AIR NEW ZEALAND

ANSETT AUSTRALIA

SUBMISSION TO THE PRODUCTIVITY COMMISSION

PRICE REGULATION OF AIRPORT SERVICES INQUIRY

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Introduction

The air transport industry in the Australian/New Zealand environment and indeed worldwide has undergone considerable change over the past two decades. As an Australasian airline with core operations in both Australia and New Zealand, the Ansett/Air New Zealand Group is in a unique position to comment on both environments.

Currently, the Productivity Commission ("**PC"**) in Australia and Commerce Commission ("**CC"**) in New Zealand are examining the economic regulation of airports. As such, this submission deals with the overall Australasian environment — not limiting comment to either Australia or New Zealand.

We note the terms of reference under which the PC is working are somewhat broader than those of the CC. In developing this submission, we have not sought to cover all the issues raised in the either the PC's Issues Paper or the CCs Critical Issues Paper. We do not attempt to address individual questions and issues raised by either the PC or the CC. Many of the issues and questions raised are, however, necessarily discussed and addressed in this submission. The discussion we put forward is in our view relevant to both forums, which are in the process of reviewing the issue of airport regulation.

The submissions to the PC by the Board of Airline Representatives Australia (BARA) and to the CC by the Board of Airline Representatives of New Zealand (BARNZ) also address some of the elements of this submission. Where this occurs, we do not repeat the detail in this submission.

Structure of this submission

This submission is divided into a number of parts.

Part 1 provides an overview of the changes that have occurred in the Australian air transport industry over the past two decades. The current economic regulation of Australian airports is then briefly outlined.

Part 2 provides an overview of the changes that have occurred in the New Zealand air transport industry. The current economic regulation of New Zealand airports is then discussed.

Summary comments of the changes in the Australasian air transport industry are then provided, noting the similarities and differences in air transport reform in Australia and New Zealand.

Part 3 examines the supply and demand characteristics of airports. This examination demonstrates airports have crucial differences to other forms of regulated economic infrastructure, which need to be taken into account in understanding the market power of airports and in assessing different forms of economic regulation.

Part 4 provides substantive evidence on the market power of airports. This is done by examining the outcomes achieved by the Ansett/Air New Zealand Group with suppliers in competitive markets compared with the outcomes achieved in negotiations with monopoly providers, such as airports. Much of the content of this part is provided to the Commission on a commercial in confidence basis as it discusses individual negotiation experiences and contains commercial, financial and strategic details we are not prepared to disclose publicly. However, sufficient publicly available evidence is given to highlight the market power of airports, with the commercial in confidence information providing assurance to the Commission that such market power is in fact exercised.

We also discuss the issue of countervailing market power of airlines, which appears to be a major theme of many of the airport submissions to this inquiry.

From this discussion, the question is then raised whether there remain any incentives for airlines to scrutinise airport costs and prices in an either unregulated environment, an environment where only minimal regulation exists, or where there is little confidence in the robustness of process or regulatory outcome. In the absence of airline scrutiny, we ask who will represent the public interest, in offsetting the potential for airports to misuse market power? Commissions on both sides of the Tasman appear to have paid little attention to this highly practical and relevant issue.

Part 5 identifies and assesses the potential forms of economic regulation for airports (on the basis that a case for intervention has been established), ranging from ‘heavy handed’ to ‘shadow’ or ‘threat of’ regulation. Each option is assessed on the basis of its ability to promote the overarching objectives for the air transport industry, recognising the crucial differences that exist between airports and other forms of regulated economic infrastructure. Issues of regulatory gaming and regulatory failure are considered and discussed for the various options. The issue of compliance costs is also discussed.

PART 1: The Australian air transport industry

Like many other industries in Australia, the air transport industry has under gone considerable change over the past two decades. Key reforms initiated by the Australian Commonwealth Government have included:

1987	The signing of the Domestic Terminal Leases between the (then) Department of Transport, Ansett and Qantas, creating long term leases over domestic terminals.
1987	Creation of the Federal Airports Corporation (FAC) to manage the major Australian airports – as a network with network pricing of airport services.
1990	Deregulation of airline operations, with the removal of the former two airline policy – in particular, the demise of the Independent Air Fare Commission which approved movements in airline fares.
1990	First new entrant Compass enters the Australian domestic market.
95/96	FAC aeronautical charges regime moved from a 'network' price to a 'location specific' price in anticipation of airport privatisation.
96/97	Tranche 1 airports sold to private operators under a CPI-X regulatory regime.
97/98	Airservices Australia introduces 'location specific' pricing for Aviation Rescue and Fire Fighting (ARFF).
97/98	Tranche 2 airports sold to private operators under a CPI-X regulatory regime.
98/99	Airservices Australia introduces 'location specific' pricing for Terminal Navigation Services.
98–ongoing	Various ACCC determinations, discussion papers and guidelines developed to give greater clarity to the regulatory framework applying to airports.
1999	Minister for Transport and Regional Services issues a policy statement 'A Measured Approach to Aviation Safety', contemplating the introduction of contestability into some parts of Airservices' business.
1999	Air New Zealand acquires 100 per cent ownership of Ansett Australia Holdings Limited
2000	The Civil Aviation Safety Authority (CASA) issues Notices of Proposed Rule Making. This proposes amendments to Civil Aviation Safety Regulation, which when put into effect, will allow for introduction of competition in the provision of Tower Services, ARFF and maintenance of aeronautical telecommunication equipment. It appears airport owners will gain the responsibility for providing the physical infrastructure for these services if not the responsibility of contracting a service provider. The status of

these reforms is as yet unclear including an economic (as opposed to safety) regulatory regime which may apply if they are implemented

