and those that are out because to avoid that specificity just creates argument that costs money. That is a list that is an attempt at producing one, it would be possible to argue around the fringes of it. It has its origins to some extent in the instruments under the PSA but it is a variation on those and it was a variation that was developed, having some regard to the arguments that those very lists under the PSA declarations have caused of which I suspect Dr Byron is aware of some. Whether it's exactly the perfect list remains to be seen but that's something that could be nipped out. But the idea behind it is, if you're going to have a 192 it should be as crystal clear as possible what it applies to.

DR BYRON: The decision 10 days ago about Canberra Airport and whether it was a road.

MR SKEHILL: Yes, and that's exactly a case in point where it's perfectly clear that the government did not intend or did intend prices for roads to be within the cap if they were to be introduced and prices for carparks to be outside the cap. Canberra Airport introduced a price for a piece of land off the road through which taxis moved and in which taxis could park in the belief that it was outside the cap. Now, the cost of that matter having to be resolved in the Federal Court at first instance and potentially on appeal is just enormous. The lack of regulatory security and risk that that introduces, not just at Canberra Airport but at every airport, is manifest; it's a very poor outcome. Particularly when one factors in that in the sale documents for the airports there was a specific exhortation that said to potential buyers, "If you buy this airport this is the sort of area where you can introduce pricing outside the cap," and so there's a very significant question behind what looks like a very simple question about whether something is a road or not a road.

PROF SNAPE: Thank you.

MR BYRON: I was wondering if you could elaborate a little bit more on the light-handed option because we did have Professor Forsyth this morning saying that he thought light-handed regulation of airports was virtually an impossibility and I would like a little bit more detail of what you had in mind than I was able to get out of your submission.

MR FITZGERALD: Perhaps it might be useful if I just run through the light-handed regulatory regime because it is something that did develop significantly over the course of last week from the time of that draft and there is a little bit more definition in the final paper, but let me just run through that very quickly. As we've said, our first best option and is clearly defensible is one of deregulation. However, if there is a view that some form of regulation is required of airports, we've put forward

a light-handed structure. The objectives of that would be to encourage innovative operating and investment solutions, to appropriately reward behaviour that generates growth, incentivise an efficient operating environment, ensure quality of services and facilities meet customer requirements, and that any broader community or aviation policy objectives can be met in a transparent and commercially sustainable manner and discourage sustained prices above efficient levels.

Our proposal is that the best framework would be an industry specific framework and for that purpose the Airports Act already provides a vehicle if that would be needed, and more specifically section 192 of the Airports Act deals with some access issues and could be amended to give effect to this type of arrangement. At its heart the light-handed approach that we'd be advocating if full deregulation was not accepted would be a prices and quality undertaking. It does have some similarities with an access undertaking which is already under Part IIIA and hopefully improved as a result of the concurrent Productivity Commission inquiry. However, as we have put forward, we don't believe that the issues facing airports are the same as vertically integrated industries, where the detail of access is more important. In airports it's really the pricing outcome of access that tends to be the focal point.

PROF SNAPE: You might notice in the draft report or in the position paper it did emphasise that it would apply to both vertically integrated and not integrated.

MR FITZGERALD: One of the issues that we'll have to look through in looking at the position paper of the Commission is the extent that the access undertaking amendments would address some of the concerns that airports have had about the very prescriptive nature and lengthy, costly and uncertain process that access undertaking as currently drafted entails. I think one of the main features of this environment is to try and get through that. The experience of airports in the privatised environment - my understanding is that two of the phase 1 airports attempted the access undertaking route, put significant resources into that approach and came up quite short, and as a result no phase 2 airport even attempted the route. So certainly to suggest that an access undertaking is a viable alternative to regulation at this stage I think is not correct, and something that gives far more certainty and a far more streamlined process that gets to the heart of the issues that face airports I think would be preferable to the generic framework.

In terms of what the price and quality undertaking would contain, our non-definitive list suggests that we'd have a statement of the services covered under the undertaking and that could be as broad or narrow as the airport would suggest, noting in that regard that Part IIIA would potentially perform the fall-back role for services not covered which would otherwise meet the Part IIIA criteria. So we'd have a statement of services, a price path to be maintained over the period covered by the undertaking. The suggestion is that may well be a CPI-X style price path, but there's no reason why another price path can't achieve the same objective. A predetermined price path we believe has the same efficiency implications as any other predetermined price path like a CPI-X regime.

Any arrangements that provide for a move away from the price path in the case of specific investment requirements - this is something that will, if we were to pursue this option, would need to be addressed. We believe there's a degree of consensus amongst airports that the current necessary new investment guidelines are not operating effectively and that for us to continue in a regulatory environment in which every new investment goes through a regulatory process is inefficient. There are number of airports who have expressed in submissions to the ACCC on Sydney Airport's pricing that they were disappointed that Sydney Airport dropped the provisions for an amount of new investment which we'd specified at \$30 million per annum be included in the underlying price. Sydney Airports has dropped that from its draft proposal to its revised draft proposal at the specific request of the airlines and due to some of the concerns expressed by the ACCC that it was inconsistent with their new investment criteria. So we'd certainly moved along that path and we'd certainly be looking to move back along that path under a different regime and believe that has the support of a number of airports.

You then face the issue of investment incentives for larger investments other than the underlying maintenance and upgrade of existing facilities. Two points arise. One is - I think Professor Forsyth raised it earlier this morning - that you would ordinarily expect a price path to cater for increments in capacity. However, that statement I think suggests that your current unit price must be close to the incremental cost of new capacity. I think it's fairly clear in the current airport environment that that is not the case. So for a sort of a constant price path to work and fund new capacity in existing airports I believe suggests a structural increase in price which may or may not be considered desirable. So that issue needs to be worked through, and whether the price path looks towards a glide path towards an incremental unit cost or whether it has a stepped change would be something that I think needs to be thought through but potentially could be left to individual airports to propose as part of a light-handed environment where they'd be putting up a reasonable case for decision.

The other issue is just some significantly lumpy investments that may arise in an unforeseen manner from time to time or unforeseen to the degree of their scope. The requirements for new large aircraft probably falls into that category at the moment. To predict up-front a requirement to invest in new large aircraft facilitation at the moment would run the risk of either significantly overshooting the amount and indeed overshooting the need for capacity or indeed undershooting it, as things as basic as runway and taxiway alignments are yet to be determined. So I think an undertaking would need to provide for that sort of eventuality.

Really at the heart of this pricing and quality undertaking would be some objectively determinable service levels. We can take a number of examples from the existing type of quality indicators. They could perhaps be some static indicators such as simply the availability of facilities by time of day. They could be measured in terms of peak availability and off-peak availability given the crucial nature of peak availability of most services. The percentage of passengers embarking and disembarking through aerobridges means that as your passenger number increases the

expectation is that you add aerobridges, not simply walk-up gates et cetera. You could go then to some statistically robust sort of passenger surveys, where indicators such as cleanliness of amenities may well be considered sufficiently objective to warrant inclusion, standard of signage to guide passengers to gates, those sorts of issues; that would then set an expectation of a quality level.

The undertaking would then have to include a statement of what would happen in the event that the quality measures are not met. The idea would be potentially that in a light-handed environment you'd be given an opportunity to redress the issue first of all, and then if there's a repeated problem with quality or a repeated overperformance of quality, that there would be perhaps a price discount or a price increase that arises from that. That really is at the heart of the quality undertaking. There may be from time to time the need for particular airports to agree with government, certain policy goals and international obligations or other standards that may be relevant for an aviation-specific or an airport-specific regime. It would be the idea that those would be predetermined and pre-agreed with the government and that the other terms and conditions for the use of the facility be included.

The process for actually having this developed and agreed in this suggestion, in our submission, would mirror the type of arrangements that are in place for master planning under the Airports Act and would certainly include a compulsory consultation process. The suggestion is that it would be the relevant minister who oversees the act who would make the final decision, that that minister, being the transport minister, could take advice on the pricing and quality guidelines from the ACCC or the NCCC or a similar body. Certainly the views of customers would be relevant and the responses from the airport to any customer issues raised in consultation prior to an approval. However, it would then be, I believe incumbent perhaps on the minister to make a decision about the balance of interests in approving the undertaking and getting the light-handed environment in place and the certainty and the signals in place rather than rejecting any undertaking and allowing Part IIIA to become the de facto regulation of airport services. I apologise for the length of that but, given it was less developed in the draft you saw, I thought it might be worth going into some detail.

DR BYRON: Thank you very much.

PROF SNAPE: Yes, thank you very much for that. I think that's been helpful, you taking us through that and answering the questions and also for your submission. Thank you for giving it in the draft form. It meant that we could in fact read it ahead of time and, as I say, apologies for any mess-up at our end on that. But that's been very helpful and we thank you for the submission and for your presentation. Unless there is any final statement you wish to make - - -

MR HUSE: No, I don't think we have any final statement but clearly as your process continues we'll be watching it very closely and would wish to participate through the various iterations that will occur over time. We've been very pleased to

have the opportunity to present our submission to you and to discuss it in some depth, so thank you very much.

PROF SNAPE: Thank you. We look forward to those iterations and for now we'll adjourn until 2.15, when Ansett will be making a presentation, then later in the afternoon we'll have the Australian Airports Association. So we adjourn until 2.15.

(Luncheon adjournment)

PROF SNAPE: We will resume our hearing. Ansett Australia are with us and we welcome them. We don't yet have a public submission from Ansett; in fact we don't have a private submission either from Ansett at the moment, but we will expect to be having a public submission fairly soon. As I mentioned before this is a public process and we try to keep the commercial-in-confidence aspects to an absolute minimum so that it can in fact discharge the obligations of our act in having a public inquiry. So we welcome Ansett and we would now ask each of the people representing Ansett if they could all separately identify themselves for the transcript and so the transcribers will know who said what.

MR HARRIS: Thank you very much, I'm Peter Harris, I'm Vice-President Government and International Affairs at Ansett Air New Zealand.

MS FRANKLIN: Helen Franklin, Manager Group Aeronautical Charges.

MS TIVISINI: Giovanna Tivisini, legal counsel.

MR VOSS: Brad Voss, Government and International Specialist.

PROF SNAPE: Good, thank you very much. The microphones are for the transcript only. They're not in fact for amplification. We're working on that and with any luck we'll have it in that form tomorrow but that doesn't help you today, so if you might just keep your voices up so that the people in the back row can hear as well as we can. So who is to lead off - Peter?

