Brisbane Airport Corporation Ltd

Submission to the Productivity Commission

Price Regulation of Airport Services

March 2001

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1 Executive summary

Brisbane Airport Corporation Ltd (BAC) defines market power is the actual ability of a firm (or group of firms) to raise and maintain prices above the level that would prevail under competition, resulting in reduced output and loss of economic welfare. The extent to which airports do possess market power, this will depend upon the degree to which they possess (natural) monopoly attributes, being:

- Barriers to entry;
- Substitutability between air transport and other transport modes; and
- Existence of economies of scale and scope.

BAC notes however, that the mere existence of these attributes does not necessarily indicate that airports have the actual ability to raise and maintain prices above the competitive price level. Further, BAC contend that there is little scope for airports to abuse their theoretical market power, and there is no evidence during the years since privatisation to indicate that they have done so. This is due to:

- Competition between individually operated airports in Australia, that takes the form of:
  - competition to attract new airline services (both passengers and freight);
  - competition for a role as a hub airport and for transfer between hubs;
  - competition between airports within urban areas, specifically for General Aviation users; and
  - competition for the provision of services at airports.
- Significant countervailing market power from the major users of airports; and
- Airports inability to withhold service.

The preceding discussion highlights the fact that airports, rather than needing specific price and conduct legislation, are in fact subject to sufficient competitive and structural market influences that they do not require specific legislation or provisions within existing legislative frameworks.

BAC believes that the current regulation has failed to meet the objectives outlined in the DoTRS *Pricing Policy Paper*, particularly with respect to the promotion of commercial arrangements. Specifically, the current regulatory environment,

- Involves lengthy, inefficient and expensive processes;
- Deters and delays new investment;
- Favours incumbent airlines and operates to detriment of new entrant airlines, and ultimately the travelling public; and

- Provides no certainty that any price reductions generated at the airport services level is actually passed onto final consumers.

BAC has yet to finalise its position with respect to what type, if any, of prices regulation it considers appropriate for the airport industry in Australia. However, there are several broad principles that BAC would expect to be part of any framework for regulating prices, including:

- The ability of the investor to achieve a fair return on existing and new investments;
- Acknowledgement of the need for early decisions in relation to long term projects, such as runways and terminal buildings
- The endorsement and rewarding of efficiency and innovation; and
- Being simple to administer for both regulators and regulatees.

2 Introduction

2.1 Purpose and Structure of this Report

This submission is the formal response to the Productivity Commission's ('the Commission') request for submissions into its review of price regulation of airport services in Australia.

This submission contains:

- Chapter 3, a general discussion on price regulation of airport services in Australia, and
- Chapter 4, responses to specific questions raised in the Commission's Issues Paper, *Price Regulation of Airport Services*.

In general, this submission will focus on particular issues of most concern to Brisbane Airport Corporation Ltd (BAC), however many of the questions raised in the Issues Paper require responses generic to the airport industry in Australia. Where confidential information is presented within this submission, it is highlighted in a text box, and BAC confirm the requirement that this information is not to be presented for public circulation.

2.2 Warranties and Disclaimer

Whilst BAC believes the statements made in this submission are accurate, BAC or its affiliated companies and their respective officers and employees give no warranty of accuracy or reliability.

BAC has prepared this submission for the purpose outlined in Section 2.1 above, and it should not be used, copied or reproduced for any other purpose without the express written consent of BAC. None of BAC, its affiliated companies and their respective officers and employees undertakes any responsibility arising in any way whatsoever to any person or organisation in respect of the information set out in this submission, including any errors or omissions therein arising through negligence or otherwise, however caused.

3 General Discussion on Price Regulation for Airport Services in Australia

3.1 Background

The privatisation of Australia's airports, commencing with Brisbane, Melbourne and Perth in July 1997 has in general been an outstanding success.

The break-up of the former Federally owned network of airports and the establishment of independent airport businesses, under the *Airports Act 1996* and associated regulations, is seen around the world as a leading example of privatisation.

The associated pricing framework, administered by the ACCC, has achieved some of the Government's objectives, although there are still areas where improvement is possible.

Airports were sold on the basis that operators would be required to reduce aeronautical charges significantly in real terms in each of the first five years. These reductions reflected the early efficiency gains that were expected from privatisation in what was at the time (pre-Asian crisis) expected to be a high growth environment. However, increases in charges were permitted within the five year price cap period in respect of necessary new investment.

The Government's very clear-stated intention is that at the end of the five year period, the CPI-X price cap will no longer apply. This is based on an expectation that airports and airlines will reach commercial agreements on aeronautical charges to apply from July 2002. The Commission is now required to recommend an appropriate pricing framework to Government in the absence of such agreement.

3.2 Historical Context

Prior to detailing the philosophy it is important to provide our understanding:

- On the basis of the initial charges set at the time of privatisation;
- What occurred during the airport sale process; and
- What has happened in the period since privatisation in July 1997.

3.2.1 Initial charges

The Federal Airports Corporation (FAC) charges on 1 January 1997 were used as a basis for the first five years. These charges were the former network charges for

FAC, adjusted in the 1996/97 financial year in a move towards airport specific charges. No comprehensive review of asset values was undertaken at the time and consequently starting charges beared little or no relationship to the value of the assets utilised by the airlines.

BAC contend that current aeronautical charges at Australian airport are so far below fair levels that any concerns held by regulators regarding airports ability to earn monopoly profits is unwarranted. Research undertaken by Transport Research Laboratory on behalf of Sydney Airports Corporation Ltd has shown that airport charges in Australia are some of the lowest in the world.

Whilst BAC took commercial risks on the profitability of Brisbane Airport during the first 5 years post-privatisation, BAC consider that it is now imperative that a new pricing framework delivers fairer commercial outcomes for airport investors than those achieved under the current regulatory environment.

3.2.2 Airport sale process

Brisbane Airport was purchased from the Federal Government in July 1997 for $1.4 billion. The purchase price represents the value of assets acquired and a premium paid for certain existing businesses such as car parking, car hire and duty free concessions and the future growth potential in property and other non-aeronautical businesses.

Airport operators had a clear expectation that they would only be permitted to make fair (not monopoly) returns on aeronautical assets. Similarly, they expected that like any other Australian company, subject to complying with the *Trade Practices Act 1974* and the *Prices Surveillance Act 1983*, they would be able (and, indeed were encouraged by the Office of Asset Sales) to grow the non-aeronautical businesses on airport.

One of the reasons why airports and airlines have such appalling relationships around the world is that the definition of aeronautical and non-aeronautical activities has been unclear. However, much to its credit, the Department of Transport and Regional Services (DoTRS) achieved the establishment of a (largely) clear definition of aeronautical activity specifically to provide clarity for the bidders within the privatisation process.

Whilst both airports and airlines have thoughts on possible changes to that definition, the industry is now in a position to move forward. Any significant change in the definition of aeronautical (regulated) and non-aeronautical activities would result in a massive reduction in the value of investment in the privatised airports. This would expose the Federal Government to multi-million dollar legal actions from airport investors, many of which are Australian superannuation funds and do untold damage to Australia's international reputation for fairness.

3.2.3 Post airport privatisation

Progress on commercial negotiations between airports and airlines has been slow for a number of reasons. Expectations of airports and airlines from privatisation were quite different. Airlines were happy to accept the reductions in aeronautical charges each year, although these were not passed on to domestic customers. Indeed, the two major domestic airlines have only reduced fares when forced to do so by the two new domestic operators.

On the other hand, when Brisbane and Perth airports introduced a fuel through-put fee, under a contract entered into by FAC, the airlines were quick to pressure ACCC and the government to take action. BAC did not enter into the contract with the oil companies. It was the FAC, a government owned enterprise, which deliberately entered into the contract, that provided for a fuel through-put fee. This contract was signed in April 1997 just as final bids were being negotiated to purchase the airports. Given that the FAC would have no future involvement in the airports, it is inconceivable to think that it was not the Government's intention that the sale price would rise if this contract was in place prior to privatisation.

Although it was clearly the Government's stated intention that aeronautical charges could be increased outside of the price-cap it was not until April 1999 that DoTRS issued a letter clarifying the position. Until that time, the airlines had been using their significant market power and refusing to agree to price increases outside of the price cap. Even then it was not until March 2000 that ACCC finalised a suitable definition of "Necessary New Investment".

This enabled Brisbane Airport, along with Perth Airport, to be the first airports to reach agreement with the airlines and ACCC to increased charges outside of the price cap in respect of necessary new investment, some 34 months after privatisation.

A similar situation occurred with the airport operator's ability to recover costs in respect of Government mandated charges.

In December 1998, DoTRS mandated that airport operators are to be responsible for international passenger and baggage screening at international terminals by 1 October 1999 and 1 June 2000 respectively. It was not until March 2000 that ACCC finalised the definition of cost recovery for these purposes.