2000 Two new entrants - Impulse and Virgin Blue - enter the Australian domestic market.

2001 ACCC approves a Qantas takeover of Impulse.

Economic regulation of Australian airports

In 1997 the Commonwealth Government began a reform program aimed at improving the efficiency of Australia's major airports. Broadly, the objectives of the reform initiatives were to:

- make better use of existing airport infrastructure;
- allow airports to earn a reasonable return on their investments;
- encourage timely investment in airports; and
- protect users from the market power of airports.

To promote these objectives, the Commonwealth Government initiated a program of privatisation and economic regulatory reform.

Ownership arrangements

Starting in 1997, the Commonwealth Government privatised the airports previously operated by the FAC through the sale of long term leases, with the exception of KSA, Bankstown, Camden, Hoxton Park and Essendon Airports. The airports were sold in two tranches the first in 1997 and the second in 1998, and included major airports in all capital cities (except Sydney).

The Government has corporatised KSA and its major shareholder is the Minister for Finance. As the Commission would be aware, the Government has recently announced it's intention to sell KSA and also Bankstown, Camden, Hoxton Park and Essendon airports.

In the mid 1980's the Commonwealth Government also transferred ownership of numerous local and regional airports to local authorities. In many cases, the local authority was actually paid to take ownership of the airport from the Government.

Economic regulation

When the airports were privatised, the Government put into place a package of economic regulation. This regulation occurs under the *Airports Act 1996*, the *Prices Surveillance Act 1983* and the *Trade Practices Act 1974*. The ACCC administers the economic regulation of airports.

The Government intended at the time of privatisation economic regulation of airports would be transitory, and the initial regulatory framework would be in

place for five years. Subsequent economic regulation would be determined after a review of the arrangements before the end of this period, with the review based on the premise that the price cap applied to aeronautical charges during the first five years will no longer operate. In it's place, the review will aim to develop arrangements targeted at those charges where the airport operator has the most potential to abuse market power.

The review will also give airport operators the opportunity to suggest alternative forms of oversight, ideally with the backing of their customers.

Just as the 'X factor' for the privatised airports was developed on an airport by airport basis, the review contemplated by the Department of Transport and Regional Services envisages the existing set of aeronautical charges will be reviewed on the same basis, with the review assessing whether services should be added or removed from economic regulation.

Economic regulation of core regulated airports

The airports subject to the strongest economic regulation are the major airports at Melbourne, Brisbane, Perth, Adelaide, Alice Springs, Canberra, Coolangatta, Darwin, Hobart, Launceston and Townsville (core regulated airports).

A modified version of the package applies to KSA, and at the time of the initial airport privatisations it was intended the same regime would apply to KSA once privatised. The impact of the lack of a certain or robust regulatory environment at KSA combined with the aggressive pricing practices of KSA, is discussed in Part 4.

Broadly, the economic regulation comprises:

- surveillance of prices for declared aeronautical services (including administration of a price cap for all of the above mentioned airports except KSA), under section 20 of the *Prices Surveillance Act 1983*;
- monitoring of prices for aeronautical related services under section 27A of the *Prices Surveillance Act 1983*. Price monitoring gives the ACCC the power to investigate price increases of aeronautical related services where there is evidence of abuse of market power by the airport owner;
- approval process for necessary new investment (NNI). Through the *Prices Surveillance Act 1983*, airports can obtain price increases for investment that improves the capacity and/or quality of service of declared aeronautical activities;
- monitoring of service quality of airports under Part 8 of the *Airports Act 1996*;
- publishing annual reports of airports' financial and other performances under Part 7 of the *Airports Act 1996*; and
- administering rules to ensure businesses can gain access to essential airport services under section 192 of the *Airports Act 1996* and Part IIIA of the *Trade Practices Act 1974*.

Definitions of the price cap, notified services and monitored services are contained in direction numbers 13, 14, 15 (now replaced by no. 18) and 16, and declarations 83, 84, 85 and 89.

KSA is subject to direction numbers 18 and 22. We are assuming the Commission is familiar with the current regime (including the recent changes to it) and as such, do not propose to go into further detail.

The Department of Transport and Regional Services also produced a *Pricing Policy Paper* to assist the aviation industry with the regulatory framework that was put into place after privatisation.

Non-core regulated airports

The non-core-regulated airports are Archerfield (Qld), Jandakot (WA), Moorabbin (Vic), Mount Isa (Qld), Parafield (SA), Tennant Creek (NT), Sydney's Bankstown, Camden and Hoxton Park and Melbourne's Essendon Airport. These airports service general aviation (GA) aircraft. The last four remain in public ownership.