MR HARRIS: Perhaps if I could. As I think you mentioned we do have a submission in preparation which we'd like to provide to the Commission in due course but for the purpose of the hearings today, perhaps if I could just take you through a few basic principles that Ansett has in mind in reference to this inquiry. Firstly, we have a strong view that airports do have natural monopoly characteristics and thus some form of regulation in this area is essential. We believe that airports have an opportunity to exercise market power and that opportunity particularly arises because the relatively small size of the overall cost imposed by an airport on an airline potentially enables them to argue, as they have publicly, that the costs that they impose on us are relatively small, can easily be passed on and we really shouldn't worry about that.

We believe that the Government recognised this in 1996 when privatised airports had put in place the CPI-X regime and it was our expectation that that regime would continue through the five years and be examined as per the principles outlined by the Government at the time which I think the Commission is now taking into account. We're also of the view that that same process should apply to Sydney Airport and that seems shrouded in some uncertainty. Thus the relevance of this inquiry to potentially - that area too is an area where we're quite interested and we're a little unsure about what the government actually intends. There are a number of areas of interest that the Commission has brought forward in relation to the Local Airport Ownership Program and to non-regulated airports under CPI-X. I don't

intend to address them in my basic comments here this afternoon but we'd be happy to provide answers if that's what the Commission was interested in in relation to specific queries.

Ansett is a supporter of the CPI-X system. We believe overall it has worked quite well. It has provided some certainty in the immediate post-privatisation period and has given airlines and airports the opportunity to perhaps generate a level of familiarity with negotiation that they didn't have prior to privatisation and which in our view in the longer term is going to be essential. Thus the nature of this review and what might succeed or what might result from it is going to be particularly important from our perspective in guaranteeing that there is some firm basis for airlines and airports to meet and to come to terms on investment which is essential to both their long term economic futures.

We also believe that airports are not in the same form as many of the infrastructure assets that are regulated at the moment and that indeed it's a failure to take into account some of the relevant aspects of airports that has led to specific considerations being put forward in recent times that suggest that the kinds of pricing regulation that is applied to other infrastructure assets can be applied to airports. Airports are clearly multi-product businesses. For example, in our view there are no shops located to the national power grid, thus the national power grid pricing models are not necessarily relevant to the pricing models that might be relevant at airports. Increasingly, if you look at the way airports are developed over the past 10, 15 years, the area of difference between what you might have seen in the 1980s and what you see today in relation to airports is retailing. The runways are basically the same and the facilities in which the airlines are dependent are broadly the same - perhaps of higher quality but broadly the same. What has changed above all else has been the retail revenue raising in both shopping and carparks and property development on and around airports.

Airports as assets share a lot of costs across both aeronautical and non-aeronautical assets. This needs to be taken into account in considering what pricing should apply at airports. We have brought forward in the propositions we prepared and discuss today some of what we consider to be the basic essential elements of an airport pricing and regulatory system. Perhaps if I can go through those now or alternatively you can perhaps - I'm happy to answer questions on that introductory statement.

PROF SNAPE: You can go through them now if you like.

MR HARRIS: Okay. From our perspective, with the regulatory options - we believe either the ACCC or some specialist group charged with arbitrating pricing is essential to maintaining confidence between airport and airline, and the travelling public is dependent on both of them. Thus in our view somebody who has the ability to arbitrate and has sufficient knowledge and information to enable them to do that competently is extremely important. Absent that, under a pricing system where there

is no arbitrator, no individual capable of exercising that power, in our view there's likely to be a substantial fall-down in relationships between airports.

Alternatives to the ACCC that might wish to be considered include specialist pricing regulators or an industry specific pricing regulator, and we note the Commission has in some of its draft reports of recent times looked at that kind of issue.

Alternatively, state pricing tribunals might be considered. The Commonwealth in privatising airports did do so in part on the basis that it expected to see those airports become more closely engaged with the states and regions in which they were active participants and providers of services. We also believe that any system that might develop with a regulator of this kind or alternatively a private arbitrated entity - but nevertheless somebody who's capable of intervening - also needs to be provided with sufficient power by the Government to do that intervention, to undertake that intervention.

So we believe some kind of regulatory support is essential. Examples of how that might apply are not common. There are not a large number of these around the world, thus from our perspective we would see it as quite important that the Commission give consideration to not just what models are currently available, but what models might be generated.

We believe it's important that any arbitrator has the ability to provide a standstill period in which discussion can take place, a period in which pricing will not move. It may also be important for any arbitrator or regulator to be able to provide bounds in which pricing increases or decreases might occur in order to enable some confidence to be developed by the participants in the pricing process at an early point.

Finally we believe that it's extremely important that there be some reporting, some public reporting, of the basis on which prices were determined, that is to allow transparency between individual customers of the airport and the airport itself. I think that's basically what we wanted to put forward.

PROF SNAPE: Thank you very much. Do any of the other Ansett people wish to add to that at this stage? Thank you very much. You're arguing, as the airlines are, that there's natural monopoly and that market power - the opportunity for market power exists. Is there any evidence that you can quote of the actual exercise of market power rather than simply saying that the opportunity exists?

MR HARRIS: I think there are examples of attempts at unilateral provision or implementation of pricing increases on behalf of the airports. We had some examples recently at Sydney of simply advice being given to us that prices were going to rise for assets. However, under the CPI-X system you tend to get control in place. So in part you're asking us to say, has there been an exercise of market power, yet as I did, we expressed confidence in the current system as being some mechanism for ensuring that that market power is under control.

MS FRANKLIN: I think it's possible though to say that at some of the unregulated airports that aren't within the CPI-X regime, you certainly do see that sort of behaviour. We get smaller airports from time to time. We had one example where they wrote to us notifying us of a change in a head tax in June but the change was notified as being effective January prior. Basically it sort of went to the wire with threats of legal action if we didn't pay back to January. You start getting that sort of behaviour with an increase in a head tax being just advised with no basis or justification as to why that increase is necessary or any evidence on what the increase relates to.

PROF SNAPE: Doesn't that happen in markets all the time? I get increased prices all the time without consultation from one supplier or another. It doesn't show exercise of market power.

MR HARRIS: You can choose not to consume those but in these circumstances you can't.

PROF SNAPE: Let's say which facilities at the airport can you choose to consume and which may you not as an airline? Where is the market power?

MR HARRIS: The market power I think relies on all the assets that an airline requires to conduct its business, that is the use of the runways, use of taxiways, use of lighting, use of terminal facilities, baggage handling. It's very difficult to disaggregate any of those and say - - -

PROF SNAPE: You handle your own baggage at Melbourne, I think.

MR HARRIS: But baggage handling systems will need to be in place at airports. If a baggage handling system is put in place by an airport it has the ability to levy a charge for it. We're discussing whether or not they can charge basically what they would choose to charge if the system was unregulated and we would argue they can. We'd argue they have market power. We'd argue that we have no ability to do this unless we actually choose to invest in our own system. The idea of trying to put a new baggage handling system - I had some experience with this at Melbourne Airport, if you wish to pursue it. The idea of putting a new baggage handling system in at Melbourne Airport on behalf of a new entrant, a matter we did consider when I worked for the Government some time ago, was extremely difficult, I'd advise the Commission.

PROF SNAPE: Okay. So let's suppose an airport was charging for aeronautical facilities for an historical reason a price that was well below what was sustainable in the longer term, then would an increase to a sustainable level be regarded as an exercise in monopoly power?

MR HARRIS: No, I think an increase to a sustainable level negotiated with airlines is essential because an airport would require a return to maintain itself in the business.

PROF SNAPE: But there is a problem of negotiating with the airlines, isn't there, when not all the airlines want the same services or the same level of services?

MR HARRIS: That's correct, but in the principles I was putting forward in the latter part of my opening presentation, I did suggest that - and I think I said it a number of times over and over again - confidence between airlines and airports is the most important aspect to be developed in a system here. There must be confidence to enable that negotiation to take place. Then on your point about differentiation or quality required from different customers, as long as there is transparency to say, "This is how I determine the price for customer A and this is how I determine the price for customer B," then you'll get a reasoned level of response, or I would argue you'd get a reasoned level of response. The biggest problem you get right now in the current system is when there is no - - -

PROF SNAPE: We've had it put to us by airports, as we have had it, for example, in the telecoms inquiry, that's not of direct interest to you, but the regulatory system itself is a barrier to forming the type of relationships to which you're referring. But the regulatory system with the arbitrator in the background and always available is in fact the principal barrier to forming the sort of normal commercial relationships to which you're referring.

MR HARRIS: I have no doubt at all that can be the case but it need not be the case and I would argue getting rid of the regulator is not the solution if that just destroys any confidence that there can be a reasoned pricing outcome between the participants. Our arguments are based around that level of confidence. There needs to be a party to which you can go and I would accept that that party needs to be maintained at sufficient arm's length and not able to be drawn in negotiations at every point in the process, such that it becomes a barrier or mechanism to prevent the development of a working relationship. But absent a regulator - and we look at our experience as a group in New Zealand on this - it's extremely difficult to generate that level of confidence.

PROF SNAPE: Again in the telecoms and again from the side of the airports we've had it very strongly put to us that it's the existence of that arbitrator in the background which encourages gaming and encourages the uncooperative behaviour.

MR HARRIS: I would concede that that is always going to be a risk. What I would not concede is that abandonment of the system is enough of a response to that risk. The alternative is to maintain a regulated system and adjust it to deal with that.

PROF SNAPE: Would you contemplate then that a system in which there was, say, monitoring of prices - and we had some discussion of this, this morning, and the

three draft reports that were released last week - there was some discussion of this in two of them.

MR HARRIS: Yes.

PROF SNAPE: That a system in which there was monitoring may in fact be a safeguard - provide the sort of safeguard that you're talking about - and yet encourage reasonable commercial relationships?

MR HARRIS: I think it is plausible to say that at some future point monitoring might do that, but I don't think it's plausible to suggest it now. The reason for that is monitoring, as I understand it, but perhaps a different concept is in mind, but monitoring as I understand it involves - from your draft reports - my understanding of those involved having a knowledge or awareness of what was going on, without any ability to be able to intercede. In my argument, if there is no ability to intercede, there is no real threat from the monitoring. The threat that has got to be there to both sides is, "If you can't come to terms, I'll come to terms for you."

PROF SNAPE: I guess the background threat in the case of the monitoring was that if it is not working then some more heavy-handed form of regulation would come in. After all, it was put forward as part of the regulatory system.

MR HARRIS: Yes.

