

RESPONSE TO THE PRODUCTIVITY COMMISSION'S INTERIM REPORT (MARCH 2019)

An important issue in the draft report is the likely response of airlines (and the resulting changes in passenger demand) to a potential increase in aeronautical charges and thus the extent to which airports have market power. The Commission accepts that the major airports subject to Review do have (significant) market power but that they are constrained in the exercise of this power, by countervailing power on the part of the airlines. This proposition is challenged by Qantas, Virgin, ACCC, and IATA; the counter argument is that airlines could not offer a credible threat because they could not withdraw services. The ACCC for example argued:

The degree of airline countervailing power is dependent on the credibility of the threat of airlines *withdrawing or significantly* reducing services from an airport. Because the major airports are in the major population centres and face little or no competition, the majority of the airlines are unlikely to have the choice of *leaving or significantly* reducing services to those airports. (ACCC, sub. 59, p. 17, my emphasis)

Putting aside the veracity of the counter argument, with its focus on non-incremental changes of airline outputs, a further question begged is whether small incremental or marginal changes in airline demand, could offer a credible threat once the nature of airport capital is taken into account. Although I am of the view that airport assets can be added-to in smallish increments, if airports choose to do so (the supply function for airport services is not necessarily that lumpy), nevertheless, once additional airport assets are operational, it is difficult to reduce the stock of capital and its associated operational requirements. Airport capital is generally fixed, if not always sunk. Thus, a small reduction in demand by airlines' can have a disproportionate impact on operating margins of an airport. (This is to be contrasted with the ability of most airlines to redeploy their capital *relatively* easily).

Important considerations in the argument are the extent which an airline's route network from a particular airport is made up of 'thin', monopoly routes and the extent to which an airline operates a mixed fleet of different sized aircraft (for example in the short-haul sector, A318/9/20s). A mixed fleet airline could, for example, reduce its throughput at an airport by reducing the size of aircraft used on particular routes (change of gauge) whilst holding service frequency constant. If necessary, to balance passenger demand with (reduced) aircraft capacity the airline could increase prices (marginally) in those market segments with inelastic demand, resulting in minimal impact on airline net revenues. Alternatively (or in addition), the airline could reduce marginally service frequency with the resulting reduction in passenger throughput having a disproportionate impact on an airport with fixed/sunk costs. (Bear in mind here that the impact on the airport includes the loss of non-aeronautical revenues associated with passenger demand).

Such strategies would be more effective where an airline commands a large proportion of the overall market as is the case at many of Australia's regional airports. But, similar strategies could be effective at major airports where an incumbent airline operates from that airport a number of 'thin', monopoly routes. In such circumstances, a change of aircraft gauge or service frequency is less likely to allow scope for competitive entry. Note

also that even at congested airports, where airlines have slot incumbency rights, an airline could wield both change of gauge and re-deployment of aircraft (and associated slots) to thinner (less dense) routes as an effective strategy, knowing that competitors are constrained by lack of airport capacity from responding (by entering vacated routes or routes that have a reduced frequency of service).

Circumstances where an airline operates a homogeneous fleet and is, therefore, constrained in its ability to adjust downwards its capacity (in response to an increase in aeronautical charges) other than by adjusting service frequencies, is dealt with in the International Transport Forum's *Discussion Paper 2013.23* which I have attached to this submission. The important point made in this Forum paper is that, with a homogeneous aircraft fleet, any (lumpy) reduction in seat capacity (reduced service frequencies or withdrawn services) in response to an increase in input costs (a hike in aeronautical charges) will, in turn affect the *level* of passenger demand.

A more infrequent service (that is, a lower quality of service) will have the effect of shifting the demand curve for a particular route downwards to the left; there will be a fall in the level of demand. This will occur irrespective of any change in the quantity demanded should the airline choose to increase fares in response to an increase in airport charges. An initial passenger price elasticity effect, therefore, is effectively *leveraged* through a combination of downward adjustments in the supply of lumpy capacity and the reaction of passengers to the resulting deterioration in the quality of service provided. Again the significance of falls in demand for airport services in circumstances where the cost of airport capacity cannot be reduced easily because of fixed/sunk costs should be borne in mind.