Non-core regulated airports are not subject to prices oversight, quality of service monitoring, third party access or public reporting. However, they are subject to the general provisions of the *Airports Act 1996* and *Trade Practices Act 1974*.

Non-regulated airports

Non-regulated airports include Australian Locally Owned Ports (ALOP), such as Cairns and Broome airports and numerous other regional airports throughout the country. These airports are not subject to economic regulation beyond the general provision of the *Trade Practices Act 1974*.

For the Commission's interest, we have provided estimates of the aeronautical charges on a per passenger basis for a Boeing 737-300 for some ports to which the Ansett/Air New Zealand Group and its regional subsidiaries operate within Australia and New Zealand on a commercial in confidence basis (figures 1 to 4). We have separately identified Terminal Navigation and Rescue and Firefighting charges as under changes being considered, it is possible these charges could also become a part of an airport monopoly revenue stream. Other Government charges (such as noise levies) are also shown.

PART 2: The New Zealand air transport industry

In common with Australia, air transport in New Zealand has undergone considerable change over the past two decades, including:

1983	Air Services Licensing Act established qualitative licensing system for domestic air transport operations – principal consideration was operator competence
1986	Airport Authorities Act 1966 amended to provide for transformation of joint venture airports into publicly owned corporations. Commerce Act 1986 established generic competition regime considered appropriate to provide safeguards against monopoly abuse. It was also thought that airport authorities and Government companies remained subject to common law obligations to set reasonable charges for an "essential facility". Guidelines issued to Overseas Investment Commission providing for up to 50% foreign ownership of New Zealand domestic airlines.
1 April 1987	Airways Corporation of New Zealand (ACNZ) established as a State Owned Enterprise with requirement to operate as commercial undertaking. ACNZ has statutory monopoly over provision of approach and en route facilities (but not aerodrome control).
1987	Auckland International Airport Limited established (Crown 50%, local authorities 50%). In 1990 the Crown increased its share to 51.6% through the purchase of the shares held by the Papakura District Council.
1987	Ansett New Zealand established as main trunk competitor to Air New Zealand.
1988	Christchurch International Airport Limited established (Crown 25%, local authorities 75%).
1988	Regulatory responsibility for rescue and fire fighting services passed to airport authorities.
1988	Up to 100% foreign ownership of New Zealand domestic airlines allowed.
24 Oct 1989	Air New Zealand Limited listed on NZL Stock Exchange.
1 Sep 1990	Civil Aviation Act 1990 enacted, removing all economic regulatory restrictions on the operation of domestic air services and establishing an autonomous Civil Aviation Authority

responsible solely for operational and airworthiness requirements of the New Zealand civil aviation sector.

1990 Wellington International Airport Limited (WIAL) established (Crown 66%, local authorities 34%).

1991 WIAL 1 – High Court upheld vesting valuation of WIAL but ruled statutory requirement to consult had not been met – the case is important in establishing consultation case law

1992 Appeal Court further clarified consultation case law in terms of finding that consultation does not require agreement.

1995 WIAL 2 – High Court action taken on basis of pricing principles used by WIAL, particularly target rate of return and operational efficiency. The Court upheld WIAL's right to recover efficiently incurred costs and earn a rate of return commensurate with risk and prevailing market expectations.

1996 Crown sold/disposed of holdings in Hamilton, Oamaru and Te Kuiti airports.

Oct 1996 Air New Zealand Limited purchases 50% of Ansett Australia Holdings Limited from TNT.

1997 WIAL and airlines entered into 5 year deed covering charges.

1997 Crown disposed of holding in Timaru airport.

1997 Airport Authorities Amendment Act 1997 enacted providing for modified regulatory regime including:

- Consultation with "substantial customers" before fixing or altering charges (including charges payable by passengers) or at least every five years;
- Consultation by specified airport companies (i.e. those with revenues in excess of $10million pa) with substantial customers over major capital expenditure;
- Disclosure of certain financial and operational information under the Airport Authorities (Airport Companies Information Disclosure) Regulations 1999; and
- Operation of the airport (which includes fixing charges) "as a commercial undertaking".

In passing the Act the Government determined that the CC would undertake an Inquiry into pricing of airport activities (later clarified as "airfield activities" as per the Act) at Auckland, Christchurch and Wellington airports in order to determine whether price control was required.

	The Act also contained a transitional provision requiring any airport company that had not consulted over charges within five years of the commencement of the Act (26 November 1998) to do so within 12 months of that date.
1998	Crown sold/disposed of holdings in Masterton, Tauranga, Hokitika, Rotorua and Palmerston North airports.
Jul 1998	Crown sold 51.6% of Auckland International Airport Limited (AIAL) by way of public float, AIAL listed on NZL Stock Exchange 28 July.
Aug 1998	Crown sold 66% of WIAL to Infratil Holdings Limited.
Sep/Oct 1999	Consultation commenced as required under transitional provisions of the 1997 Amendment Act with, inter alia, AIAL and Christchurch International Airport Limited (CIAL) (neither of these processes were complete by the statutory deadline).
Jun 2000	Air New Zealand Limited completes purchase of News' 50% share of Ansett Australia Holdings Limited.
Aug 2000	AIAL sets charges, imposing increases of 8.5%, 5% and 5% over the next 3 years, with the first increase effective from 1 September 2000. The Airport Departure Charge was also increased by $2 to $22.
Oct 2000	Air NZ files legal proceedings against AIAL on the basis of AIAL's conduct of the consultation process.
Dec 2000	CIAL sets charges, essentially decreasing charges for international operations and increasing charges for domestic operations, effective 1 January 2001. Air New Zealand is considering its position in relation to the behavior of CIAL as there are issues of principle (such as pre-financing) which cannot be accepted.
Apr 2001	Qantas NZ's parent company Tasman Pacific goes into receivership.