3.2.4 Summary

Essentially, airport owners and users find themselves in a position where:

- There was no fundamental basis for the aeronautical charges originally set at the time of privatisation, and therefore prices are not reflective of the requirements for an efficient pricing framework;
- The privatisation process created a framework from which future price negotiations could take place; and
- The involvement of regulators has stifled the negotiation process and the development of aeronautical facilities.

3.3 Pricing Philosophy

3.3.1 Prices Oversight Regime

In order to establish the context for the post 2002 pricing framework, BAC consider it is useful to reiterate the objectives of pricing oversight as originally intentioned by the Commonwealth Government, and expressed in the DoTRD *Pricing Policy Paper* of November 1996.

'Pricing oversight arrangements at airports post-leasing have been designed to achieve an appropriate balance between public interest and private commercial objectives.

Pricing oversight arrangements are intended to promote operation of the airports in as an efficient and commercial a manner as possible. Pricing is fundamental to the efficient use of airport infrastructure. It is in the interest of airport users in particular, and the national economy in general, that commercially-driven decisions be made about maintaining existing airport infrastructure, and building new infrastructure.

The arrangements should also aim to protect airport users from any potential abuse from market power by airport operators. Market power stems from the fact that airports have natural monopoly characteristics.

It is the Government's intention to step back from setting prices at individual, privately-leased airports; and to provide a framework in which – over time – airport operators and their customers are encouraged to negotiate directly, and resolve prices rather than involve the Government of the day.'

With respect to reviewing the prices oversight arrangements established at the time of privatisation, the DoTRD *Pricing Policy Paper* noted:

'The leasing of Federal airports ushers in a new operating environment for airports in Australia. Clearly, a period of adjustment is needed for new operators, airport users and Government in regulating the industry.

Because the environment is a new one, some adjustment to pricing oversight arrangements set in place when airports are leased may be necessary. However, arrangements for the initial five years are fixed.

The first five years of the scheme is viewed essentially as a period of transition, to allow all stakeholders to adjust to the new operating environment for airports.

Toward the end of the first five years, the ACCC will review the prices oversight arrangements for airports.

The review will be based on the premise that the price cap applied to aeronautical charges during the first five years will no longer operate. In its place, the review will aim to develop arrangements targeted at those charges where the airport operator has most potential to abuse market power. The existing set of aeronautical charges will be examined, on an airport-by-airport basis, with the review assessing whether services should be added or removed from surveillance.

A key objective of the review is to ensure that the aviation industry retains appropriate protections. The guideline also makes clear that the ACCC can recommend stronger forms of prices oversight if operators have a consistent track record of abusing their market power.

The review will give airport operators the opportunity to suggest alternative forms of oversight, ideally with the backing of their customers. The Government's aim is that airlines and new airport operators form close and cooperative working arrangements.

Beyond the central issue of market power, it is not intended that the review place further obligations on airport operators with respect to pricing. As with the initial five year period, the Government will not mandate the use of single till approach to airport pricing. This will remain a matter for operators.

By framing the review in this way, it is intended that airport operators and aviation users will have maximum incentive to develop normal commercial relationships over the first five years. Such a commercial environment will improve the efficient operations of the airports and reduce the compliance costs of regulation on the industry as a whole.

The outcome of the review will take the form of recommendations from the ACCC for consideration by the Government, allowing decisions to be taken beyond the end of the initial five year pricing period.'

Clearly, the intention of the Commonwealth Government at the time of the privatisation was that the current prices oversight regime would no longer operate at the end of the initial five-year period, and preferably airport operators and customers would resolve prices through commercial negotiations rather than involving the Government.

BAC believes that these noted intentions of the Commonwealth Government reflect the fact that it clearly understood that airport operators post privatisation will be charged with managing a commercial business. Further, any pricing policy beyond this initial prices oversight period would therefore need to reflect this, subject to the usual issues surrounding service provision of significant infrastructure businesses.

3.3.2 Pricing Principles

Various regulators and proponents of pricing reform all note that pricing structures should be designed to meet the general objectives of

- *Efficiency*, which comprises the following three components:
  - Productive efficiency: requires the provision of goods and services at the lowest possible cost;
  - Allocative efficiency: requires that resources are consumed by those who value them most highly; and
  - Dynamic efficiency: requires that efficiency improves over time in response to technological change and innovation in management.
- *Equity*, which relates to:
  - Where the consumer pays according to ability to pay – wealth or income;
  - Where the consumer pays according to how much they consume; and
  - Where incidence charges are minimised so that the impact of any change in pricing policy does not fall too heavily on one consumer or group of consumers.
- *Financial viability*, which requires prices to yield a revenue that is sufficient to finance the efficient operations of the supplier; and
- *Simplicity*, which suggests that the pricing system must not be costly to implement, simple to administer and simple for consumers to understand.

BAC note that any pricing framework proposed for the period from 1 July 2002 should aim to reflect all of these principles.

3.3.3 Investment Philosophy

Underpinning BAC's original bid for Brisbane Airport was the philosophy of being able to achieve a fair return on investment, all else being equal. This philosophy, which is what any rationale investor holds, remains core to BAC's corporate being.

4 Formal Response to Productivity Commission Issues Paper

4.1 Why regulate prices of services provided by airports

Question *Is the potential for abuse of market power an appropriate rationale for airport-specific regulation of airport services ? Are there other appropriate rationales ?*

Response In the context of prices regulation, BAC considers that the only appropriate rationale for regulation should be the redress of an actual market failure. This means that specific prices regulation for airport services should not exist to merely protect against potential abuse.

Rather, if the Government is merely wishing to achieve a mechanism by which to protect against potential abuse, BAC contend that the existing *Trade Practices Act 1974,* and specifically Section 46 (Misuse of market power), provides an appropriate framework for this.

4.1.1 Identifying airports with market power

Question *Do airports in Australia have market power ? What are the sources of their market power ?*

Response BAC defines market power as the actual ability of a firm (or group of firms) to raise and maintain prices above the level that would prevail under competition, resulting in reduced output and loss of economic welfare.

Under this definition, BAC consider that while airports in Australia have the theoretical ability to raise and maintain prices above a competitive market outcome, they do not have any actual ability to achieve market power outcomes, in either price or other terms and conditions. This is due to:

- Competition between individually operated airports in Australia, that takes the form of:
  - competition to attract new airline services (both passengers and freight);
  - competition for a role as a hub airport and for transfer between hubs;
  - competition between airports within urban areas, specifically for General Aviation users; and
  - competition for the provision of services at airports.
- Significant countervailing market power from the major users of airports;

- Airports inability to withhold service; and
- Ability for any pricing dispute to be independently arbitrated by the Australian Competition and Consumer Commission (ACCC) under Part IIIA of the *Trade Practices Act 1974*.

To the extent that airports do possess market power, this will depend upon the degree to which they possess (natural) monopoly attributes, being:

- Barriers to entry;
- Substitutability between air transport and other transport modes; and
- Existence of economies of scale and scope.

BAC notes however, that the mere existence of these attributes does not necessarily indicate that airports have the actual ability to raise and maintain prices above the competitive price level. Further, BAC contend that there is little scope for airports to abuse their theoretical market power, and there is no evidence during the years since privatisation to indicate that they have done so.

Question *Do some airports with market power have more market power than others ? Why ?*

Response Economic theory indicates that low elasticities of demand may be evidence of market power. However, BAC contend that it is extremely difficult to accurately determine the elasticity of demand for airport services as:

- Prices for airport services in Australia are regulated, and therefore it is difficult to identify a true market response to an 'unconstrained' price movement; and
- Charges for airport services are presented to consumers in a bundled price for air transport. Any demand analysis would therefore need to isolate a response to a price movement in airport services specifically, rather than a response to a price movement from the other components that make up the bundled price for air transport.

Question In which services/activities are these airports likely to have most market power ? Why?

Response BAC consider that if the theoretical sources of market power for an airport relate to barriers to entry, various services and activities that are necessary for civil aviation are likely to be uneconomic to duplicate, and therefore be declared under s192(5) of the *Airports Act 1996*.

The ACCC's Draft Guide *Section 192 of the Airports Act – Declaration of airport services* outlines its view as to whether airport activities and services are likely to be declared. The ACCC view with respect to the likelihood of declaration under s192(5) for various airport services is presented in the table below.