PROF SNAPE: And, if you like, a halfway house between no regulation and the type of regulation under Part IIIA, so you have in the background the possibility of regulation.

MR HARRIS: Take our New Zealand experience as an example. We have something not dissimilar to that. We have a system that requires some reporting by airports of how they disaggregated their costs and how they went about allocating them to different customers. That reporting was out of sync in New Zealand with the imposition of prices - and I mean imposition of prices - where a consultation process was put in place. Discussions occurred between airlines and airports. Airlines and airports failed to come to terms. Airports imposed pricing increases - very substantial pricing increases - and provided some advice, I think part-way through the process in some cases and after the process in other cases, of how they had disaggregated their costs.

The nature of that system seems to be quite akin to the nature of a system that involves some kind of, as you say, shadow regulation, some kind of monitoring, and implied threat that the Government might do something if things go off the rails. But there seems to be no guarantee in New Zealand's case that the Government will do anything. As I said, I come back to the basic point. I think it's the lack of confidence in the ability to negotiate that's primarily at fault here. If you don't have a system that allows both sides to feel with some confidence that they're going to get a fair exchange at the table, then they will either (a) run off to the regulator if there's a

regulator readily available, attempt to gain the regulator, or alternatively take legal action under sort of common law processes.

In New Zealand we're spending a very large amount of money - and I think this point is quite relevant to the deadweight costs estimations that I notice the Commission took in case of its Part IIIA consideration - we're spending a very large amount of money on legal action in New Zealand, primarily aimed just to guarantee that process is observed. Ie, the only bit of the law that is available to us which we believe hasn't necessarily been observed - we're now going to pursue it through the courts. This doesn't seem to me to do any more than guarantee that we will have a continuing bad relationship between airline and airport, and that the ultimate outcome of that is a court case which says, "Let's remake the process." It doesn't actually get us to the point of having a decided position on charges.

So I'm very unconvinced about the basis of moving from a current regulated system, no matter what particular concerns might exist with it, to a system which simply says, "We'll monitor and oversight, and we might intervene if we think there's a problem, but no guarantees." Why in those circumstances would anybody who has the ability to impose a price, not simply impose the price and dare the Government to respond?

PROF SNAPE: Well, one might say because of the consequences, which may be much less favourable to that party than the - you know, it's the risk of, as far as they were concerned, a very severe penalty.

MR HARRIS: Correct, but - - -

PROF SNAPE: It's the deterrent effect of the death penalty, if you like.

MR HARRIS: But as we sit at the table with them, negotiating, that's where the power lies and we know it. We know the power lies to impose price on the other side of the table. That circumstance doesn't encourage a negotiation. I doubt there's any texts or advice on negotiation which would suggest that people go in with any level of confidence into such a set of circumstances.

PROF SNAPE: The current system does seem in some regards to encourage - or at least we have been told that it encourages gaming, and the problem of getting airlines to agree to additional investment when in fact it might be regarded as harmful to one of those airlines, as at Canberra. Various other examples have been given to us - or we have perceived - where there would seem to be gaming, under the current procedures, which would seem to be quite inefficient, quite wasteful. These would be avoided under your suggested principles?

MR HARRIS: I'm not sure they would be avoided, but I'm not sure they're avoided in the market at large either. The fact is that any participant - - -

PROF SNAPE: No, for the moment I was simply trying to compare the existing situation with your alternative suggestion.

MR HARRIS: I think in the outline of the system that we have in mind that there is a party who arbitrates - who can arbitrate or has the ability to arbitrate - who can extract information and can make sure the outcomes of that process at the end are made transparent and the basis on which they were determined made transparent, who can obtain information to do that. I think that sort of process, that sort of outline will - certainly it won't prevent gaming. I think anyone will try and game any regulated system if they possibly can. I mean, I would always start from the presumption of self-interest. That would apply to both sides, not just to airlines but to airports as well.

Nevertheless, the only solution that I can see is that you come back to a system which has perhaps greater flexibility between the parties at the table, and an encouragement to negotiate between the parties at the table, but with that final ability to go to the arbitrator. As an example of that, it was suggested to me that in the industrial relations system, for example, there have been some private arbitrations which have occurred where you only get to go to the arbitrator when you're prepared to abide by the decision in favour of one side or the other; ie, it's not a compromise. It is just the decision. So you put your final submissions between parties and the arbitrator only has to choose one or the other.

That's a great incentive not to rush off to the arbitrator every five minutes. It's certainly a system that requires people to put a position. If that position at the end of the day is all or nothing, which is the suggestion about for example development or new investment on an airport, if an airline opposes a development and an airport wants a development, it's an all or nothing position. You won't necessarily, under almost any other model, see a very positive outcome from that. But under a model which says, "Well, the arbitrator has only got one choice; it's to accept your position or the other position," perhaps you will. Perhaps you will see that as an incentive for negotiation between the parties.

PROF SNAPE: We gave some consideration to that option in the telecoms draft report, and rejected it for telecoms. But it might be helpful if you could give some further consideration to it in this context, to see whether it proves to be more attractive in this than it did in telecoms. It won't necessarily provide for an efficient price, whereas of course one of the reasons that we were - where it is important that an efficient price be struck, our view in the telecoms one was that would not necessarily be the outcome. Anyway, that was what we thought there. Leaving that on one side, how would your proposals relate to necessary new investment - or investment in general?

MR HARRIS: I don't think I've thought through far enough to be able to give you an answer on that. Necessary new investment, as you know, has got in fact really a very recent history. A set of rules and processes have been developed around it because it was one of the gaps, if you like, in the CPI-X system. There was a

descriptor for how the regulator should determine whether or not something was necessary, but putting that into practice in a way that enabled the participants to agree that the investment was both necessary and effectively priced has only recently developed.

We as an airline have a reasonable level of confidence again in having some kind of system that enables you to determine that. If you were to substitute something for necessary new investment, all I can suggest is that the participants at the table - if the Commission developed a system and the Government implemented it, which had nothing there - would probably revert to what is existing in place and try and improve that between themselves. I only say that on the basis that both airline and airport seemed to need something to deal with the situation, after CPI-X was first brought in. I can't see why they wouldn't need something on a continuing basis.

PROF SNAPE: I suppose one of the options is a much broader-based CPI-X, so it does embrace all investments.

MR HARRIS: Yes, it's a difficult - well, I haven't actually put my mind very much to expanding CPI-X. It seemed to me that the transition was clearly stated as being CPI-X is in place for five years; it covers a specific set of aeronautical charges; those charges have got a productivity reducing element annexed to them. I hadn't looked beyond that, I must say. I had always worked on the basis that, as outlined in the pricing policy document, we would be moving to something that was somewhat more flexible, where behaviour justified that.

DR BYRON: I'd like to come back to your early observation about basically all airports have natural monopoly power. Do you think that that extends to all airports, including the very small, or are there differences in the extent to which airports can exercise this monopoly power that they have? Where and how would one draw the line between those that really need regulation and those that might not?

PROF SNAPE: Could I just emphasise in this that our terms of reference are not confined to the existing regulated airports; that they refer to airports in general.

MR HARRIS: It's hard from my perspective to disentangle, when you get to the smaller airports, what is market power and what is too small to be bothered with. Thus where you get a dictate from a local council-owned airport, for example, which says "raise the price" by a certain amount, you have the choice of fighting it or not fighting it. Under the current system - this is a point that I probably should have brought out earlier - the expectation is the airlines will do that, will act in the public interest if there is a public interest, will oppose an increase if it can't see a justification for it. In some ways you should debate with yourself why an airline would do that, why an airline wouldn't simply pass it on.

You do get that attitude from some of the smaller airports - "just pass it on to the customer" - where he had to increase the price. So I think you can argue in the case of some of the smaller airports, yes, an airline has the ultimate sanction of

saying, "We're going to withdraw services." Whether an airline in any competitive market would choose to do that, I personally doubt, because you lose the traffic to your competitor or competitors and you don't wish to do that. As long as everybody pays the increased head tax then your competitive situation is no worse off. The consumer is somewhat worse off. But the expectation, as I said, seems to be that the airlines would fight that. You must question why airlines would continue to do it.

PROF SNAPE: I guess I was thinking particularly in the sense of say Kendells in New South Wales, where some of the rural airports I believe have fees and charges that are 10, 15, 20 times what you would actually pay when the aircraft lands at Kingsford Smith. That seems to me to be rather strange. It makes me wonder who actually has either locational power or the market power, and it's not obvious that it's Kingsford Smith vis-a-vis Cowra, Orange, Bathurst, Dubbo, Albury, Wagga et cetera.

MR HARRIS: I think I was trying to answer that by saying the incentive is always there for us to - or is currently always there for us to oppose a pricing increase we think is unjustified at a major airport, because there is a system for us to do so. A pricing increase at a minor airport - at some point the airline, being expected to act in the public interest, has got to get to the stage of saying, "Is it worth the trouble? As long as everybody has to pay, is it worth the trouble?" So I think there is a flaw here, if that's what you're drawing attention to. There is a flaw here in the sense that it expects that airlines will act always as the publicly interested party, and yet at the end of the day we're privately interested individuals. I'm not sure why the system should anticipate that we would.

PROF SNAPE: That leads on to the second question that I was going to ask, when you said that the ACCC or some special regulator or arbitrator - it has also been put to us in some of the submissions that the airlines themselves, and their associations - whether it's BARA or whatever - are in a position to very effectively both monitor all the charges of all the airports that they use, and also to influence them, to lead or react to whatever - that the airlines are actually far more informed and far better placed and have the motivation to do that far more thoroughly than any well-intentioned regulator might.

MR HARRIS: I think that the way the system operates at present is that's the expectation of the regulator as well; that to the extent there is information asymmetry - and there's obviously information asymmetry in every regulated system - the inducer of the change, the airport, has a lot of information. We have some information and the regulator probably has less information. The regulator is out there trying to extract it and the expectation is we will provide the alternative side of the argument. As I said, to the extent that the system minimises itself and gives us relatively little reason to believe that that's going to happen, I'm not sure why we would persist in playing that role. What we would spend our time on instead is ensuring that our competitors all pay the same price.

So I can't really answer your question other than answer it with another one, which is a large question in my mind, which is in a sense: if there is no system in

place - and the evidence exists that there are airports in Australia which are effectively unregulated - historically I don't think there has been that much opposition to paying their charges relative to the opposition that's occurred at major airports where a system has enabled the debate to take place and potentially, we would argue, consumers pay less as a result.

PROF SNAPE: I suppose the largest of the unregulated is Cairns. How has Ansett's relationship with Cairns been or with unregulated airports in general?