Economic regulation of New Zealand airports

Until 1987, airport air traffic services, route air navigation facilities and rescue fire services were provided by the State through the Civil Aviation Division of the Ministry of Transport. The State, by regulation, set charges for both domestic and international operators. Airport infrastructure had developed as a series of partnerships between the Government and Local Authorities in "joint venture" agreements where the partners shared the cost of constructing and operating airports. Charges were also set by regulation and the partners shared the operating profit or loss.

Since 1987, the Government has moved to transform joint venture airports, where viable, into publicly owned corporations. Each airport has been structured as a separate legal entity, with a Board of Directors who have a first responsibility to the Company. The aim has been to ensure that airports are operated no differently to any other commercial entity in New Zealand. The restructuring of the sector was intended to bring about three main benefits:

- Economic efficiencies: commercial imperatives would drive airport decisions and companies could commit to future development with planning certainty. The consultative process would assist cost effectiveness; airport charges would be transparent and sustainable;

- Improved airport management: airports would respond more quickly to airline user needs, bringing improved supplier/customer relationships; and

- Expenditure savings: taxpayer and ratepayer deficit funding or capital injection would be avoided. Taxpayers and ratepayers through the sale of the airport would be paid back for their earlier investment as well as receive an appropriate return from company dividends and interest from any shareholder loans. The Government would get the usual taxation applicable to the commercial sector.

Ownership arrangements

In July 1998 the Crown sold its 51.6% share in AIAL by way of a public float. The company was listed on the New Zealand Stock Exchange, and the following year on the Australian Stock Exchange. Local Government shareholders agreed not to sell their shares within 6 months after the initial public offering. In 1999, North Shore City sold its 7% shareholding to Singapore's Changi Airport. Other significant shareholders comprise Auckland City Council (25.8%) and Manukau City Council (9.6%).

In August 1998 the Crown sold its 66% shareholding in WIAL by way of trade sale to NZ Airports, wholly owned by Infratil NZ Ltd. Wellington City Council has retained its 34% shareholding.

The Crown retains a 25% shareholding in CIAL with the remaining 75% held by local authorities.

The Crown no longer retains an interest in Waikato, Oamaru, Te Kuiti, Timaru, Masterton, Tauranga and Hokitika airports having sold/disposed of its interest to the relevant local authorities.

The Crown sold its holdings in Rotorua and Palmerston North airports as a package to Central Avion Holdings Limited. The local authorities retain their respective interests in these airports.

Economic regulation

Regulatory obligations for airports differ depending on the size of the airport. So-called "specified" airport companies – those with revenues in excess of

$NZ10 million per annum - are subject to a more robust consultation and disclosure regime than those with revenues below this level. While all airport companies are required to consult over charges, specified airport companies are also required to consult in respect of capital expenditure over a specified threshold. The specified airport companies are Auckland, Christchurch and Wellington.

The regulatory environment encompassing airports in New Zealand comprises three legs:

- Consultation obligations in respect of new charges, or no less than every five years for existing charges, and, in respect of specified airport companies, consultation on capital expenditure plans where the amount of that forecast expenditure for the next five years would exceed more than 20% of the value of the identified assets of the airport company (under the Airport Authorities Act 1966);

- Annual disclosure obligations in respect of charges, revenues, costs, specified performance standards, and to some extent methodologies, relating to "identified airport activities" (under the Airport Authorities (Airport Companies Information Disclosure) Regulations 1999);

- The backstop of the Commerce Act in terms of access issues and Part IV price control.

The Airport Authorities Act regime of consultation relates only to those parts of the airport business deemed to provide airports with significant market/monopoly power, termed "identified airport activities". These activities are further delineated into "airfield activities", "specified passenger terminal activities", and "aircraft and freight activities".

Overview

In both Australia and New Zealand, reform initiatives aimed at improving the performance of the air transport industry have had to recognise the fundamental differences between the delivery of airline and airport services.

In the case of airlines, governments have promoted improved performance by reforming the external conditions of the market, promoting increased competition. Certainly, one can readily observe the result of the reforms in the provision of airline services – international, domestic and regional operations are subject to a highly competitive environment. Entry, and threat of entry is obvious. Hence, the airlines themselves have decided on the operational changes necessary to allow them to successfully compete in the new competitive environments. This has resulted in an airline industry more aligned with the needs of the market, bringing improved services for passengers at lower prices.