Service	***Market power issues***	***ACCC view on the likelihood of declaration under s192(5)***	***BAC Response***
Airside facilities and runways	These facilities are fundamental to the operation of an airport, with their costs appearing to be subject to economies of scale, and involves large, sunk infrastructure. Airside facilities cannot be provided off the airport site, while general aviation facilities considered inadequate for aircraft used on international and major domestic routes.	Yes	BAC concurs with this analysis, however BAC also wish to point out that competition within the same geographic marketplace (vis-à-vis Coolangatta airport) limits BAC's ability to exercise market power.
International passenger processing areas	These services are considered necessary for the facilitation of international air travel, and while they could potentially be developed off-site, the ACCC questioned the economics of duplicating these facilities at a general destination away from the international terminal.	Yes	New technologies and processes are likely to provide alternatives to aspects of the current methods of international passenger processing, eg: electronic check-in, off-airport processing at hotels, in the CBD, on other transport modes (trains), etc. As these technologies and processes evolve, these services are unlikely to continue to satisfy the tests for monopoly infrastructure.
Domestic passenger processing areas	These services are currently provided under long term leases between domestic terminal owners and airlines, and therefore outside of the scope of s.192(5) as per Declaration 87. Regardless, it is likely that these facilities are able to be economically duplicated, as they have been in the past. The development of these facilities at Melbourne and Sydney confirms this point.	Case by case basis	New technologies and processes are likely to provide alternatives to aspects of the current methods of international passenger processing, eg: electronic check-in, off-airport processing at hotels, in the CBD, on other transport modes (trains), etc. As these technologies and processes evolve, these services are unlikely to continue to satisfy the tests for monopoly infrastructure.

Service	***Market power issues***	***ACCC view on the likelihood of declaration under s192(5)***	***BAC Response***
Admin. office space	Airlines require some office accommodation in close proximity to the airport to operate effectively, however the amount of accommodation required on site is discretionary above some minimal level. These facilities can be provided off-airport.	No	BAC agree with ACCC.
Commercial and retail facilities	These facilities are not essential for the provision of civil aviation services, and they are readily located off site. In many circumstances, retail facilities on-airport compete with off-airport counterparts, eg: duty free shopping.	No	BAC agree with ACCC.
Flight catering facilities	The ACCC concluded that it was doubtful that these facilities had monopoly characteristics, combined with the fact that there were likely to be many substitutes for the location of these facilities off-airport.	No	BAC agree with ACCC.
Refueling facilities	While the ACCC concluded that aircraft refueling was a necessary service, it also noted that some airlines have capacity to by-pass given airport refueling locations. It therefore differentiated between facilities and the land under which these services are provided.	Refueling facilities – Case by case basis. Land for refueling facilities – Yes	BAC consider that the ACCC failed to give the same consideration to the impact on existing contracts on this service as it did so with its analysis of domestic terminals. The ACCC has inappropriately criticised BAC for its introduction of a fuel throughput fee, which it was entitled to do under existing contractual arrangements developed by the FAC.

Service	***Market power issues***	***ACCC view on the likelihood of declaration under s192(5)***	***BAC Response***
Ground service and freight handling equipment storage facilities	The on site provision of storage facilities was considered necessary by the ACCC for the efficient provision of civil aviation services. Again, the ACCC differentiated between the provision of facilities and the provision of land from which to develop facilities on. The ACCC argued that it was uneconomic to duplicate sites, but the duplication of relevant facilities may vary from airport to airport.	Ground service and freight handling facilities – Case by case basis Land for ground service and freight handling facilities – Yes	BAC note that as there is significant land available on airport for these facilities, it will always be in BAC's best interests to develop these facilities for tenants on a commercial basis.
Cargo terminal facilities	The NCC concluded that it is economic to duplicate a site on which to construct cargo terminals off airport.	No	BAC agrees with ACCC. Further, the discussions noted above with respect to ground service and freight handling facilities also holds for cargo terminal facilities.
Light and emergency maintenance facilities	These facilities were considered to be interdependent with airside facilities, and were therefore determined to be necessary for civil aviation services and uneconomic to duplicate.	Yes	BAC agrees with ACCC
Heavy and planned maintenance facilities	The nature of these activities are such that as long as aircraft have access to facilities by appropriate roads or aprons, it is likely these facilities could be located off-airport, or at selected airports.	No	There is considerable competition amongst airports to be the site for particular airlines maintenance facilities. This competition is fueled by local and state governments business development goals. Recent examples include the competitive bidding process to secure the QANTAS maintenance facility, which BAC secured over other airports in Australia and New Zealand.

Service	***Market power issues***	***ACCC view on the likelihood of declaration under s192(5)***	***BAC Response***
Landside vehicle facilities	There is a fundamental requirement that airline passengers are able to access terminal buildings in order to facilitate air travel.	Yes	BAC notes that the ACCC confirmed that car parks at airports were outside the scope of this analysis. Clearly, it is not necessary for passengers to park on-airport, given the various transport modes by which passengers can access airports, combined with the fact that off-airport car parking exists. These alternatives confirm that airport car parking businesses do compete against other businesses and forms of transport to secure consumers.
Waste disposal facilities	The ACCC concluded that these facilities were not necessary to be located on-airport, and could be economically duplicated at other off-airport sites.	No	BAC agrees with ACCC.

Clearly the above analysis reveals that airports effectively compete in the marketplace for many of the services and activities they provide. Rather, it is only those services and activities that are solely dependent on the airport's natural monopoly infrastructure assets that could theoretically be classified as having market power.

However, BAC reiterates that the mere existence of these attributes does not necessarily indicate that airports have the actual ability to raise and maintain prices above the competitive price level. Further, BAC contend that there is little scope for airports to abuse their theoretical market power, and there is no evidence during the years since privatisation to indicate that they have done so

Question *How significant are economies of scale in airports and to what extent are economies of scale a barrier to entry ? Which services / activities provided by the airports exhibit significant economies of scale.*

Response Doganis (1991) found that British airports showed that unit costs fall sharply as traffic throughput increases, particularly up to 1.0 or 1.5 million passengers. However, unit costs flatten out as traffic grows beyond a level of 3.0 million passengers, and do not vary much with airport size. Further, with the advent of congestion at these facilities, it is likely that unit costs increase in the short term.

Starkie (1999) has suggested however that compared to more traditional 'natural' monopolies, supply in the airport industry is probably characterised by increasing, rather than decreasing, long run costs at quite moderate levels of output. Salazar de la Cruz (1999) confirmed this in recent research into production functions at Spanish airports. That is, Salazar de la Cruz found that airports serving between 3.5 and 12.5 million passengers a year, present constant returns to scale, however when annual passenger traffic increases beyond 12.5 million, total average costs grow either linearly or quadratically, depending on how production is considered.

There are no compelling reasons as to why these results would not extend to the Australian airport environment. Therefore, with Brisbane Airport consistently recording passenger movements in excess of 10 million per annum, it is unlikely that BAC would be able to achieve significant reductions in unit costs beyond their current levels. Rather, as the demand for airport services grow, BAC are likely to incur increases in short run marginal costs until additional capacity becomes available.

Question *How sensitive is demand for a particular airport's services to any change in the prices charged, or the services offered, by that airport ? What alternatives do consumers have (eg: other airports, or transport / communication modes) ? How does this price elasticity of demand vary between the short to medium term and the long term ?*

Response As noted above, BAC contend that it is extremely difficult to accurately determine the elasticity of demand for airport services as:

- Prices for airport services in Australia are regulated, and therefore it is difficult to identify a true market response to an 'unconstrained' price movement; and
- Charges for airport services are presented to consumers in a bundled price for air transport. Any demand analysis would therefore need to isolate a response to a price movement in airport services specifically, rather than a response to a price movement from the other components that make up the bundled price for air transport.

While this is the case, BAC considers it worthwhile highlighting to the Commission the context in which any price elasticity of demand analysis should be considered. As consumers are only presented with a 'bundled price' for air travel, any increase

in price for airport services needs to be considered in the context of this bundled price. That is, research presented by Doganis (1991) and Betanor and Rendeiro (1997) indicates that airport charges as a proportion of airlines operating expenses are minor, about 3% to 5%, and therefore any change to airport charges would have virtually no effect on consumers demand for air travel. This analysis could suggest that airports theoretically hold significant market power as most consumers will not change their consumption in response to a price rise. That is, demand for airport services are relatively price inelastic from a consumer perspective.

However, the mere evidence of low elasticities of demand does not conclusively mean that airports are able to inappropriately utilise their market power to groundlessly increase prices. Specifically, any market power BAC or other Australian airports may theoretically posses is diminished due to:

- The significant countervailing market power of major airport users;
- Competition from individually owned and operated airports; and
- Part IIIA of the Trade Practices Act arbitration process.

Again, BAC contend that there is little scope for airports to abuse their theoretical market power, and there is no evidence during the years since privatisation to indicate that they have done so.

Question *How important is the port of entry / exit to international tourists ? How important is hubbing through a particular airport en route to another destination ?*

Response BAC contend that the relative importance of a port of entry / exit for international tourists relates to consumer preferences and the availability of flights to particular destinations. That is, where an international tourist is able to depart from his / her closest international airport to their chosen destination, then they are likely to choose this port of exit. However, where particular services to destinations are not available, or not available in the frequency required, from their closest international airport, international tourists are then required to utilise ports of exit in other locations.