MS FRANKLIN: I guess we've raised with Cairns on numerous occasions issues about the airport efficiency and the charges at Cairns. We have concerns there's a very large head tax that applies at Cairns. You add the head tax to the amount of charges that Cairns imposes and it's a very costly airport to operate at. We've obviously tried to meet with Cairns, talk to Cairns, over a number of years and have had no real impact.

PROF SNAPE: Other unregulated airports? Mount Isa you go to.

MS FRANKLIN: We got a whole raft of the smaller unregulated airports and to a certain extent, as Peter points out, we do have a focus on them but it's probably a lesser focus. We have some experience of trying to work with unregulated airports and to try and oppose the charges and increased charges. The charges that the smaller airports impose are often in the form of head tax type charges as well as aeronautical charges paid by the airline rather than collected on the ticket, and they seem to think that because it's on the ticket it's an irrelevancy for us, which is not the case. So it's a matter of trying to negotiate with them, but there's no real answer there. We obviously talk to a number of the State Governments as well about the levels of airport charges in their state because some governments are quite interested in the cost of operating to some of their regional ports in particular, and a lot of the regional ports have exceptionally high charges.

PROF SNAPE: The same owners are at Townsville and Mount Isa. One is regulated and the other one is not regulated. It seems in their submission that the relationships have been much easier at Mount Isa than they have been at Townsville.

MS FRANKLIN: I don't recall a proposal to increase prices at Mount Isa in recent times.

PROF SNAPE: I think there was quite a significant investment there, for example, kangaroo-proof fence around the airport, which was apparently negotiated without any great fuss. You obviously have quite an interest in kangaroos not getting caught in your engines, but maybe it was just that there was a strong coincidence of interest in that case, but there was no regulator to go to. So no-one was gone to say, "Okay - - -"

MR HARRIS: My point earlier was, do you consider that to be a desirable outcome? In other words, the fact that an airline would choose to pass on a cost

without scrutiny, is that a desirable outcome? I would argue it probably isn't if you're worried about the public interest, but the expectation is we will act as the public interested party. That was my point earlier: why would we do this if there's no system to do so? The purpose of this inquiry amongst other things is to consider what should be the succeeding system to CPI-X and to argue that - - -

PROF SNAPE: If any.

MR HARRIS: If any, precisely, and to argue that it's desirable that there be no system when the history, as you're pointing out, is that where there is no scrutiny, doesn't seem to me to be a terribly positive one.

PROF SNAPE: In most industries of course there is no scrutiny other than that which is under the general provisions of the Trade Practices Act and so on. What we're talking about is specific provisions or particular provisions for this industry, and so we have to then elicit what's different about this industry that in fact could warrant that and indeed, even more than that, what's different about this industry, as you're arguing it, that it is not even adequate to have the general provisions of the Trade Practices Act, including Part IIIA, as the safeguard.

MR HARRIS: I think, just on the Part IIIA issue, we believe we have access. What we don't necessarily have is a system which enables agreement on what should otherwise be commercially conducted negotiation. The ultimate position that we've tried to adopt for the purposes of this inquiry is that there should be commercially negotiated outcomes between airport and airline, it should be possible to do so. The history is at major airports it has been possible to do so, at minor airports I think frankly people just accept that as long as everybody pays the same amount there's no competitive cost to us and therefore we pass it on. I'm personally not convinced that's a desirable outcome, and I think that the transition from CPI-X should be aimed at a system which encourages commercial negotiation between airline and airport rather than relying totally on a regulator. But the absence of a regulator, the absence of an arbitrator, the absence of somebody with the power to intervene, seems to me to just beg the option of us going just like we do at the minor airports - simply passing on the charges as long as we can be assured that everybody in the market pays the same amount.

I would take issue therefore with the proposition in the Part IIIA inquiry which seemed to suggest that the deadweight costs of allowing that to occur were in some way quite small, and smaller relatively than the deadweight costs that go with a regulated system. I'd be very interested to see the analysis that went behind that. It does suggest to me, for example, that you could extend that argument to make the basic point that it isn't really worth intervening in any antitrust circumstances where it's cheaper not to do so; where it's cheaper to the economy to allow anticompetitive activity, you simply do that. If that's the logic of the argument, it doesn't seem to me to stop at airport pricing; it seems to me to go a long way further into the nature of the systems we're trying to operate where, as I understood it, governments regulated anticompetitive activity not just because of the individual anticompetitive activity of

the firm concerned but because of the general impact it would have on efficiency within the economy if all those that had market power were allowed to exploit it to the full.

PROF SNAPE: I'll let the IIIA report speak for itself on that rather than to pursue it here. In passing you mentioned the possibility of state pricing tribunals. Would you like to elaborate on that?

MR HARRIS: It's not a first preference from our perspective because we'd rather obviously, as a national operating network, a consistency of position between different airports but, as I noted, one of the Government's considerations in privatising airports was to ensure that the airport was better accepted in its local community, became part of its local community, met the State planning laws more effectively. You could consider the option of state pricing tribunals. It's important from our perspective that the other points that I made about the nature of a pricing tribunal are observed, but it could be considered that way.

DR BYRON: At the moment my understanding is that the state pricing tribunal - well, in New South Wales anyway - has only Government-provided services. So there might have to be some adjustments there.

MR HARRIS: Indeed, airports are Commonwealth territory and so applying a state pricing tribunal on Commonwealth territory would be another issue that would be relevant. All we're saying is, we're trying to look at the complete panoply of available parties simply because we believe an available party is necessary. I did express a preference for the ACCC because we know where we stand with the ACCC and because they are generating a background in aviation and airport-related matters, but I'm cognisant of the fact that the sequence of inquiries here does suggest that some consideration is going to be given to potentially looking at other parties. We did want to look at other parties, and I think we would want to ensure that the Commission - in considering where it might go if it's concerned particularly about the nature of regulation as currently conducted - looks at all parties.

DR BYRON: It still seems to me that the system we have at the moment is premised on the notion that airports are natural monopolies, they have the potential to abuse market power, absent a regulatory system they will therefore exercise that and so, in a sense pre-emptively, we put in place a regulatory system, just in case they might be thinking of exercising this market power. You could imagine a different system that says, "You're innocent until you're proven guilty in the sense that you can do what you like, but if you get out line" - and here is the line - "we'll come down on you like the proverbial ton of bricks." That's a very sort of fundamental choice in terms of regulatory framework - whether you're pre-emptive or, if you like, reactionary and say, "We have the regulator, who stands well in the background but only comes in when there is strong, clear prima facie evidence that the market power is actually being abused. But absent that evidence the regulator stays firmly in the background and lets commercial business get on."

MR HARRIS: It is an option as you outline it. I think it's a risk, a substantial risk in my view. As I said, I refer to the experience in New Zealand, where we've had large unilateral price increases imposed on us under such an arrangement. I would also point out that I think you would struggle, frankly, or the Government would struggle, to implement such a system if in the interim it sold Sydney Airport on the basis of a pricing system that someone had purchased - which is what you buy with an airport. You may buy a bunch of assets but in practice you buy a pricing system and if you bought a pricing system which said pretty much, "Zero regulation but if you get out of line we'll come in and regulate you," I suspect that the owners and investors in that airport would very strongly lobby, protest and influence against the Government ever implementing that regulation and we are faced with that set of circumstances right now. You may be privatising under a system which is outlined rather than necessarily implemented and that's, to my mind, a regulatory risk to the participants in the investment process and one they will seek to minimise by getting guarantees from Government on how Government might behave in the future.

PROF SNAPE: I suppose that with the existing privatisations they didn't get any guarantee of that fall.

MR HARRIS: No, in fact under the existing privatisation the pricing policy paper made it quite explicit what would happen. The Government did say the same thing as you've suggested, that it would regulate, but the Government also outlined in far more detail and with far more confidence what would happen with CPI-X if behaviour was good, ie it alluded to positive behaviour leading to the sort of change that is now being considered by the Commission. My view was that was a positive incentive and the kind of incentive which would encourage better working relationships between airports and airlines. Perhaps it hasn't necessarily worked out like that in all cases but that was the intention. Whereas a system which says, "There is no regulation but we might induce some," I can't actually see the incentive other than for somebody to act in advance and say, "Well, gee whiz, I'd rather not see any regulation implemented or imposed upon me in the next five years, 10 years, whatever period I can negotiate." We are dealing in the current circumstances with the possibility that regulation is a tradable commodity.

DR BYRON: Can I try on you the point that I discussed with Professor Forsyth this morning when he basically said that any airport with monopoly power would immediately exercise that in terms of substantially increased prices and while I agree that that's what our theory says, it doesn't seem to be consistent with all the observations that I see, that in many cases the airports seem to be more intent on increasing traffic throughput at existing prices or slightly higher prices rather than double or triple or tenfold increase in prices which is what the textbooks might lead you to think.

MR HARRIS: Yes.

DR BYRON: I was trying to think through why would an airport, which presumably wants to maximise its returns to shareholders, focus more on increasing

the volume of business rather than just sort of attempting to greatly increase prices as quickly as possible?

MR HARRIS: One possible reason is that airports, as I mentioned earlier and what's changed at an airport the last 10, 15, 20 years has been the emphasis on the ability to earn revenue from passengers per se rather than from airlines through carparking and retailing and related activities and an airport may well find that it wouldn't necessarily act to raise prices to the full extent possible if, and it's a large if, a better way of raising that revenue was in fact to gain that from the retailing side. I can't necessarily see where in the pricing system that would occur, although I guess you create some examples if you wanted to look at it. If this is an important area to the Commission I think we might be able to provide some advice on it, but it's not something I want to discuss in detail today.

PROF SNAPE: The distinction you drew between airport infrastructure and other infrastructure was that the airports are a multi-product firm and that is the only distinction that you wish to draw upon?

MR HARRIS: No, there are lots of other distinctions, I'd be happy to reserve my position on any of them. But that for us was a pivotal point.

PROF SNAPE: In terms of regulation, as to why it was required, why it needed regulations separate from the general provisions of the Trade Practices Act, for example.

MR HARRIS: No, I think the point I was trying to make was something which presumed that there might be some form of regulation and that this was an important factor to take into account in structuring that regulation, that it was not simply the same as every other area of infrastructure provision. In this particular case airports are quite complex creatures, and attribution of cost is highly problematic. It's a point made by a number of submitters that I have read to the Commission and it seems to me unarguable, that trying to relate cost directly to price is problematic and whatever regulatory system is put in place should allow that to perhaps be made more flexible or more malleable between the parties and I come back to this basic position of negotiation.