Governments have been unable to introduce competition to the provision of airport services – largely due to the natural monopoly characteristics associated with the provision of such infrastructure services. Instead,

governments have imposed regulatory and operational changes in an attempt to more closely replicate conditions it considered would prevail if the services provided were subject to competition. Attempts have also been made to introduce greater efficiency through airport privatisation, although the inherent conflict with pro-competitive policy objectives has become increasingly obvious.

The Ansett/Air New Zealand Group would agree wherever possible, the introduction of competition to a market is the best way of promoting improved performance. Hence, the improvements in efficiency, commercial and customer focus achieved by airlines have by and large exceeded those of airports.

The current economic regulation of the major airports in Australia and New Zealand differ markedly between countries. In Australia, Tranche 1 and 2 airports are required to justify cost increases on the basis of improved or enhanced capacity in addition to the operation of the CPI-x price cap reductions passed through to users. KSA is in a rather unique position, where the Government twice changed the rules to accommodate SACL's pricing proposal, secure higher aeronautical revenues and ultimately higher bid prices for the airport.

At the time of writing, it is not known what (if any) regulatory environment KSA will be subject to upon sale. It would be extraordinary if the answer was, effectively, none. However, the extraordinary seems to be becoming the norm with regard to Sydney.

In New Zealand, the major airports essentially operate in an unregulated environment. Instead, 'shadow' regulation, including the current review of airport pricing, is used as the mechanism to curb the market power of these airports. New Zealand's regulatory regime is generally described as "light-handed" in the sense of eschewing sector specific regulators in favour of a generic regime based on the Commerce Act, the CC and the Courts. The regulatory regime for airports is essentially of this nature as although the Airport Authorities Act sets out consultation and information disclosure requirements, the only avenues currently available for settling disputes are the CC and the courts.

Unfortunately the courts have no expertise or inclination to address matters of principle, focussing instead on process issues – where the regime currently provides airports with a right to set prices as they see fit – and the focus of the Commerce Act is on competitive markets, rather than dealing with situations of monopoly abuse. The doctrine of prime necessities has also been deemed by the Courts to no longer apply in New Zealand with the advent of the Commerce Act. Also of note is the fact that the current Airport Pricing Inquiry is the first instance of the Commission exercising its Inquiry powers under Part IV of the Commerce Act, powers which are integral to the "credible threat" element of the light-handed regulatory regime.

Overall, airports in Australia and New Zealand have the ability to exercise market power. Airlines have offsetting market power only to the extent they

can choose to not increase, or to reduce services, to an airport. As demand from consumers is relatively insensitive to the charges levied by airports, and as airlines have competitors (unlike airports) which will fill the gap if one chooses to take a stand and reduce services, the countervailing power is mythical.

The objective of regulation reviews on both sides of the Tasman should be to move the current systems towards a market capable of operating with minimal administrative oversight.

Neither the Australian nor the New Zealand pricing system today provide an effective means for making such a transition. Current review processes should address this issue as their prime objective.

The objective can be more specifically stated: it should aim to provide for effective price negotiation.

Privatisation is not solving the problem. Selling off assets and not dealing with the flaws exposed in the pricing systems as a result of experience will mean serious pieces of infrastructure – potentially the most important assets in the economies of both Australia and New Zealand if international tourism interests are taken into direct account – are likely over time to become an impediment to growth.

The claim that the quantum of price impacts is small, and thus the cost of getting it wrong is also small, is particularly worrying in this context. The infrastructure assets are strategically significant and the incentive and ability to exploit them is great, in the absence of a regulator. In the end, consumers will have little ability to resist, if airlines do not resist on their behalf.

We ask, as an overall conclusion, how there can be any reason for an airline to do more now than simply pass on **<u>any</u>** increase sought by an airport, if the regulatory system is to offer no effective ability to settle future prices by <u>even-handed</u> negotiation?

Giving (or, in NZ, retaining) the power to unilaterally set prices to entities which can and thus *may* exploit market power must of necessity undermine any ability to negotiate, even if the airport itself in the end acts benevolently and chooses not to abuse that power.

PART 3: Market arrangements for airports

The supply and demand characteristics of airports have important implications for the way in which airports and airlines interact, which differentiates them from other types of regulated economic infrastructure. These differences need to be taken into account in understanding the nature of the market power of airports and the appropriateness of different economic regulatory models.

Supply

Airports provide a vast variety of services and assets. To allow for a greater understanding of the services and assets provided by airports, they may be broadly classified as:

- core aeronautical infrastructure;
- ground access; and
- retail.

The assets contained in each category also have different characteristics, which adds to the level of complexity associated with airport operations. These characteristics include whether the asset is 'common user' or 'airline specific', who has ownership and control of the asset, and if the service can be made contestable between potential suppliers.

Core aeronautical infrastructure

Core aeronautical infrastructure represents airport assets and services required by an airline to allow it to conduct operations. At most major airports it includes:

1) Terminal buildings (domestic and international), which contain:
   a) check in and queuing facilities;
   b) check in desks;
   c) baggage systems;
   d) ticketing and information facilities; and
   e) concourses, which contain:
      i) security;
      ii) gate lounges; and
      iii) airline lounges.