For example, data from the Department of Immigration, Australian Bureau of Statistics and Department of Transport and Regional Services reveals that in the 12 months to July 2000 slightly more than 170,000 Queensland residents did not use Brisbane Airport as their port of exit, with nearly 110,000 of these international travellers utilising Sydney Airport as their port of exit. Broadly speaking, this leakage of international travellers from Queensland would equate to about 425 747-400 services.

We note however that these official statistics are likely to underestimate the true volume of Queensland residents utilising ports of exit for international air travel other than Brisbane Airport. That is, these statistics do not appropriately record the number of tourists who travel between Brisbane and Sydney on international carriers, and then depart Sydney Airport to their final destination.

Regardless of this issue, given the size of this potential demand, BAC is actively working to attract additional services from existing and new entrants in order to capture a significant amount of this leakage.

Question *How important is demand for airport services to changes in the quality of those services ?*

Response With respect to airport service quality as an influence in consumer demand for airport services, BAC considers that consumers view airport services as a component of a total air transport product. Therefore, it is in the best interests of both BAC and airlines to work together in order to provide a high quality air transport experience to consumers.

Given this, BAC conducts various studies into the quality of air services provided by them, and then utilise these results to work with airlines in identifying those aspects of airport services that require improvement. For example, BAC annually engages independent consultants to undertake a comprehensive review of the quality of airport services provided in Brisbane Airport from the perspective of the travelling public. Further, BAC also conducts an annual public opinion survey. While the results of the quality services monitoring are required for ACCC regulatory purposes, the results from both quality monitoring exercises are presented to the Airline Operators Committee (AOC) at Brisbane Airport as a basis for identifying areas for improvement.

Question *Currently, what is the extent of competition between Australian airports ? Do airports compete on quality and / or price ?*

Response BAC contend that major airports in Australia compete against each other at several levels, including:

- Competition to attract new airline services (both passengers and freight);
  - BAC is reviewing means by which they can effectively encourage airlines to introduce new services in a competitive environment. BAC understands that airlines are now increasingly looking to airports to demonstrate their partnership approach, and share the risk associated with the introduction of new services. Further, BAC also appreciate that while any incentive an airport can offer is not significant in the overall cost of operating a flight, it does demonstrate the willingness of the airport to assist the airline and is a tangible offer of goodwill.

    BAC's desire is to ensure that any incentive mechanism introduced is:
    - capable of being offered to all airlines;
    - fair; and
    - relatively easy to administer.
- Competition for a role as a hub airport and for transfer between hubs;
  - It is obvious that Sydney and Melbourne airports are actively engaged in competition to be hub airports for various international carriers. The most recent example of this is the competitive process undertaken to be the initial Australian destination for Gulf Air.
- Competition between airports within urban areas, specifically for General Aviation users; and
  - Quite apart from competition in the general aviation arena, where BAC actively competes against Archerfield Aerodrome, Brisbane Airport also competes for domestic and international services against Coolangatta Airport.
  - Research presented by Standard & Poor's noted that:

    'The significant reliance on the volatile leisure travellers exposes Brisbane airport to changes in tourism patterns. More than 70% of total passengers passing through the airport are leisure travellers. Reflecting the airport's sensitivity to the leisure travel base, total passenger numbers at the airport declined by 1.6% in fiscal 1998 as a result of the Asian economic crisis before recovering to grow at 1.6% in fiscal 1999.'

    'Over the longer term Coolangatta airport may develop as an alternative arrival point for leisure travellers to south east Queensland… While a low likelihood in the medium term, potential expansion at Coolangatta airport present a risk to both domestic and international tourist traffic at Brisbane airport over the longer term.'

- Competition for the provision of services at airports.
  - BAC competed with virtually all major airports to secure the operational and maintenance headquarters of Impulse and Virgin. Further, BAC successfully attracted the maintenance facilities for QANTAS Airways. This process involved bidding against other airports in Australia and New Zealand.

Question What is likely to happen to competition in the future ? What factors, other than regulation, are likely to be the most influential in curtailing / promoting competition ?

Response Competition between major airports in Australia is only going to increase into the future. However, BAC note that unless returns to aeronautical investment improve from those currently achieved, the focus of competition will be on non-aeronautical activities (such as heavy maintenance, cargo terminals, etc) where the potential to earn a return on investment commensurate with the risk involved is greater.

BAC considers that the largest barrier to competition in the future will be capacity constraints. Capacity is likely to be constrained where airports are unable to timely invest in new infrastructure, due to various impediments such as:

- Government planning bureaucracy;
- Inability to structure charges to allow for the pre-funding of major facilities, such as a new runway; and
- Gaming by major users of airports.

4.1.2 Assessing the extent of market power of airports – what is an efficient pricing benchmark

Question *What is an appropriate price benchmark (for example, in relation to costs, particularly opportunity costs of the use of facilities) against which to assess potential abuse of market power by airports ?*

Response BAC considers that an appropriate price benchmark is one that is consistent with the expected outcome in a competitive market place.

Asset based approaches to price regulation have tended to utilise a ‘building block’ framework. This framework sets an upper bound of revenue that could be expected in a competitive market over the longer term, as it allows regulated firms to generate a revenue sufficient to cover:

- Operating and maintenance expenses;
- The return of any capital invested (depreciation);

- A return on the capital assets invested, adjusted for risk; and
- Any tax payable (under a post-tax framework).

Question *What is an efficient level and structure of prices in airports ? Would a two-part pricing system, combining the sale of take-off and land slots with charges for use of facilities be a feasible and efficient pricing policy ?*

Response Simply, an efficient level and structure of prices in airports is one that mimics a competitive market outcome. However, in an environment where prices are regulated, it has been shown that the setting of prices below a competitive market outcome has significantly greater negative effects in the long run than does setting prices above a competitive market outcome.

That is, the analysis presented in the NECG submission to the Productivity Commission Inquiry into Part IIIA of the Trade Practices Act 1974 (of which BAC endorsed), and then extended by Australia Pacific Airports Corporation response to the ACCC Draft Decision on Sydney Airports Corporation Ltd Aeronautical Pricing Proposal, clearly shows overpricing and underpricing by the same amounts relative to the competitive price level are equally damaging to welfare. However, in the long run, the welfare effects of over pricing versus under pricing are not equivalent. Rather, the welfare losses resulting from setting a regulated price below the market level are far greater than those for allowing a price slightly higher. In these situations where the regulated price is less than the market price, it is clear that a supplier would either exit the industry when reinvestment is required, rather than investing in infrastructure assets that are able to earn normal returns.

BAC note with interest the comments made by the Chairman of the OECD Roundtable on Competition Policy and International Airport Services with respect to the setting of airport charges [at congested airports].

'If airport charges are fixed at average cost, the scarcity rents are essentially gifted to the airlines, and the airport, which has made the investment in capacity, has its market power expropriated. The consumer doesn't benefit from this gift-giving, continuing to pay monopoly prices for air transport.'

BAC notes the question with respect to a two-part pricing system, and defers any comment at this stage.

Question *What is likely to happen to the level and structure of prices at airports under review if prices regulation were removed ? Are there any constraints on efficient pricing of airport services ? Would removal of prices regulation result in airports earning excess profits ?*

Response The answer to the question depends on one's assessment of the structure of the market for airport services. BAC contend airport services can be classified as either:

- Bilateral oligopoly (ie: few suppliers and few consumers); or
- Monopoly-oligopsony (ie: one supplier and few consumers); or
- Bilateral monopoly (ie: one supplier and one consumer);

depending on how the geographic market for airport services is defined.

In the United Kingdom Office of Fair Trading (OFT) Research Paper 16, *The Welfare Consequences of the Exercise of Buyer Power*, it noted the conditions necessary for buyers to exercise buyer power. These being:

- The buyers contribute a substantial portion of purchases in the market;
- That there are barriers to entry into the buyer's market; and
- That the supply curve is upward sloping.

In the case of the market for airport services, it is clear that the preconditions for buyer power are evident. That is,

- The duopsony of QANTAS and Ansett account for greatest proportion of aeronautical revenues in all major Australian airports;

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Further, BAC have analysed aeronautical revenue by airline alliances for the financial year 1999/2000, and found that oneworld and Star alliances contributed 40.0% and 36.7% respectively to aeronautical revenue at Brisbane Airport. This confirms the high, and increasing, concentration of airline buying power.

- There are significant barriers to entry in the airline industry, both from a capital and procedural perspective;
- Airport services exhibit a vertical supply curve (at a given level of capacity).