I've used the example with some people in discussions with airports in recent times of airlines being like the anchor tenant in a major shopping centre development where the anchor tenant provides the drawing power, the throughput and the shopping centre earns a lot of its return from the smaller shops that necessarily locate there because of it. In those circumstances, no-one sits down, as I understand it, between Coles Myer and the provider of a shopping mall and says, "Well, your costs are this, so my price is that." Instead they negotiate and they negotiate around, as I understand it, the fact that the shopping centre will be earning substantial revenue from another group of participants drawn to that centre as a result of the location of Coles Myer.

That suggests to me that whatever regulatory system is put in place needs to allow for that commercial negotiation and commercial negotiation itself between the participants at the table needs to recognise that each of them have an interest in revenue from the airport as a whole rather than just simply from that part of the facilities which is provided for their benefit. So I'm getting closer to this single till, multi-till idea, but my logic is again that, to bridge the gap between airport and airline, it has to be done commercially. It has to be done with the recognition that the airport will want to earn an effective rate of return that it can justify to its shareholders on those facilities. I think if there's a bridge between airports and airlines, that's the bridge. Thus if you were having a regulatory system, and I think there is a need for one, it would nevertheless need to take that into account in a way which allowed it to be commercially negotiated between the parties rather than dictated by a regulator.

PROF SNAPE: So to take your point there with the shopping centres generally that is in fact simple commercial negotiation that they take into account. I suppose we've got two steps to be considering in this aspect of it: one is should there be regulation or shouldn't there be. Secondly, if yes, the answer to that is yes, should it simply be of a generic form of Part IIIA or should there be some special - Part IIIA plus Part IV - or should there be some special regulation as there is, for example, for telecoms and in that one we said, "Yes, there should be some but these are the reasons why there should be." We pointed to a couple of very specific to telecom's characteristics, largely relating to history and the ownership of the local loop that said telecom's were different from others and therefore required some specific regulation though pushing generally for a convergence. But nevertheless said, with respect to this, there should be some specifics.

Now, if we come to airports we say, "What are the characteristics that would lead to some specific regulation rather than just drawing on the general regulation?" and as I understand what you're pointing to there as the key feature is the multi-product nature of the airports as a distinguishing feature.

MR HARRIS: Presuming that you have a regulated system a separate argument applies to why - to your first query about why you'd have - - -

PROF SNAPE: Then you'd go over that one and go onto the second step.

MR HARRIS: Yes. In a sense I'm going in the same direction I think you are, which is to say how do you get to a system where the market can effectively, much more than a regulator, determine the outcomes here and I'm suggesting that the bridge is in this very area, that each of the firms concerned need to recognise more, not just that they have an interdependency, I don't think there's been any doubt between them on that, but how that interdependency is expressed in a commercial sense. In a commercial sense I would argue that seems to be the area of opportunity: thus to have a regulatory system which in some sense tries to predetermine that, I think, will always lead to this lack of trust between the participants at the table. Someone will

think they've got an advantage out of the mandated till - if it isn't one kind of till it's another till and here is the structure of the till.

I'm suggesting that you need a system which enables that confidence to develop between the participants on either side of the table without actually dictating the outcome. So it will be useful to see this recognised in the construct of prices rather than running very much, as the system currently does, around a guarantee that this is infrastructure and infrastructure is costed on the following basis and on the basis of that cost we set prices.

PROF SNAPE: I wonder if you could just focus in this on the efficiency questions of this rather than just whose dollar is it.

MR HARRIS: So you're asking us to be public interested again?

PROF SNAPE: No, we're asking for a separation of - one is whose dollar is it, which is one very interesting question and, of course, very interesting for the participants. But, as you say, from a public policy point of view there is a separable question of what are the efficiency consequences of who gets that dollar. So where are the efficiency implications of what we've been discussing?

MR HARRIS: I find it hard to - I mean, I know you can and I've again read a couple of submitters who've tried to break up the different kinds of efficiencies and their version of the impact between them. My solution and the proposition that we're advancing here, the outline of what I think is needed from a regulated perspective, a transition away from the current model but one which provides confidence between the participants at the table, seems to me to potentially enable the sorts of things that have been criticised in some of the submissions for failing to provide absolute efficiency, particularly productive efficiency to be addressed. There seems to be a presumption in the criticisms on productive efficiency from a regulated model that it's a cost-plus regulated model that necessarily must apply and I don't think that's ever been accepted. In fact, I don't think the current CPI-X system really is a cost plus. In terms of the prices that are regulated under the current system, they are just the existing prices however they were set - - -

PROF SNAPE: The question is, I guess, is whether it will inevitably converge to a cost plus.

MR HARRIS: There is evidence obviously as a regulator seeks to provide some certainty to how they've achieved their decisions that they go to cost because it's a more certain object than anything else in the market. But if you go for a system which doesn't necessarily apply that specific requirement, that is the need to go to costs, which emphasises more negotiation between the parties, which requires to have some consideration given to the fact that this is a multi-product firm that's being dealt with and which provides an arbitrator or a party capable of determining the outcome if the parties themselves aren't, but on a basis which provides no incentive for the people to run off to the arbitrator or regulator at every opportunity, then you

do get something closer to an outcome which I think will serve efficiency driven from a demand perspective, from the different demand perspectives of customers as much as from the costs perspective of the supplier.

I mean, again trying to provide a bridge here rather than necessarily presuming that if you have a regulator it will be a cost-plus regulator. I don't think it has to be a cost-plus regulator and I understand the arguments on productive inefficiency in relation to that and I think there is some substance in it. But I don't believe that the system should simply be thrown out on the basis that it necessarily might tend in that direction. I think it would be better to adapt it to enable it to take into account efficiency at all levels, at all economic levels. Perhaps that's an impossible outcome but I'd rather start it from that position than start from the position which says there's no regulation because I go back to that, I look at what's happening in New Zealand and I don't think it's necessarily providing us with a reasonable realistic outcome. By "us" I don't just mean the airlines, I mean those who will have to pay the charge in the end.

PROF SNAPE: For efficient allocation of slots at a congested airport and for efficient allocation of the use of those slots at a congested airport or at congested times?

MR HARRIS: We gave quite a bit of thought to this and it seems to me that to develop a positive allocative efficiency argument in relation to congestion at airports potentially leads you to the position where you don't charge anything for activity on the ground, you merely charge for slots. I'm not sure that if I owned an airport I'd be terribly thrilled with that because they don't own the slots. In other words, the allocative efficiency, the fact that a slot should be allocated to the individual, the user with the highest potential value on that, is a system which is quite dissimilar from the current way we charge for airport access and trying to - in other words you could make a first best case for saying allocative efficiency is served by just charging for slots and we're indifferent to what happens on the ground. I can't see how that provides you with a system which necessarily encourages investment on the ground, so you'd have to find some feedback from the charges for slots to deal with investment. I can't see how you could provide that without necessarily affecting the prices that are currently applied on the ground.

PROF SNAPE: One thing we just ran as a possibility for comment in the issues paper was a two-part charging system, one part of which could be the cost of the ground parts of it - that is the wear and tear on the runway and so on, the use of those facilities which of course as they became congested in terms of apron et cetera and passenger, those charges presumably would go up and provide the incentive for in fact the investment. The other part of the charge that we mentioned, just flying as a possibility, was in fact a charge for a slot which would give you the use of the slot for say a year or five years or 10 years or whatever, according to specification, together with the necessary facilities that go with it and that that would - well, it could be traded, it could be sold. I mean, the ownership of that could go to the airports or the airlines but traded one way or another.

MR HARRIS: Slots can be traded now. Ownership is a wholly problematic proposition because slots are the - the right to plan to perform a movement, not actually the right to perform a movement. So you're not actually buying something that you can guarantee you can use, which is one of the limitations on actually selling them.

PROF SNAPE: Any contract would have to be well designed of course. But that shouldn't be - the human ingenuity which can arrange to get all the parts on time to build a 747 should not be beyond the realms of that ingenuity to arrange a market in slots.

MR HARRIS: I wouldn't underestimate that proposition because the market in slots is a market and a choice between competitors. In other words, if I have the slot to arrive at 8.05 but I'm continuously off slot and impede someone's 8.10 arrival, I will expect the provider of the slot, if I've paid for it, to do something about it. Currently the system doesn't really require that. I would want a guarantee or something which requires performance, not necessarily for my own benefit but to ensure that what I paid for is what I got - premium arrival time. I'm not sure when you introduce the concept of payment that the party charging is going to achieve your allocative efficiency objective unless they're able to meet that. In other words, they could just tax. They could tax quite happily.

PROF SNAPE: Presumably there could be, say, five slots or whatever it is between 8 o'clock and 8.20 and that the contract can be designed like that. I mean, there are various ways in which contracts can be - five slots are sold within that range of time, for example.

MR HARRIS: It's not something to underestimate though because there is some international experience which suggests that if slots are allocated without a guarantee like that and continue to be allocated that eventually you devalue what people have originally - well, in most cases they haven't paid for, there's not too much trading. But that is a very, very important characteristic and one which from previous experience of mine when we looked to try and develop a system which might have actually involved charging for slots, it was very difficult to demonstrate that you could say to a customer, not just, "You're going to get", or, "not get what you paid for" - because customers could deal with that - "but that somebody else won't get a better deal here." Someone else might not have a premium slot, a guarantee, a greater reliability, and to the extent that the party selling the slots is a party commercially driven, there will always be that suspicion. I'm not sure there's going to be a great deal of confidence in a system which enabled that.

So I come back to, if you're considering the allocative efficiency version of slot management, want to provide charging for it, it will necessarily have some impact on how the overall level of charges for access to that airport are determined, to my mind, because in a sense I'll want to know what I'm paying for if I'm paying for this. I want to know not just that I'm paying for the slot, I want to know that I've got the runway,

the terminal, I've got everything else lined up. I can't necessarily see how you can vary the current system to be able to deal readily with that. I'll be very interested to see the propositions as they're put forward.

PROF SNAPE: In terms then of efficient use of scarce resource, then do you see that the current system is in fact working towards that or your alternative scheme would work towards that better or how should in fact efficiently these scarce resources be rationed?