2) Aircraft departure/arrival infrastructure, including:
   a) aero bridges;
   b) ground service and equipment and ramp areas;

c) aprons;
d) taxiways;
e) runways;
f) refueling;
g) catering;
h) cleaning;
i) maintenance; and
j) services provided by Airservices Australia and ACNZ on a location specific basis:
    i) terminal navigation; and
    ii) aviation rescue and firefighting.

3) Airline staff facilities, including:
    a) staff car parks; and
    b) airline offices.

4) Freight centres.

The large number of core aeronautical infrastructure assets and services is the first feature distinguishing airports from other types of regulated economic infrastructure. As a comparison, the National Electricity Code in Australia specifies only three types of services for the transmission grid: entry; transmission network; and exit.

The core common user aeronautical assets at airports are runways, taxiways and aprons. These assets are owned and controlled by airports. Common user aeronautical assets have true natural monopoly characteristics because it is economic for only one provider to supply the entire relevant market. Because they are owned and controlled by airports, there is no contestability in their provision.

The provision of core common user aeronautical assets has remained broadly the same and has not changed fundamentally due to changes in technology or demand requirements from airlines. For example, there have been no new runway developments in Australia since the third runway at KSA.

However, other common user aeronautical assets, such as international terminals, which also have natural monopoly characteristics, have evolved with changes in demand and technology.

Airline specific assets include many domestic terminals, passenger lounges within common user terminals and freight centres. They may be designed for the exclusive use of an airline (and sometimes other airlines through agreements) and are often distinguished by the use of brands.

An important distinction between common user and airline specific assets is that airline specific assets are a source of competitive advantage for one airline over another. For example, investment in domestic terminals or airline lounges can improve the overall level of service quality for passengers, which differentiates the operations of the airline from competitors. The importance of airline specific assets also differentiates airports from other types of regulated economic infrastructure, which are dominated by, or only provide, generic common user assets and services to the competitive sector of the market.

Ownership and control arrangements for airline specific assets differ by both the asset and between airports.

In Australia, many domestic terminals are owned and controlled by an airline through long term leases, while international terminals are owned and controlled by the airport. In New Zealand, domestic and international terminals are owned and controlled by the airport. Airport ownership and control over airline specific assets is a strong source of market power for airports over airlines. Even when the airport does not directly control the asset in question, the way in which different assets interact also provides an airport with a degree of market power.

The extent of ownership and control by an airline over an airport asset depends on the terms and conditions (especially length) of the lease.

Heavy Maintenance facilities (as opposed to line maintenance facilities which exist at most airports to some degree) are a good example of a 'special case' in airport operations. Because significant heavy maintenance facilities are not required at every major airport, there can be a degree of competition to attract these facilities – they must be located at an airport but the question of which airport is then relevant. In Ansett's Australian experience, whilst airports may offer some incentives to base facilities such as these at their airport, generally, the greatest source of competition and incentive packages is between State Governments (due to the employment and state based investment generated etc) rather than the airports in question.

Ground access facilities

Ground access facilities are assets necessary to allow passengers and freight to travel to and from the airport. They include:

- roads;
- passenger car parks;
- train stations;
- hire car and coach facilities; and
- valet car parks.

Passenger car parks, train stations and most roads are common to all users and are controlled by the airport. Valet parking is a service provided by

individual airlines, and is a source of competitive advantage. Some airports also offer valet parking services.

Retail activities

Retail activities include food courts, bars and merchandise shops and advertising.

One of the most distinguishing features of Australia and New Zealand's major airports since the 1980's is the growth of retail activities. If one looked at our larger airports in 1980 and compared that picture with what is there today, the primary difference is the growth in retail – often accompanied by new or expanded terminal areas to accommodate this growth. As noted above, there has been no significant investment in new core aeronautical infrastructure in that time – with the exception of the third runway at KSA. Terminal development has, in the main, been driven more by the desire for expanded and enhanced retail operations than the incremental increases in aeronautical capacity, although necessary increments in aeronautical capacity is often presented as the reason for more significant developments.

As a consequence, airports increasingly earn their money through retail and carparking activities - not core aeronautical infrastructure. The importance of retail and car parking revenue is highlighted by the fact that at the time the Australian airports were privatised, the bid price for many airports was influenced by the perceived ability of the new owners to increase revenue and profits through expanded retail activities – with the Commonwealth Government achieving exceptionally high earnings multiples upon sale based on this. The prospectus for the sale of the Crown's 51.6 per cent share of Auckland International Airport notes the importance of expanded retail and commercial facilities to the future revenue streams of the company.

The growth in retail activities — transforming airports into multi-product businesses — differentiates them from other forms of regulated infrastructure in Australia. Airports and airlines are mutually dependent customers. Airlines rely on airports to provide core aeronautical infrastructure and to provide the space and facilities within reasonable proximity to the necessary infrastructure to enable airline specific products to be delivered. Airports rely on airlines for the 'bread and butter' aeronautical revenues paid to the airport but, increasingly, the more important relationship is that airlines bring in passengers who then spend money in retail shops and carparks at the airport.