The OFT paper concluded that in the case of oligopsony in a competitive supply situation, generally the greater the concentration of buyers, then the greater is the distortion in factor price and quantity below the competitive level, other things being equal. Further, applying to monopsony, oligopsony or dominant buyer situation, it should be observed that for a given demand curve, the lower the elasticity of supply, the greater the welfare loss resulting from buyer power.

This would suggest that any theoretical market power associated with airports, is at least matched by the significant amount of buyer power, or countervailing power, actually held by airlines.

BAC would expect that in situations where prices for airport service are no longer regulated, standard commercial negotiations would result in a market competitive price being achieved. Such a price would allow airports to earn a normal return on investment.

Question *What expected rate of return is required to attract new investment in existing airports ? In new airports ?*

Response BAC considers that the rate of return required for new investment activity, in either existing airports or new airports, is reflected in respective airports weighted average cost of capital (WACC).

The ACCC determined BAC's pre-tax nominal WACC to be 11.9%. BAC contend that several of the parameter values used by the ACCC in determining this amount were understated, and in fact its pre-tax nominal WACC should have been 13.2% to fully reflect the risk associated with its business.

At this stage, BAC would also like to note concerns it has with the ACCC's use of a post-tax WACC framework. Specifically, BAC considers that the post-tax WACC framework:

- Produces rate of return outcomes that reflect the theoretical minimum returns that would be earned under long run equilibrium conditions, rather than returns that businesses would expect to earn for generating and delivering sustained productivity gains to customers;
- Produces rate of return outcomes that are inconsistent with the returns that should be set under an incentive regulation system;
- Is unnecessarily complex and lacks transparency; and
- Over the longer term will significantly weaken the positive incentives that are provided under an incentive regulation system and lead to higher prices.

Question *How significant are common costs in the provision of airport services ? What are the major common costs of providing airport services ?*

Response BAC contends that the vast majority of costs incurred by airports are readily identifiable as either aeronautical or non-aeronautical. However, where there are common costs to both aeronautical and non-aeronautical, airports are able to utilise methodologies used by other regulated industries to appropriately allocate these expenses. Given this, the significance of common costs is not considered by BAC as a major issue in airport pricing.

Question *How pervasive are demand complementarities in the provision of airport services ? How do they affect pricing of these services ?*

Response The Civil Aviation Authority Consultation Paper, *The 'Single Till' and the 'Dual Till' Approach to the Price Regulation of Airports*, discusses the issues of demand complementarities and economic efficiency in detail. The key points of this discussion are:

- It is acknowledged that there are some complementarities in demand between an airport's aeronautical business, and it's non-aeronautical (or commercial) business. That is, if more passengers use an airport, commercial revenues (and commercial costs) are likely to be higher;
- If complementarities are very close, it could be theoretically argued that a single till approach to price setting may be efficient - where the single till was set in relation to activities which displayed such complementarities;
- There are a number of counter arguments to this proposition, being:
  - Demand complementarities may in practice not be very strong, so long as the different airport services are not perfect or very close complements, the interdependencies in demand are not a convincing reason to treat an

airports commercial services in the same way as the core aeronautical services;

- The impact of interdependencies is likely to be very small, or even positive, at congested airports. At uncongested airports, it is an empirical question;
- The incorporation of revenues from non-aeronautical activities, but not other socially important costs (such as scarce capacity), is seen as being arbitrary;
- The accounting profits of commercial activities may not truly reflect the economic costs of the activities; and
- Where complementarities are strong, airports will have a strong incentive to set low aeronautical charges in any case.

This issue of complementarities, or interdependencies, has also been raised in the recent Sydney Airport Corporation Ltd Aeronautical Pricing Proposal. Professor Alfred Kahn, in his capacity as advisor to SACL, noted very similar points on the role of interdependencies to airport pricing:

- As Sydney Airport is already close to full utilisation, lower aeronautical fees could not appreciably increase its use for aeronautical purposes, and, therefore, the demand for the non-aeronautical services; and
- If the respective cross-elasticities were such as to make the kind of single till pricing economically efficient, it would also be profitable for a privatized Sydney Airports Corporation. Even, that is to say, if the regulator were to permit it to price its aeronautical services at their full incremental costs, it could increase its profits by reducing them below that level in order to increase its sales of non-aeronautical services and, in the process, its total profits. If, in other words, the BARA proposal were correct in terms of economic efficiency, it would not be necessary for a regulator to order it!.

Airline operators argue that a ‘single till’ approach provides an appropriate mechanism for the sharing of benefits generated by non-aeronautical related services through the airlines passengers. That is, airlines argue that as they provide customers for the total airport, both aeronautical and non-aeronautical services, landing charges should be subsidised to reflect the additional income earned by airport through airline customers.

This argument assumes that the airline companies are the sole originators for passenger movements in and out of Australia. That is, the tourism industry and the appeal of the destination have no impact on the generation of tourist related passenger demand, or the general economy has no impact on the generation of business related passenger demand. Clearly, this is not the case.

Question *Is there any evidence of abuse of market power (and excess profits) by airports that are not subject to price regulation (Cairns Airport, for example) or by regulated airports in their unregulated activities ? Is there evidence of attempts to abuse market power by unregulated airports in Australia and / or overseas ?*

Response BAC are unaware of any example of abuse of market power by either regulated or unregulated airports in Australia in the provision of aeronautical or non-aeronautical services.

In setting prices for non-aeronautical activities, BAC compare prices being charged at off-airport sites that exhibit locational benefits similar to sites on-airport so as to ensure that BAC is not exploiting the public. In recent evidence by Professor Alfred Kahn with respect to the Sydney Airport Corporation Ltd Aeronautical Pricing Proposal, he noted:

> *'The net supernormal profits from the retail services sold at airports are not, strictly speaking, monopoly profits, but true economic rents, reflecting the value of locating those services at the airport (witness, for example, the difference between charges for parking nearby and at a distance from the check-in facilities). The fact that, as I understand it, Sydney Airports Corporation requires its retailers to price their services at levels similar to those charged by retailers in convenient downtown locations (prices, that is to say, that reflect the rental value of comparably valuable locations outside of airports), makes it clear that the former prices simply reflect the incremental value of location at airports – true economic rents – which, to the extent the franchisees authorised to offer those services are selected by competitive bidding, accrue to the airport authorities.'*

In the case of BAC, a comparison between the cost of car parking on-airport reveals a similar pricing profile to car parking in the Brisbane CBD.

Length of Stay (hrs)	Brisbane Airport - Short term Domestic	Wintergarden	Myer Centre	118 Charlotte Street
0 – 1 hr	$5.00	$5.50	$6.00	$6.50
1 – 2 hrs	$7.00	$9.00	$9.30	$9.50
2 – 3 hrs	$9.00	$10.50	$11.50	$12.50
3 – 4 hrs	$11.00	$12.50	$13.70	$13.50
4 – 5 hrs	$12.00	$15.50	$13.70	$15.00

BAC has also followed this principle in setting the rental rates in a recent review of retail tenancies in the International Terminal Building. This is confirmed by independent advice by Knight Frank Valuations Queensland, who noted:

> *'Face rentals in prime buildings in the Brisbane CBD, such as the Riverside Centre, are generally in the range of $400 to $500 per square metre inclusive of building outgoings, and are generally in line with the rentals being achieved in the International Airport Building on a net rental basis.'*

4.1.3 Countervailing power of users of airport services

Question *Do airlines and/or other users have any countervailing buying power when negotiating with airports ? Is there any relevant Australian or overseas experience?*

Response It is clear from the analysis presented previously that airlines do have significant countervailing buyer power, and in contrast to airports, generally fully exploit this when the opportunity arises. There are numerous examples of this happening in the Australian airport context, primarily associated with the necessary new investment (NNI) process. There would not be one airport in Australia that has not been obstructed by airlines in the development of new facilities since the introduction of the current price regulation.

Many of the new facilities are originally requested by the airlines, who only then attempt to 'game' the process in order to achieve the lowest aeronautical allocation, and therefore minimise any cost pass through under the CPI-X arrangements. Further, many of the projects that are obstructed are projects that would assist all major airline users of the airport, including new entrants into the air transport industry in Australia. Clearly, while price outcomes are a fundamental driver in the bargaining conduct of incumbent airlines, frustrating new air transport industry entrants is also a major incentive to disrupting the new investment process at airports.

Question *Are there any constraints on, or disincentives to, airlines and other users exercising such power ?*

Response In contrast to airports, who are price regulated by the *Prices Surveillance Act 1983*, airlines are not subject to any specific prices oversight regime. Given this relatively unregulated position, airlines have traditionally exercised their market power and priced their services according to monopoly pricing principles. It is only in since the introduction of competition in the domestic air transport industry in Australia have we seen any real reductions in the cost of air travel to the consuming public. Further, it is only on those routes where competition has occurred that we have seen reductions in the price of air travel.