MR HARRIS: Certainly our alternative scheme wasn't aimed in this direction. We've seen slots as being for better or for worse a rationing system designed by the Government to ensure that a certain performance level at the airport is allowed. That performance level at the airport, as I'm sure you'll be well aware, was generated by noise management considerations as much as anything else. Slot management has had a positive knock-on effect in terms of better scheduling practices but that was always I think the subsidiary to ensuring that there was - I'm talking in terms of Sydney Airport here - an 80 per hour limitation; that was driven from noise management perspectives. We therefore haven't gone to that issue from the point of view of could or should we vary the slot system. Our alternative scheme is aimed at rather the successor arrangements to CPI-X.

PROF SNAPE: I guess we're trying to think around the various dimensions of efficiency in terms of an airport, both in terms of a supply of airport services but also in the efficient allocation of the demand for those airport services. So we're trying to think around both aspects of it; the efficiency is of many dimensions. We are trying to highlight or to focus our minds on those efficiency questions as an issue, and to separate it as much as possible in our analysis from the distributional questions.

MR HARRIS: Yes. Currently I can't see that that slot management at Sydney Airport is causing such difficulty that you could argue allocative efficiency isn't being served. I'm not aware of too many occasions where you can't obtain slots. I know that they're going to emerge and they are emerging at the moment but again, as I understand it, internationally tradable - trading in slots can occur. As I understand the current Australian regulations, trading in slots can occur. So you can have a market, you can therefore have a second-best system of allocative efficiency under the current system. I can't necessarily see the problem is so immense that you'd want to go to a first best system of some kind of removal of slots and enforce charging for them, and in part if you don't vary the charges on the ground that's just going to be an increased cost to consumers.

You may argue that that charge will apply to the people who want to operate at the times for the highest values for slot purchases, but there's no guarantee that that will be put in place, again between operators that share both peak and non-peak slots, for example. They may just choose to spread the charge over all parties. There's no guarantee that you'll actually spread the allocative efficiency judgment from the airline to the consumer. So I'm not sure that the problem is so immense that this is really worth dealing with.

PROF SNAPE: The point was made to us this morning that in the peak morning time at Sydney Airport - and I'm not speaking within the ring fence, I'm talking about outside the ring fence - that there are an extraordinary number of planes, small planes, plying their trade between Canberra and Sydney and moreover it was said that that is well known to be a way of parking slots and that route is the way in fact of maintaining control of slots by running a whole lot of small planes just in case those slots would be needed for another purpose later on. That, if true, would seem to be a very inefficient use of a scarce resource. Would you like to comment?

MR HARRIS: That's not one that is going to be resolved in any different way by applying a direct pricing system versus an indirect pricing system. I mean, presuming what you say is true - and I must say I don't see any evidence for it myself as a former Canberra consumer but there you go - ultimately they are being parked either to be used or disposed of. If they're going to be disposed of via an informal market system - which, as I said, is available if people wish to use it, as I understand it - a price will be provided, some kind of price whether it's cash or not, and slots will change hands and move to high value users. As I said, it's an option right now.

The question is, is the problem so large that in some way that can't occur. If there was no tradability, if there was a regulation saying you can't trade, even under the table, that swaps can't occur and trades can't occur, I think you'd have a greater chance of making a case that there needs to be some kind of market allocation over time. But in the absence of that I can't see why it's a problem. Even if slots are being parked, if someone wants those slots, no slots are being parked, goes and makes an offer under the table to the individual concerned and says, "I'll take these slots off you for a large amount of money."

PROF SNAPE: Yes. I suppose the implicit assumption in this case was that the possession of slots by an airline at those times in Sydney gives it some form of monopoly power, because of grandfathering and because of "use it or lose it" et cetera and that gives them monopoly power over slots which they can then use - and this was the example given - that the retention of that power would in fact mean that Virgin Blue doesn't have a slot at that time between Sydney and Melbourne.

MR HARRIS: If Virgin Blue wants to buy that slot it pays the price under either model to the Government or it pays it to a participant in the market. From an allocative efficiency point of view, if you're just looking at that, "is this slot going to the highest value user or not", it's occurring under either model. You can argue that the rents shouldn't go to a particular participant, that's a moral judgment and I'm happy for people to make that argument if they want to, but a system is in place and in a sense it's a bit sterile.

PROF SNAPE: Are you telling us that they are in fact readily traded?

MR HARRIS: I know that they are readily traded overseas and I also am firmly of the view that there is no impediment in the Australian system to enable them to be

traded. Thus all the argument comes down to here is for what period are they sat upon - someone who presumably isn't making very effective use of them. If they're running between Sydney and Canberra in some higher than optimal frequency level then they're obviously making less than they should be making with these slots. One presumes if people are behaving rationally in the market and if someone comes along and makes an offer they'll sell them off. If they don't sell them off, perhaps there is some better case for that but right now we've had a 40 per cent increase in traffic and therefore a very substantial increase in slot utilisation in peak and off-peak hours into Sydney airport, and it has occurred without this trading system.

PROF SNAPE: Are there any examples of trading congested slots in Australia?

MR HARRIS: I'm not personally aware of any examples that are being traded but you wouldn't need to know, if you know what I mean, they may occur anyway. I'm aware of airlines offering slots for sale.

PROF SNAPE: In Australia?

MR HARRIS: In Australia.

PROF SNAPE: At congested times?

MR HARRIS: Yes.

PROF SNAPE: I think I'm getting near the end of my list, if not at the end of it.

DR BYRON: I've got a very small point. We've discussed quite a lot about, because of the small proportion of the total fare that even a doubling of a landing charge at a relatively small airport is unlikely to alter the airlines' behaviour in terms of routes, frequencies, gauge et cetera. Is the converse also true in halving or 100 per cent discount on landing charges also has very little impact on behaviour? You're not going to fly somewhere because the landing charges are free if there isn't the passenger traffic to justify it?

MR HARRIS: I think in principle you're quite right. I have seen that airports have - I'm sure they can provide advice to you on this - offered introductory or supportive arrangements of that kind. I'm personally not aware of any examples where I would have thought behaviour had changed as a result of that discount. It's more in the nature of the last positive step, if you like, in establishing a new service. I think you're probably right with that comment.

DR BYRON: I am thinking of Adelaide in particular trying to line up new international routes and so on and if it's true that the landing charges are only a very small proportion of the total cost of flying a route, even if they give it away for three years, it's unlikely to make an unprofitable route attractive. I also note that some of the smaller country towns in New South Wales have zero landing charges for their

RPT because they think that's going to bring a great deal of business to their local economy but it sounds like that's wishful thinking too.

MR HARRIS: Honestly, it is quite difficult to separate this because it's the difference between rationality and human behaviour and there are differences. I think if someone offers you an incentive, no matter how small, you're probably more prepared to consider the alternative benefits that are also raised, so there is something in that. It's like all marketing, all advertising. Probably not much more than the equivalent of marketing or advertising, but it's got a cash number attached to it. It may have some attracting benefit but I think the principle is quite correct. At the end of the day if you halve the charge or if you double the charge, particularly in a system where there's no regulation, I come back to the proposition why would the airline take the publicly interested stance? It just involves itself in expense and irritation. As long as everybody is paying the same charge behaviour is logical to pass it on. So I think the principle that you're advancing is probably correct.

DR BYRON: I'm not sure if that gets us anywhere but thanks.

PROF SNAPE: You have considerable experience in managing domestic airport terminals, at least Ansett has. Does Ansett see any difference in the efficiency with which you run your own terminals or with Qantas' running their own terminals, that is your own managed terminals, as compared with common usage terminals? I realise that the common use terminals are generally international ones so one is comparing across unlikes to a certain extent but nevertheless, have you any comment on that?

MR HARRIS: Yes, perhaps we could come back to you with something on that. We're not aware at the table of anything specific that might help at this point.

PROF SNAPE: Okay. Thank you very much and we look forward to getting the submission and digesting it further and if there are any other points on which you would like to comment then please send additional supplementary submissions, perhaps after you've had sufficient time to digest those three draft reports last week and any of the implications of those for what you were proposing, then that would be helpful. Thank you very much, unless there's any final statement you'd like to make?

MR HARRIS: No, thank you.

PROF SNAPE: Thank you very much and we will now have a short break and resume at 4.15 when we will be having Australian Airports Association.

PROF SNAPE: Well, let's resume and we welcome the Australian Airports Association and we thank you for your submission. We would now invite each of you to identify yourselves for the transcript and then whoever is to speak for you to speak to your submission. Thank you very much.

MR KEECH: Thank you very much, Prof Snape. I am Ken Keech and I am the CEO of the Australian Airports Association.

MR FORREST: Bill Forrest, consultant to the Australian Airports Association.

MR SKEHILL: Stephen Skehill, special counsel Mallesons Stephen Jaques, solicitor to the association.

MR RYNNE: Brendan Rynne, consultant at KPMG, adviser to the Australian Airports Association.

PROF SNAPE: Thank you very much. Ken, are you going to speak to the - - -

MR KEECH: I will, thank you very much, Professor. Again, on behalf of the Association we thank the Commission and their staff for the opportunity to be here to present today. We have provided you with a submission and it's nice to see that on one occasion, this particular time, the association actually got its submission in on time, unlike some of the other presenters.

PROF SNAPE: Thank you very much for that and also for making it nice and short.

MR KEECH: We figured that if we went to 89 pages it might be a little too long, but we did make it essentially very short because we felt that in your issues paper you identified three particularly common areas of concern which need to be addressed, particularly from the Association's point of view. I might also add, Professor, that we're speaking on behalf of our membership in general. Our submission and the comments today are essentially overarching comments on the basis that each individual airport will be making a presentation to you and will be slanting those particular presentations to local issues and in some issues perhaps local war stories.

PROF SNAPE: I hope not all of your 240 members are making submissions.

MR KEECH: No, they're not. I might also add that the three gentlemen here aren't really ventriloquist's dummies. They are here to contribute and also to be part of the discussions that we hope will take place. A couple of things I might like to just start with. Professor, you raised the issue earlier about baggage handling at some of the privatised airports, and again that raises the issue of the domestic terminal leases. I'm not sure that you might want to talk about that, but in terms of anchor tenants that does have an impact on the domestic terminal leases that still have quite some time to go, and within those domestic terminal leases the airlines do have direct control over their own services levels and also over their baggage systems, so you were quite

right. I also just want to pick up a point that was raised earlier with regard to rural and regional airports. It's a subject, as you can appreciate, with so many members that are out there representing the rural and regional communities of Australia that it's very dear to my heart. The example that was presented to you earlier was a true example from an airport in Western Australia. I might add that what was neglected to comment upon was at the time that those charges were increased the carrier concerned was in arrears of over 120 days with paying their bills. So one needs to put things into perspective. If you have any further queries with regard to issues for rural and regional airports - you raised the issue of Townsville particularly, where they spent a lot of money putting up a kangaroo - - -

PROF SNAPE: Mount Isa.