As an example, a marketing campaign by an airline or tourist authority to encourage growth in air travel will, if successful, directly improve the profitability of airports in both core aeronautical infrastructure and retail activities by bringing more passengers through the airport. Investments in core aeronautical infrastructure are no longer taken by airports without reference to the impact on retail activity and revenue – one only needs to again read the evidence of KSA to the PWC Committee regarding SA 2000 to see this (see BARA submission to PC). Similarly, the AIAL Prospectus notes 'Any increases in aircraft and, in particular passenger movements, will in turn

provide greater revenue opportunities for retail and commercial services based at the Airport'.

One way of thinking about the airport/airline relationship is to consider airlines as the 'anchor tenants' of airports. Airline operations are the non-substitutable activity bringing in the passengers allowing airports to earn revenue through retail, advertising and carpark activity. Without airline operations, most major airports would become badly placed shopping malls with retail activities inferior to those of their competitors.

In the competitive market place, the 'anchor tenants' have considerable commercial bargaining power and are able to use this bargaining power to ensure favorable terms are obtained. Lessors are required to offer favorable terms to the anchor tenant because of the strong competition from other shopping malls for the location of the anchor tenant's store. For example, it is unlikely that Coles Myers is expected to pay 'locational rents' to lessors given they are primarily responsible for the creation of such rents in the first place.

In the world of aviation, airline operators can be considered the anchor tenants of an airport. Hence, the value of an airport is largely driven by airline operations, even when the land is on 'prime' real estate. If the market for airport services was competitive, airlines would not be expected to contribute to 'locational rents'.

Given the changing structure of airport revenue streams, it is symptomatic of the lack of maturity in the Airline – Airport relationships that the importance of this linkage is not more widely recognised – debate is still largely centered around the single till – dual till arguments both of which we submit are outdated in their pure form. Competitive markets have developed mechanisms to address this. However, whether due to the rate of change in the aviation industry or the power imbalance between airports and airlines, or both, the aviation industry is yet to successfully do so.

Interactions between airport assets and services

Airports are distinguished by the variety of assets and services provided, some of which are not necessary for air transport operations. These assets and services do not operate in isolation. Any change to one asset can have flow on effects to other assets and services.

For example, the expansion or development of a new terminal may compromise efficient operation of freight facilities. Development of a new terminal in a particular location can mean the loss of aircraft parking bays, meaning further investment is required sooner than would be otherwise necessary. The location of roads and taxi ranks can effect the ease by which passengers can gain access to one terminal versus another. Development of more retail shops in a terminal may impede the ability of passengers to easily find their way to airport gates and lounges. Desire by airport owners to maximise retail spend may lead to removal of adequate seating and inadequate sizing of gate lounges impacting on passenger comfort - but forcing people into shops. At KSA, for example, there are a number of 747

gate lounges which have seating capacity for 67 passengers. A fully laden 747 carries around 400 passengers.

The main priority for an airline in respect of an airport is to ensure passengers can get through the airport quickly and safely with little or no hassle. Airports, on the other hand, have as a primary objective maximising the amount of money passengers spend at retail shops. The promotion of expenditure maximisation by passengers can conflict with the airlines' objective of quick and safe transit of passengers through the airport. It can lead to aircraft delays while ground staff search the retail facilities for 'fail to board' passengers or while large or bulky goods purchased at airport retail stores are properly stowed. This creates an inherent level of tension between airports and airlines in the planning and delivery of airport infrastructure, as well as day to day operational management. As you would expect there are some airports who work closely with the airlines to minimise these problems. There are many who do not.

As can be seen issues surrounding new or expanded assets extend beyond the price and service quality of that asset. Discussions must also take into account the effect the asset can have on the transit of passengers and freight through the airport.

This is an important rationale for the tests the ACCC has developed to assess NNI – in particular, the user support test. Airlines understand airport facilities needed to facilitate airline operations. Airlines understand the relationship of different parts of an airport to other parts. It is also reflected, although to a much lesser extent, in the New Zealand regulatory regime through the limited consultation requirements relating to forecast capital expenditure.

So long as there is an incentive for airlines to scrutinise, challenge and devote resources to participate in airport investment proposals, the importance of these interactions is given appropriate consideration.

Were the Commission to peruse the NNI files held by Ansett of the submissions and comments we have made to airports and the ACCC on airport investment proposals, it would be clear many of the comments relate first to the demand and need for specific investment but also, to possible 'knock on' impacts of the proposal put forward and questions as to how those are to be minimised and also, possible alternatives to the project proposed. These discussions do not relate solely to price.

The supply of services by airports has fundamental differences to other forms of regulated economic infrastructure. These differences include the importance of airline-specific assets, the growth of retail activities, the interaction between assets on airports and the potential conflict of objectives between airports and airlines. Because airlines can be considered 'anchor tenants' of airports, they should not be expected to pay 'locational rents' as airline operations are the primary reason for such rents existing.

Demand

As with the supply characteristics, demand characteristics of airports have both similarities and important differences compared to other types of regulated economic infrastructure.

Demand for air travel is primarily a derived demand.

Passengers choose their origin and destination based first on their desired travel plans and second, available airline schedules. The decision is not made on whether the airport shopping is better at Sydney, Brisbane, Melbourne, Auckland, Christchurch or Wellington. In the world of aviation, ***airlines*** cannot elect to not use certain airports or to cease to expand or operate until an airport offers an attractive package to use their facility: ***passengers*** make that choice.