Examples of this include:

- A recent price of $39.00 one-way between Sydney and Brisbane by Impulse Airlines, which was matched by QANTAS. Full-fare airfares between Sydney and Brisbane one-way are usually $179.00 for Impulse Airlines and $366.70 for QANTAS;
- The full-fare for a return trip between Brisbane and Darwin is $1,577.40 for QANTAS and $1,577.40 for Ansett. This route has not been subject to competition from new airlines, and as such, the incumbent airlines have been able to maintain duopolist pricing on this route; and
- QANTAS recently incorporated a surcharge for the cost of increased aviation fuel on their domestic flights, which has not been reduced even when the world fuel price has subsequently reduced. Further, in the recent announcement of their half yearly results, QANTAS indicated that its hedging policy had protected the airline from the full impact of fuel price rises, generating savings of about $255 million.

Question *How vigorously do airports compete for airlines and other users ?*

Response The attraction of new airlines, additional routes, and other aeronautical and non-aeronautical services is fundamental to BAC's future growth plans. In order to achieve these growth plans, BAC understand that it will be necessary to compete not only with other airports in Australia and overseas, but also off-airport locations.

BAC is aware of the importance of price competition. BAC see the need for an incentives scheme in order to be price competitive against other major Australian airports, who do offer discounts to charges (where agreed) - see Section 7.2 of the Sydney Airport Conditions of Use (Version 1 – January 2000).

4.1.4 Potential effects on efficiency and income distribution of airport market power

Question *To help gauge the order of magnitude of potential efficiency losses and income redistribution effects arising from the abuse of market power of airports, what are the quantities sold per year of major airport services and their prices ?*

Response The ACCC Regulatory Accounting Statement provides an analysis of the key aeronautical and aero-related activities undertaken by BAC. For the 1999/2000 financial year, a summary of this analysis is presented in the table below.

Aeronautical Services			
Description	No. of Units	Basis of Charge	Revenue ($'000)
Landing charges:			
- Domestic	2,991,443	$5.30 per 1,000 kg MTOW	$16,058
- International	1,987,112	$5.30 per 1,000 kg MTOW	$10,524
International terminal charges	1,987,112	$2.43 per 1,000 kg MTOW	$4,825
Domestic terminal charges			
- Level 1 & 2	N/A	$200 - $300 per turnaround	$0
- Level 1	N/A	$50 - $100 per turnaround	$240
Government mandated charges			
- APS	4,715,252	$0.53 per 1,000 kg MTOW	$2,568
- Passenger screening	1,197,771	$1.06 per departing pax	$1,270
- Baggage screening	116,712	$1.21 per departing pax	$141
Parking charges – GA / small	N/A	$11 per day	$28
Parking charges	N/A	$100 - $300 per day (+ scrty)	$0
General aviation landing charges	90,662	Minimum $27.50 per landing	$548
Other aeronautical charges	N/A		$1,067
Total aeronautical			$37,269

Aero-related Services			
Description	No. of Units	Basis of Charge	Revenue ($'000)
Refuelling services	64,182	Av. $9.17 per metre square	$589
	626,946,500	$0.004 per litre	$2,508
Aircraft maintenance sites & buildings	204,483	Av. $6.39 per metre square	$1,306
Freight equipment storage sites	N/A	$ per metre square	$0
Cargo facility sites and buildings	227,079	Av. $12.67 per metre square	$2,877
Ground facilities fee	Various		$1,000
Ground support equipment sites	51,774	Av. $35.81 per metre square	$1,854
Check-in counters and related facilities	Various	$26.75 per hour for check-in counters & $18 per hour for desk	$2,429
Public car parking	Hourly rates		$13,641
Staff car parking	Mthly rates		$1,156
Total aero-related revenue			$27,360

Question *Is the demand for air travel (and airport services) of foreign travellers to Australia more or less price elastic than that of domestic travellers ?*

Response A detailed analysis of price elasticity of demand for foreign travel to Australia is presented in the Bureau of Transport and Communication Economics Working Paper 20, *Demand Elasticities for Air Travel to and From Australia*. The key findings of this working paper were:

- Airfares, income and relative prices were found to be important determinants of leisure travel to and from Australia, whereas income and relative prices were found to be the most important determinants of business air travel;
- Business travel was found to be less responsive to changes in airfare than leisure travel, and airfares were found to be less significant overall in explaining business travel demand; and
- Airfare elasiticies were found to differ, often significantly, between passenger type and origin-destination market.

Question *Are airports with market power in a position to discriminate between buyers of their services ? Is such price discrimination precluded by regulation ? Is there evidence of price discrimination by airports in Australia or overseas ?*

Response BAC has interpreted the above question to mean detrimental price discrimination to consumers, ie: pricing above a fair market level. In this context, BAC do not engage in such practices. We note that the current regulatory environment does not specifically regulate prices, and therefore price discrimination, but rather regulates the total revenue airports may earn from aeronautical activities. Prices monitoring does occur with respect to aero-related services under the ambit of the *Prices Surveillance Act 1983*.

In the context of positive price discrimination, being the provision of discounts to standard charges, BAC encourages airlines to introduce new services in a competitive environment. Any incentive mechanism needs to be:

- capable of being offered to all airlines;
- fair; and
- relatively easy to administer.

Question *Is there any evidence that airports tend to be efficient in production ? Do they have a tendency to under- or over-investment in new capacity and quality ?*

Response BAC has found no empirical evidence that compares the productive efficiency of airports relative to other sectors in the economy. There is however some empirical research that compares the productive efficiency of airports in Australia against one another, and against other international airports.

Hooper and Hensher (1997) completed a total factor productivity analysis of 6 Australian airports – Sydney, Brisbane, Melbourne, Perth, Adelaide, and Hobart - over the period 1988/89 to 1991/92. While this period is pre-privatisation, it does provide some insight into the relative productive efficiency of these airports under one corporate structure, the FAC. This analysis revealed that Brisbane Airport was the best performing of all the airports under review, on an output-adjusted basis.

The Bureau of Industry Economics (BIE) completed a review of airport operating performances for the year 1992/93. Labour productivity was measured in terms of specific processes, including air traffic control, fire fighting and rescue services, while capital productivity was more problematic to measure as the indicators used, aircraft movements per metre of runway and passengers handled per aircraft movement, could not account for exogenous factors such as aircraft mix, position in the investment cycle, and regional weather conditions. Despite the difficulties in making like with like comparisons between airports, the BIE concluded that Australia's airports tended to have productivity levels that are on par with many overseas airports.

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Based on these partial performance indicators, it appears that Brisbane Airport has been able to maintain its relative position as the most productively efficient of all major Australian airports in a post-privatisation environment.

Question *Is there any difference in performance between regulated and un-regulated airports?*

Response BAC have found of interest a research paper by David Parker on *The Performance of BAA Before and After Privatisation*, presented in the Journal of Transport Economics and Policy (Vol.33, Pt 2). The key conclusions of this paper were:

- Over the period 1979/80 and 1995/96, there was no evidence of any improvement in technical efficiency as a result of privatisation;
- The aggregate results of technical efficiency for BAA are a composite of varying performances across the different airports operated by the company over time.

Of interest however is the author's speculation as to why this has occurred, and not the expected outcome that privatisation should have raised performance. That is, Parker suggests that the regulatory environment in which BAA operates may have actually distorted the incentives for efficiency, and that BAA's performance may have actually been blunted by the continuing state regulation of outputs and inputs.

4.1.5 Are airports different from other industries

Question *Are airports different from, or likely to have more market power than, other industries with some natural monopoly characteristics ? In what respect, if any do, airports differ ?*

Response Industries that have been traditionally regulated due to their ability to exhibit natural monopoly characteristics – such as gas, water, electricity, and telecommunications industries – are generally characterised by:

- A small number of providers;
- A large, diverse range of customers;
- The products and services provided are generally key business inputs and basic community necessities.

In the case of airports, these characteristics are significantly different. That is, while airports may comprise only a small number of providers, the other characteristics mentioned above are not met because:

- Airports provide intermediate industrial services that constitute a smaller component of the end price paid by the final consumer;
  - Research presented by Doganis (1991) and Betanor and Rendeiro (1997) indicates that airport charges as a proportion of airlines operating expenses

are minor, about 3% to 5%;

- Small numbers of oligopsony airlines possess and utilise significant countervailing market power; and
  - This countervailing market power is only increasing with the increased concentration of airline ownership and operations, eg: Air New Zealand and Singapore Airlines ownership of Ansett Australia; and the growing collusion of QANTAS, Ansett, BARA and IATA in any ACCC airport pricing matter;
  - The advent of the STAR and oneworld alliances has concentrated international airlines buying power in Australia and reduced services. In addition, there has also been a reduction in services due to increased code-sharing arrangements;
- The immediate consumers of services provided by airports are a group of highly organised corporations that have multi-national reach and significant political power;
  - Airlines are a much larger employers of people than are airports, and as such, have considerable influence with governments at all levels.