MR KEECH: Mount Isa, sorry. There are a number of other regional or rural airports that have had to face for small communities not insignificant amounts of money to manage, if you like, the wildlife issues on their airports, but we won't get into that today unless you have some specific queries. I think that, as I said, our submission, as brief as it is, covers what we consider to be the main, overarching issues. Having said that, I would welcome any questions that you or Dr Byron might wish to address.

PROF SNAPE: Thanks very much for that, Mr Keech. Would any of your other representatives like to speak as well?

MR SKEHILL: Can I just raise a couple of things in the interests of getting them off the table. Your first presenter this morning, when asked whether there had been any evidence of exercise of market power, suggested that the action of some airports in introducing fuel throughput fees and taxi fees were examples of use of market power. I'd suggest to you that you might like to take this up with individual member airports as they appear before you, particularly those that have those fees, but I think what they'll say to you is this: that in the case of fuel throughput fees they didn't exercise market power; they exercised a contractual right that had been negotiated by the FAC and for which they had paid a sum of money in purchasing their airport. They were exercising a contractual right, not market power.

In relation to taxi fees, I think they'll say to you that they were responding to statements made by the Commonwealth in the sale documents when they suggested that an area in which potential purchasers could gain revenue was to introduce charges for people who transact business at the airport but don't currently pay a fee and that in doing that they were not exercising market power. Just in case those matters aren't subsequently raised, I think it's important to put those matters on the record at this stage.

PROF SNAPE: Thanks very much, Mr Skehill, for that. In your submission you do concede that airports have some characteristics that suggest the existence of market power, but you suggest that there are a number of factors which mitigate this theoretical market power and, most importantly, you mention the countervailing

power of airlines. You mention problems of new investment at Melbourne, Adelaide and Brisbane airports as examples of the airlines exercising countervailing power. But those examples are in the context of the regulatory system in which they are able to use the regulatory system, as you argue that they use the regulatory system, particularly through the new investment criteria et cetera. So that's not in the context of a deregulated system, and what we're interested in exploring is the countervailing power in the context of no regulation rather than using the regulation to exercise countervailing power. Do you consider that they have credible countervailing power in the absence of a current regulatory system?

MR RYNNE: Certainly some previous submissions today have indicated that, additional to the current regulatory framework, market power by airlines is also held with respect to a couple of issues: firstly, their political strength and the size of their business relative to the size of the airports' businesses, that they're able to utilise those political links to push through and highlight issues that they come across when dealing with the airports; so there's that perspective.

PROF SNAPE: So political; we've got through the regulatory system; we've got a political one. Any others, any that are if you like outside of the government sphere?

MR SKEHILL: They certainly have the capacity to take a deal of their business elsewhere in their location of facilities and services that are not mere landing and take-off - the location of maintenance facilities and non-essential at-site services of that nature - and they having that power have, I would suggest, a significant negotiating capacity with an individual airport. There was, I think, widely reported significant competition between various airports to attract the headquarters of Virgin, the location of Impulse's heavy maintenance, and most recently some of Qantas' maintenance that went to Brisbane. I think the power that derives from that capacity to locate differentially should not be overlooked.

PROF SNAPE: Are there any examples that you know of in which that power to locate maintenance facilities elsewhere, or similar facilities that they could locate elsewhere, is being used to lever aeronautical charges, for example?

MR SKEHILL: Not that I'm personally aware of, and I suspect that's something that you'd need to put to individual airports. But I suspect that the absence of any examples simply says that the existing regulatory regime for pricing provides enough gaming opportunities without having to use another one.

PROF SNAPE: What about at non-regulated airports?

MR SKEHILL: I don't know whether Ken is aware of any?

MR KEECH: Not really, no.

MR FORREST: There was a comment made this morning of the very different sizes of the corporations involved with the large airlines and the airports, and I think

that's something that's often overlooked. One of those comments that was made Ken just mentioned earlier: airlines' refusal to pay increases in charges at unregulated airports; that's quite a common feature. In fact, it's a concern to the AAA for all sorts of things, that that is a power: if they just don't like it, they don't pay.

MR KEECH: That does happen, I might add also, at regulated airports from time to time for one reason or another. Whether it's just posturing on behalf of the airline or not is another issue, but it has happened at regulated airports where - - -

PROF SNAPE: You don't threaten to impound an aircraft or two?

MR KEECH: My personal view would be that that's something that ought to be looked at, but on this occasion it wasn't.

MR RYNNE: There has to be the legal right to impound an aircraft, and mostly that legal right to impound an aircraft will come through a condition of use agreement. The majority of the airports, as I understand it, are either finalising or have in place a condition of use agreement that gives them the right to impound an aircraft, but I understand some airports are looking at that option in condition of use agreements.

MR KEECH: A lot of the regulated airports have pursued a conditions of use document but they are having difficulty in getting some of the airlines to come to the party to actually sign it. That might be a question that perhaps could be addressed to each individual airport if they so wish to advise you accordingly.

PROF SNAPE: So that's not something that the Association itself is pursuing?

MR KEECH: We are pursuing it but it's something that's not going to happen overnight. But it is a concern for airports of all shapes and sizes.

PROF SNAPE: Yes, because I'd have thought that, as you say, it was something which may concern all airports and not just one or two of them. We may hear more of that sometime.

DR BYRON: We have to anticipate, at least hypothetically, a deregulated future. What would you expect would happen to aeronautical charges if the current price cap was removed? I'm thinking in terms of both levels and structures of fees, and I guess I'm asking you to speculate on how you think airlines might react if that involved higher landing charges.

MR KEECH: I'm sure there are some differing views here, but one would expect that commercial commonsense would play a role in this particular exercise. But experience to date over the last three years would suggest that perhaps that's going to be difficult to achieve.

PROF SNAPE: The regulation itself - the regulatory framework - provides a barrier to normal commercial relationships.

MR KEECH: I think it has created a five-year window of opportunity, if you like, for the airlines to keep a very tight rein and provided them with a process where they can keep a lid on their aeronautical charges. They have pursued that particular course of action with a great degree of enthusiasm which I think you will find out from some interesting case studies during the next two or three days with the individual airports.

MR SKEHILL: I think it's quite clear that the existing regime has provided a barrier to the development of normal arm's length commercial relationships. It provides two very powerful incentives to do otherwise; firstly, to the extent that you can delay new investment that's necessary for new start-up entrants, why would you hasten to agree; secondly, to the extent that you can defer the incident of a price increase, why would you hasten to agree? The current regime is epitomised by the fact that the regulator is a port of first call, not a port of last call. Everything has to be endorsed by the regulator and if only for the reason of delay it's worthwhile engendering delay.

If there is to be a continuing regulation - and I think it's explicit in what Ansett itself said this afternoon - the regulator ought be a last resort. It was a clear plank of the Government's policy objectives to encourage the development of mature commercial relationships between airlines and airports. I think it's clear that that hasn't happened. To some extent it's understandable it hasn't happened because the commercial reasons for failing to reach agreement are just so strong.

DR BYRON: So the current regulatory framework is actually impeded attaining that government goal?

MR SKEHILL: Yes, and I think the real challenge for the Commission, given the position that you've taken in the draft report on the PSA and assuming that you see a continuing role for Part IIIA in relation to airports is to avoid the ACCC wearing its Part IIIA hat being simply a pricing regulator of first instance. By that I mean the incentive in that regime will be to constantly notify disputes so that the introduction of new charges is delayed or potentially so that the construction of new investment is delayed. It's necessary, in that context, for the ACCC to have a power and, as it were, a legislative mandate to say to the parties, "We're not intervening until you have negotiated this as far as you possibly can." In that respect there's some quite significant differences between Part IIIA and Part XIC that are pointed out in the Sydney Airport submission to you. I think, as I say, if Part IIIA is continue to have a role, changes of that nature will be vital to make sure that we don't just swap one set of gaming for another set of gaming.

MR FORREST: There's an interesting example that you have I think in the submission that Townsville and Mount Isa Airports have made being under the same management. They make it quite clear that one is regulated and one is unregulated and they don't seem to have trouble reaching those commercial decisions on the unregulated airport.

PROF SNAPE: Ansett, of course, were suggesting that that's because it's a much smaller airport. They gave the impression that probably one accepted things more readily at small airports.

MR KEECH: I might also add that if they were to be completely honest they would also tell you that it's probably one of their most profitable routes as well, which might have something to do with commercial attitudes.

PROF SNAPE: Have you given any consideration to what we've discussed with other participants today and that was the monitoring, rather than the regulation option which we have mentioned in the Price Surveillance and Part IIIA reports, as I said as an option on the one hand to access and not going the whole hog onto declaration; on the other, in fact of, coming back from declaration to halfway to complete deregulation.

MR SKEHILL: It seems to me that it's clear that if someone is looking over your shoulder and threatening to do something to you that you don't want done to you, it does condition your behaviour. I think each of the people that have addressed this to you today really have in one way or another acknowledged that monitoring with a threat of reregulation would act as a real constraint, that the threat of reregulation is in fact a form of regulation. There's been slight differences I think in what's been put to you, such as, "Well, the threat is only effective if one knows what is likely to be visited upon the misbehaving." But I think it would be very easy for that threat to be quite real. I suspect if you said to the currently regulated airports, "We'll remove the existing regulation but we'll reimpose exactly the same thing if we perceive that you are abusing market power," that would be a very powerful tool because they feel so strongly about the existing regulation and that it is inhibiting their businesses.

It's not inhibiting their abuse of market power, it is inhibiting their capacity to run their businesses for the advantage of some at least of their customers and for their shareholders in terms of ordinary commercial returns and in that sense for the public benefit. So I think monitoring and the threat of reregulation are very real incentives.

MR FORREST: Provided it doesn't end up being a de facto price control. It depends upon the system, I think.

MR RYNNE: It depends upon any price monitoring system what's actually going to be the trigger for reregulation. I suppose the experiences with the ACCC so far, I'd say most airports would agree that, whatever these triggers are, they mustn't be able to be misinterpreted such that any body that could reregulate an airport decides upon itself to interpret policy the way that it wishes to interpret policy, so it must be very explicit.

PROF SNAPE: But with explicit criteria you would prefer it to current regulation. You say that if some form of regulation is required your preferred option is to have it airport specific and designed to recognise both the particular dynamics of the airport-airline relationship and the rest of the airport regulatory structure. In these

circumstances which airports would you see as to be the most likely to need regulation?