Question *Are any such provisions so significant as to warrant specific provisions ? If so, are these specific provisions best incorporated under the TP Act and/or PS Act, or under separate legislation ?*

Response The preceding discussion highlights that airports, rather than needing specific price and conduct legislation, are in fact subject to sufficient competitive and structural market influences that they do not require specific legislation or provisions within existing legislative frameworks. Rather, BAC contend that the amount of regulatory intervention required for airports should be limited to, and no greater than, the extent necessary to redress any actual market failure, as opposed to theoretical market failure which the current regulatory framework has been based upon.

4.2 Effects of current prices regulation

Question *Are these objectives appropriate ? Has the current regulation met these objectives?*

Response The promotion of efficiency is central to the on-going commercial operations of Brisbane Airport, however BAC considers it inappropriate that this requirement be specifically legislated. As outlined in Section 4.2, BAC currently faces considerable competitive market forces, and fully expects these competitive forces to increase in the future. Therefore, the impetus for efficiency will necessarily come from commercial pressures, rather than legislative requirements.

Further, BAC contend that any government arrangements with respect to protecting abuse of market power should not be based on theoretical potential, as is currently the case. The key issue should be the actual abuse of market power, rather than the mere possession of it.

BAC believes that the current regulation has failed to meet the objectives outlined in the DoTRS *Pricing Policy Paper*, particularly with respect to the promotion of commercial arrangements. Specifically, the current regulatory environment,

- Involves lengthy, inefficient and expensive processes;
- Deters and delays new investment;
- Favours incumbent airlines and operates to detriment of new entrant airlines, and ultimately the travelling public; and
- Provides no certainty that any price reductions generated at the airport services level is actually passed onto final consumers.

4.2.1 Prices, profitability and efficiency

Question *What have been the implications of the current arrangements for prices of declared, monitored and other airport services ?*

Response Prices for declared activities, and some monitored activities, at Brisbane Airport have declined in real terms since the introduction of privatisation. Prices for monitored and other airport service have increased in line with commercial market outcomes. The following table provides a summary of price movements across aeronautical and aero-related activities undertaken by BAC.

Selected Indicators	1997/98	1998/99	1999/00	Avg. % Δ p.a
Aeronautical charges				
Landing charges– Domestic & International (per 1000 kg MTOW)	$5.72	$5.42	$5.30	-3.7%
International terminal charges (per 1,000 kg MTOW)	$2.62	$2.48	$2.43	-3.7%
Aero-related charges				
Aircraft maintenance sites and buildings (avg. $ per metre square)	$6.08	$6.12	$6.39	+2.5%
Ground support equipment sites (avg. $ per metre square)	$35.06	$35.08	$35.81	+1.1%
Check in counters and related facilities				
- check in counters ($ per hour)	$26.75	$26.75	$26.75	0.0%
- desks ($ per hour)	$18.00	$18.00	$18.00	0.0%

Question *Has the delineation of services under the current pricing system has been appropriate ? Has there been pressure to shift costs and prices across services ?*

Response BAC believes that the delineation of services between aeronautical and non-aeronautical as per Declaration 83 made by the Treasurer pursuant to section 21 of the *Prices Surveillance Act 1993* (PS Act) remains appropriate.

However, during this first period of regulation under the price cap arrangements, BAC have experienced significant (inappropriate) pressure from the ACCC with respect to the classification of new charges at Brisbane Airport, specifically ground facilities fees and fuel throughput fees. BAC contend that the approach taken by the ACCC in considering these fees was a blatant attempt to alter Commonwealth Government policy and change the 'playing field' on which airport owners have based their investment decisions. That is,

- Despite advice from the Department of Transport and Regional Services confirming the ground facilities fee introduced by BAC as a non-aeronautical revenue stream for pricing purposes, the ACCC continue to pursue an approach that incorporates this revenue stream within the aeronautical services price cap; and
- Despite the fact that the Federal Airports Corporation had already contracted with major aircraft refuelling companies for the introduction of a fuel throughput fee prior to the privatisation process occurring, and the fact that the Commonwealth Government's Office of Asset Sales confirmed to airport bidders during the privatisation process they would be contractually entitled to

introduce a fuel throughput fee, the ACCC have attempted to introduce price control over this revenue stream, even though they themselves could not conclude that BAC had abused their market power.

Question *What has been the effect of current arrangements on airline prices to final consumers ?*

Response BAC contends that there is no evidence to suggest that the travelling public has benefited from any decreases in airport charges. Rather, incumbent airline prices have remained excessive on those routes where competition from new airline entrants has not yet emerged.

This is highlighted in the following graph, which indicates that landing charges at Brisbane Airport are some 13% lower in real terms since privatisation, while economy and business class airfares have risen 14% and 17% respectively in real terms over the same timeframe.

Question *What has happened to each airport's costs, productivity and operational efficiency under the price cap arrangements ? What has been the impact on airport profitability ?*

Response BAC's profitability with respect to aeronautical activities has declined each year since privatisation, which is clearly demonstrated by the simple analysis in the following table.

	1997/98	1998/99	1999/00
Earnings before interest and tax – Aeronautical	$3,675,000	$2,413,000	$195,000
Property, plant and equipment – Aeronautical	$258,638,000	$248,188,000	$493,511,000
Return on assets	1.4%	1.0%	0.0%

Aeronautical revenues have been lower than expected, primarily as a result of the Asian crisis and a reduction in flight numbers due to code sharing, while aeronautical costs have been greater than expected, primarily as a consequence of the legislative framework in which BAC operates. That is, costs have been greater than anticipated as BAC has been required to employ additional staff and external consultants to effectively deal with the necessary new investment process specific to Brisbane Airport, as well as maintain its understanding of ACCC's interpretation of the regulatory framework in which it operates.

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Whilst BAC took commercial risks on the profitability of Brisbane Airport during the first 5 years post-privatisation, it is now imperative that a new pricing framework delivers fairer commercial outcomes for airport investors than those achieved under the current regulatory environment.

Question *What are appropriate ways to compare airport performance ? Have the prices regulation arrangements facilitated benchmarking comparisons across airports ?*

Response Hooper and Hensher (1997), BIE (1994) and the Civil Aviation Authority Consultation Paper (2000), *The Use of Benchmarking in Airport Reviews*, provide a comprehensive discussion on the measuring of performance of airports. Key points highlighted in these discussions include:

- The quality dimensions of different airport services needs to be appropriately defined in terms of outputs;
- Differing operational environments and legal frameworks impact on the comparability between airport benchmarks;
- Airports have different strategic objectives, which influence the inputs and outputs of airport benchmarks; and
- Efficiency can be distorted as a result of where an airport may be on its investment cycle.

BAC contend that while the current prices regulation arrangements have facilitated benchmarking across airports, for the reasons presented above, the performance benchmarks utilised do not appropriately provide a true picture of the environment in which individual airports operate. In particular, BAC believes that the quality benchmarking undertaken by the ACCC is too subjective, and open to abuse by airline respondents.

4.2.2 Congestion and demand management

Question *Which airports have congestion problems ? What is the nature of these problems (for example, do they only occur at certain times of the day or year) ? What is the cause of congestion (for example, airspace, terminal space, or runway congestion)?*

Response Congestion is not a significant problem at Brisbane Airport. There are however a few congestion issues at certain times of the day at both domestic and international

terminal buildings. For example,

- The customs outwards and passenger transit areas at the International Terminal Building (ITB) often become congested on Saturday mornings;
- The Common User area in the Domestic Terminal Building (DTB) is rapidly reaching full utilisation due to the growth of the new airline entrants, Impulse and Virgin;
- Airport Drive, the main road corridor into and out of Brisbane Airport, often becomes congested on Friday nights due to the volume of inbound domestic traffic. BAC are working through this issue with the Queensland Department of Main Roads.

Question *What has been the effect of the demand management and congestion charge provisions in practice ? What have been the efficiency and distributional effects of the current arrangements ?*

Response BAC has not been impacted by the demand management aspects of the Airport's Act 1996.

Question *Does the current regulatory and price regime encourage efficient pricing of available capacity ? What constraints are there on airports adopting pricing policies such as congestion charges and peak load pricing ?*

Response BAC contends that the current regulatory price framework does not encourage the efficient pricing of available capacity due to the fact that the aeronautical prices set at the time of privatisation did not allow for the generation of revenue sufficient to cover:

- Operating and maintenance expenses;
- The return of any capital invested (depreciation);
- A return on the capital assets invested, adjusted for risk; and
- Any tax payable (under a post-tax framework).