MR KEECH: I would reluctantly answer that question - - -

PROF SNAPE: I can understand.

MR KEECH: Yes, because - - -

PROF SNAPE: If you are going to have some parts of your body cut off you might specify them.

MR KEECH: That's exactly right. There are a number of - the process to date doesn't seem to have given account to the operational requirements of the regulated airports. The example, I suppose, is Townsville and Mount Isa: both are privatised; both have differing demands upon them. What's appropriate for Townsville certainly may not necessarily be appropriate for Canberra or Adelaide. In the past there's been the Phase I which is the Perth, Melbourne and Brisbane airports. I mean, you've had Phase II, and there's been some inconsistency and we just think perhaps, without me being specific, that that is an issue that does need to be looked at.

DR BYRON: There is a very significant difference or a number of very significant differences between the Phase Is in Sydney on one hand and all the Phase II airports, although the differences between the Phase II and all other airports is probably a bit more subtle.

MR KEECH: Yes, I agree with that.

DR BYRON: When we were talking about Part IIIA, for example, I wonder whether Townsville or Hobart, let alone Kalgoorlie, would pass the test for national significance and materiality to be subject to that. I can imagine that Sydney might but I don't think some of the smaller airports would. So presumably there's going to be a line drawn there somewhere but I don't know where.

MR KEECH: When you look at the smaller airports - and Townsville is an example - I mean, if you were speak to the Department of Defence they would say that that particular airport is of national significance. You look at Newcastle and you say, "Well, Newcastle is a stone's throw away from Sydney," but again if you talked to the Department of Defence, they would say that's an airport that's of national significance, the same with Darwin. Alice Springs could be seen by the Department of Defence, given the relationship with the US, as being of national significance; that's, I guess, part of what I'm saying that there's a bit of inconsistency here.

DR BYRON: The difference between Cairns and Townsville, in terms of one being subjected to three or four different forms of regulation and Cairns not being subjected to most of them anyway, when they're relatively similar and relatively close by in the larger scheme of things. Again there are a few anomalies like that that stick out.

MR KEECH: There are and in the industry we refer to them as the joint user airports which have a commercial component and also a Department of Defence component. Katherine is another one in the Northern Territory.

DR BYRON: Even Launceston, would it be difficult to argue in the presence of - when you add in Devonport, that Launceston has such great monopoly power that it needs to be subjected to the same treatment as Canberra or Adelaide.

MR KEECH: No, it doesn't.

MR SKEHILL: I think it's clear that there are inconsistencies, that somewhere along the spectrum there's a line that should be drawn. I don't know that it's for us to seek to tell you where to draw that line as an association but quite clearly - I think it's quite clear that there are airports that are currently affected by section 192 that would not meet the Part IIIA test. If that was to be the rule of it that you were to use for whether an airport is inside or outside the regulatory regime that goes beyond say Part IV then it's not been appropriately applied at this stage. So there's an important point I think for the Commission to ascertain if there is to be continuing price regulation, which airports it applies to and whether it applies in a graduated way, airport by airport, having regard to inherent characteristics.

DR BYRON: Just turning to the subject of new investment at airports, it seems to me that our terms of reference cover a number of elements of that. Who decides on what new investments are made and when? There's the question of who pays for it and there's the question of how do you decide how much each party pays towards these new investments. I think a lot of the arguments and the debates and a lot of the material in the submissions is coming down to that. In terms of who pays for it, I think it has to be taxpayers, passengers or either shareholders in airports or shareholders in airlines. The distributional mix of that doesn't bother me a great deal, although it obviously bothers the parties concerned, but it seems to me that our current regulatory framework is not very adept at that first question of how do you decide what new investments should proceed and when. It may well be that the way that price signals are in some ways modified and distorted is part of what's holding up that process of sorting out investment.

MR FORREST: And I think there is a complication here at the moment with the new entrants. I mean, there are competitive aspects that affect behaviour that I think are upsetting that process, and when you combine that with the long-term leases to Qantas and Ansett you've got some inputs there that are complicating the regulatory process.

DR BYRON: It seems to me that part of the regulatory process is a bit schizophrenic. There are measures to try and force airports to make necessary investments but other measures to try and stop them from making excessive investments, and what Impulse told us in Sydney last week was that their problem was with having airports make enough investments rather than the fact that airports

were inclined to make excessive investments. That's their particular experience, no doubt, and it's not common to all.

MR FORREST: I think most airports have said that they want to expand their businesses and they're looking for opportunities. Unless you're constrained in some way, it makes good sense for an airport to do that, and the only risk to a third party or an airline that's using it would be that you're gold-plating it or something that's making it more expensive than it needs to be.

MR KEECH: I think one of the things that you'll find will be a common thread when the individual airports make their presentations to you is that there is going to be a reluctance to even consider what's been previously termed as necessary new investment, and each of them in their own way will qualify exactly the reasons why. My personal view, for what it's worth, is that the process, if you like, has encouraged the incumbent airlines to frustrate the process for commercial reasons. I understand the reasons why. I can understand it, but it is frustrating for the airports and certainly is an inhibitor for any likely new entrant airlines, particularly if they wish to expand their services.

MR FORREST: And it's not simply a matter of terminals and the obvious infrastructure that you might deal with. There have been issues with improving taxiways and access to runways and things to speed up aircraft movements in particular parts of the airport, and to impede this process it can be used right across the range of infrastructure that the airport is putting in.

DR BYRON: The consultative mechanism that seems to be required may almost give each airline a power of veto on a proposed new investment and, given that even if all four airlines gain, if one gains disproportionately more or less than the others, the one who gains relatively least would have an incentive to exercise their veto on any new investment. Is that possible?

MR KEECH: That's a very accurate summary, actually.

MR SKEHILL: That's essentially what happens.

MR KEECH: That's what's happening right now.

MR FORREST: And it was admitted by Ansett, I think, this afternoon, where there is no competitive advantage in that process they agree quite readily because they pass it on. It's got no competitive impact on the airlines concerned.

PROF SNAPE: I'm not sure if you can speak about the leases at all but, if you can, what are the provisions in the leases with respect to access, and do these provisions make Part IIIA irrelevant?

MR KEECH: I honestly don't know the answer to that.

MR SKEHILL: You mean the government leases of the airports to the airport operators?

PROF SNAPE: Yes, the leases which they've purchased.

MR SKEHILL: I think the leases - and I'm going from memory - probably go no more than requiring that the airport be used as an airport, which inherently implies that you're going to give access to somebody but I don't think requires - - -

PROF SNAPE: The question is of course denial of access.

MR FORREST: Are you talking domestic terminal leasing or - - -

PROF SNAPE: Yes.

MR FORREST: Not the airport lease, the domestic terminal?

PROF SNAPE: No, not the terminal leases. I'm talking about the airport leases.

MR FORREST: Because there's an access regime in the domestic terminal leases as well.

MR RYNNE: It explicitly excludes contracts, so the domestic terminal is outside - - -

PROF SNAPE: No, I'm talking about the leases of the airport.

MR SKEHILL: Maybe I can take some advice on that and give you an answer later.

PROF SNAPE: Good, yes. If we're talking about Part IIIA, for example, if in fact that is already covered in the leases, I know that you can't deny an aircraft that it will land but you might be able to not allow it to take off. Perhaps you can get back on that one.

DR BYRON: Just on Part IIIA and section 192, am I right in understanding that the criteria for application of 192 are actually different to Part IIIA?

MR FORREST: Yes.

MR RYNNE: Part IIIA requires the economic significance test. There's no such test in 192.

DR BYRON: And the declaration?

MR FORREST: Yes.

DR BYRON: There are differences not only in declaration but also in coverage and treatment. So 192 of the Airports Act isn't really just a direct copy of IIIA; it has a whole series of special modifications or adaptations. I guess what I'm trying to get to is whether you feel those are necessary, useful, helpful or the opposite, that it would be better to get rid of section 192 and keep IIIA or vice versa, or whether section 192 needs to be amended so that it basically complies with the general template of Part III A.

MR FORREST: We've recommended that 192 be amended in two respects, and one is to limit it to the airports that reasonably meet the national significance criteria and whatever and the other one is to limit it to a specific listing of airport services. So we've recommended that it be brought into line with Part IIIA rather than - - -

DR BYRON: In both coverage and application?

MR FORREST: Yes.

MR SKEHILL: The first preference is that there be no 192, but that if you think of it as a series of fall-back positions, before you get to amending 192 you need to consider the question of whether there ought be 192 at all or whether if you're going to have the potential for a Part IIIA application it should be a Part IIIA application in its ordinary right.

MR SKEHILL: I think I can tell you a little bit about airport leases.

PROF SNAPE: You've been taking advice?

MR SKEHILL: There is a requirement in the lease and I think it's common in all the leases, certainly the ones I've seen, that you operate the airport as an airport and that you not deny access to interstate and international traffic save in, I think, two circumstances and the collective wisdom could only remember one of those two, and that's non-payment of outstanding fees that are legally payable. I think there is another circumstance. Having said that, I think it has to be said that it's a regime that requires that access be given but it's not a regime that provides a mechanism for the determination of terms and conditions. It works on the assumption of commercial negotiation, hopefully.

PROF SNAPE: Okay. It's access but without, as you say, the terms and conditions and, if it were left to IIIA that's what it would add.

MR SKEHILL: Yes.

PROF SNAPE: I think we've had a very clear submission and exposition of it and your points are quite clear there. So thank you very much for that, unless there is anything you would like to add at this stage.

MR KEECH: No, nothing more other than to again reiterate our thanks for the opportunity to present to the Commission.

PROF SNAPE: Thank you very much for that from the Australian Airports Association. As I said at the beginning of today's proceedings, I would then invite anyone who is present to make an unscheduled presentation if they should wish to do so. I don't get any takers, so in that case I will say thank you very much and we'll close today's proceedings and we shall be resuming tomorrow in the same place at 9 o'clock, when we'll be starting off with Melbourne Airport followed by Adelaide Airport, followed by Brisbane Airport, followed by BARA, followed by the MTAA industry superannuation - and, of course, they've invested in a couple of other airports - and then Qantas. So it's airports and a couple of airlines.

MR KEECH: Have a nice day.

PROF SNAPE: So we'll close today we'll resume tomorrow morning, 9 o'clock. Thank you very much.

AT 5 PM THE INQUIRY WAS ADJOURNED UNTIL
TUESDAY, 3 APRIL 2001

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