With respect to the adoption of congestion charges, BAC notes that Direction 20, made by the Minister for Financial Services and Regulation, pursuant to section 20 of the Prices Surveillance Act 1983, allows for congestion charges, employed as part of an airport demand management scheme under the Airports Act 1996, to be fully passed-through in the price cap.

BAC notes that unless an incremental congestion charge is of a value that, when combined with the current charges, creates an economically efficient price, then

the addition of any congestion charge below this value will still set an inefficient price level.

4.2.3 Quality

Question *Is quality monitoring necessary ? Why or why not ? What has been the impact of quality monitoring ?*

Response BAC believe that quality monitoring is necessary in a framework of prices regulation in order to ensure that airport operators do not attempt to maximise profits through reducing necessary expenditure, thereby running down the quality of the services provided at the airport.

Quality monitoring has provided a source of information to BAC from which to implement action programs that allow for continuous quality improvement in the services and activities offered at Brisbane Airport.

Question *Are the indicators used to measure quality adequate and sufficiently defined ?*

Response BAC remain concerned as to the lack of focus of the quality monitoring undertaken by ACCC where airlines and government agencies are surveyed on the quality of the services and activities offered at Brisbane Airport. Many of the questions asked in this process are too broad and ill defined, and merely provide an opportunity for airlines to baselessly criticise the performance of BAC.

Further, the exclusion of domestic terminals from any form of monitoring tends to distort the true picture of the quality of the airport services being provided.

Question *Has quality of airport services been rising or falling ? In what ways ? Why ?*

Response Quality, from the perception of the travelling public, has remained relatively stable at Brisbane Airport since privatization, albeit at significantly high levels. This is confirmed by the independent research conducted by Marketshare Pty Ltd over the past 3 years. A summary of selected quality indicators is presented in the following table.

Commercial in confidence			

Commercial in confidence			

4.2.4 Investment

Question *How have the investment provisions operated in practice ? Have they facilitated appropriate investment at airports ? What have been the major issues involved in applying the investment provisions in practice (eg: price determination, rates of return, asset valuation) ?*

Response BAC have been strongly arguing against the ACCC interpretation and application of the investment provisions as per Declaration 13 made by the Treasurer pursuant to section 20 of the *Prices Surveillance Act 1993* (PS Act). In particular, BAC considers that:

- Airlines have been utilising the procedural aspects of the 'necessary new investment' (NNI) provisions as their primary means by which to undertake regulatory gaming, and thereby stifle new aeronautical investment activity at airports;
- The ACCC have incorrectly interpreted the scope of NNI provisions to exclude replacement capital expenditure. It is clear that the Commonwealth Government's policy intention was that replacement capital expenditure was to be considered 'new' for the purposes of the NNI process.

  From advice received by KPMG in May 1999, BAC defines new infrastructure investment to include:

  - The creation of a new asset;
  - The complete replacement of an existing asset that has reached the end of its useful life; and
  - The material change of the nature of an existing asset.

  This view is consistent with the advice provided by the DoTRS in April 1999 which stated that new investment must be:

  'demonstrably not part of on-going maintenance of existing capital stock'.

  The impact of this incorrect definition of NNI by the ACCC has been the rejection and deferral of investment in replacement aeronautical infrastructure as airport owners are unable to justify capital expenditure on assets that do not allow for the recovery of full costs and a return on capital.
- The process undertaken by the ACCC has been arbitrary in the determination of many of the parameters used in analysing the appropriate rates of return for NNI applications. This is evidenced by comparing the premium over the risk free rate being achieved in NNI decisions.

The above graph indicates that at the beginning of the NNI process, the ACCC attempted to delineate risk between airports by adopting differing asset betas, thereby creating different premiums over the risk free rate for each airport. However, as the NNI process became increasingly burdensome as a result of regulatory gaming by airlines, the ACCC has appeared to take a more standard approach to risk analysis across the regulated airports, with the outcome being relatively similar asset betas and risk premiums for all Phase 1 airports, even though there are differences in each airport's risk profiles.

Question *Are the processes involved, including consultation and time allowed for a determination to be made, appropriate ?*

Response BAC contends that the processes involved in NNI applications are administratively burdensome, and essentially favourably bias airlines over airports. The requirements of the NNI process place airports in the position of having to more than justify any capital expenditure proposal. Further, it certainly appears from BAC's perspective that the ACCC approach to NNI is similar to a 'guilty until proven innocent' framework.

In considering some price increases under NNI, the ACCC has taken an excessively long time to reach draft and final determinations. These delays result in increased costs to the airport, both in terms of actual costs and delayed revenues.

4.2.5 Scope of prices regulation

Question *What is the rationale for these different approaches to airport regulation ? Is it appropriate ?*

Response BAC understand that the range of approaches to airport regulation undertaken by the Commonwealth Government was to recognise the differing levels of potential market power that could be exhibited by the various airports. If airport regulation were considered necessary, BAC believes that one standard framework should apply to the airport industry in Australia, however individual airports may or may not be subject to the framework depending on each airports actual ability to exert market power over major users.

Question *What has been the experience of regulation for the different airports ? Do the different regulatory approaches create a competitive advantage or disadvantage for*

any airports ?

Response BAC contends that the differing regulatory requirements have disadvantaged their operations relative to other Non-Phase 1 airports. That is, the Phase 1 airports are required to undertake the greatest amount of regulatory reporting of all airports, and therefore are subject to the highest regulatory and administrative costs of all airports. As the current price cap regulations do not allow these additional expenses to be specifically recovered, BAC and other Phase 1 airports are financially penalised relative to other airports.

4.2.6 Compliance costs and procedural issues

Question *What have been the compliance costs of prices regulation of airports ? Are they changing over time ?*

Response The compliance costs associated with airport regulation have been significantly more than anticipated by BAC due to the interventionist nature of the ACCC. Further, BAC believes that the cost of regulatory compliance is increasing each year as regulatory processes become more complex, eg: the adopting of post tax WACC modelling. These additional costs incorporate both:

- additional internal resources required to prepare ACCC documentation; and
- the costs associated with the hiring of external consultants to provide independent specialist advice on various issues, including WACC, NNI applications, legal interpretation, etc.

4.2.7 Other issues

Question *Has prices regulation facilitated competition in the provision of services within airports ? Has it impeded competition ?*

Response BAC contends that the current price regulation has actually impeded competition between airports in Australia. Specifically, where airports would have normally invested in new facilities in order to attract new airlines or new services from incumbent airlines, they are now not prepared to do so prior to final NNI decisions from the ACCC due to the high levels of regulatory uncertainty surrounding these determinations. This is evidenced by the recent NNI process completed for the Domestic Express multi-user terminal at Melbourne Airport. This process resulted in the setting aside of a commercial contract between Australia Pacific Airports Corporation and Impulse Airlines which was struck under normal commercial negotiations.

Question *Has current price regulation protected against discrimination in relation to small users and new entrants ?*

Response BAC believes that the current price regulations have had a neutral effect to smaller users and new entrants. That is, they have neither protected nor advanced their position in the air transport market place.

Question *To what extent has the current price regulation provided a basis for the development of a more commercial approach to pricing and investment decisions ? Has it facilitated or hindered commercial negotiations ?*

Response BAC has attempted to develop positive commercial relationships with all airline users of Brisbane Airport since privatisation. Through co-operative approaches with the Brisbane Airport Airline Operating Committee (AOC), BAC have, in the most part, successfully worked with airlines to enhance the facilities and services provided at Brisbane Airport.

While BAC has been critical in this submission to the regulatory gaming approach taken by airlines in NNI proposals, BAC note that the instances of such behaviour are generally less common than instances of mutual agreement to projects. Further, BAC has found that many of the projects that are obstructed are projects that would assist all major airline users of the airport, including new airline industry entrants. Clearly, while price outcomes are a fundamental driver in the bargaining conduct of incumbent airlines, frustrating new air transport industry entrants is also a major incentive to disrupting the new investment process at airports.

Question *What are the types of externalities involved in airport operations ? Should incentives for the reduction of negative externalities be included within the price cap ? Have they been adequately addressed in the present price cap ?*

Response The key types of negative externalities involved in airport operations are noise and congestion. BAC contend that the most economically efficient way to reduce these negative externalities is to introduce a pricing regime that allows airports to specifically charge for these factors.

4.3 Future prices regulation

BAC has yet to finalise its position with respect to what type, if any, of prices regulation it considers appropriate for the airport industry in Australia. However, there are several broad principles that BAC would expect to be part of any framework for regulating prices, including:

- The ability of the investor to achieve a fair return on existing and new investments;
- Acknowledgement of the need for early decisions in relation to long term projects, such as runways and terminal buildings
- The endorsement and rewarding of efficiency and innovation; and
- Being simple to administer for both regulators and regulatees.

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