The arguments by airports to suggest they cannot or will not misuse market power are pitched very much at airlines being able to apply countervailing market power, by choosing to withdraw services. This might be an option in an environment where airlines face no competition, or threat of entry. It is not an option in Australia or New Zealand. Airlines have insufficient countervailing market power to constrain the market power of airports by ceasing operations if a particular airport is where their customers wish to fly. Withdrawal of services by a single airline acting unilaterally will simply result in their losing market share as a competitor moves to replace required capacity. Airlines must make their operational decisions accordingly and will fly where their commercial analysis of the market tells them their customers wish to go – however, whether this can be done profitably or not is something on which airports can have a significant impact.

A key driver of demand is economic activity, influencing both business and leisure customers. The load factors of airlines are clear and early signals of any slowdown or recovery of the economy or business confidence. However, airlines do have the ability to influence the level of demand, both overall and between operators. This can occur through initiatives aimed at changing or improving the price and quality of service provided, yield management practices and activities such as marketing and promotions.

The ability for airlines to influence demand occurs to a far greater degree than in other infrastructure industries with monopoly and competitive elements. Few electricity generators seek to differentiate the product (electrons) they provide to final users. The telecommunications sector is perhaps closer to that of air transport on this issue, but even it is unlikely to have the same degree of price differentiation.

Unlike other forms of regulated economic infrastructure, airports have a more direct influence on the value consumers obtain from air travel. Unlike the national electricity transmission grid or local telephone loop, people have direct physical contact with an airport. The value passengers obtain from air travel is a function of their experience both at the airport and in the aircraft with the carrier from whom they have purchased a service. Interestingly,

although passengers interface with services provided by airports, they do not generally have any sense of 'value' as they are generally not aware of the cost of airport facilities. Hence, unless airports and airlines are encouraged to act in a cooperative manner to maximise the value passengers obtain, the value of air travel to passengers can quickly diminish.

Airports also have the ability to affect the quality of service provided by airline specific assets and services (by the size, location, terms and conditions offered etc). Hence, airports have the potential ability to affect the overall level of demand and demand between airline operators. As described earlier, airlines rely on the airports to provide airline specific assets and services – or to provide appropriately located space for them to do so. The ability of an airline to obtain competitive advantage and gain custom is often linked to the supply of such services. Again, this is a result of the fact that airline passengers have a direct experience with airports even though they equate that experience with the airline they are flying with. The late or unsatisfactory supply of a required service (for example, the recent problems experienced with the Baggage Handling Service at Sydney International Terminal) can quickly erode the benefits the airline had sought to achieve – with most passengers blaming the airline for the problem. As such, service quality (both of the asset directly and its interaction with other assets and services) can in some circumstances be a factor as important as an efficient price. These features of airline specific assets mean they can be an important source of market power for airports.

Airports have important demand characteristics that differentiates them from other types of regulated economic infrastructure. This flows from the direct physical contact passengers have with airports even though this is generally considered by passengers an experience associated with using a particular airline carrier.

PART 4: Market power of airports

A key consideration in determining any future economic regulatory regime is whether any airport has sufficient ability to misuse market power such as to warrant government intervention.

The Ansett/Air New Zealand Group contends that the major airports in Australia and New Zealand have substantial market power and this market power is exercised to the detriment of both the airlines and final consumers. Airport market power stems from:

- the natural monopoly characteristics of airports;
- limited countervailing power of airlines;
- limited competition for transport services in the final market (substitute transport modes); and
- the importance of airline specific assets combined with the interaction between different assets and services.

Many of the issues outlined above are covered by BARA and BARNZ and will not be repeated in this submission.

Both the PC and the CC are interested in evidence on the extent of market power of airports. For regulated airports in Australia, evidence of market power can appear to be a somewhat problematic issue, given the difficulties in determining the counterfactual outcomes. However, some light can be shed on the issue by examining the kinds of contracts and outcomes achieved by the Ansett/Air New Zealand Group with other suppliers that operate in competitive markets.

Some of the goods and services required by the Ansett/Air New Zealand Group are usefully classified as being 'strategic critical' to our business. They represent a high cost to our business and the service provided is critical to the efficient delivery of air travel and the quality of service associated with our brand to passengers.[1]

Strategic critical inputs for the Ansett/Air New Zealand Group include suppliers such as airports, aircraft manufacturers, catering, fuel and air navigation.

Strategic critical inputs require long-term relationships to be developed with suppliers due to the cost and/or difficulty of changing suppliers or because only one supplier is available.

Where possible, the Ansett/Air New Zealand Group seeks to obtain the best value for money through creating 'competition for the market' by a competitive tendering process.

[1] An individual input is usually considered high cost to a business if its total cost represents more than one per cent of the organisation's total cost.

Where there is competition between suppliers, conditions of supply are *determined by the purchaser*[2]. Key elements of the conditions of supply include:

- specification of the services required;
- development and agreement on key performance indicators (KPIs);
- commercial consequences (incentives, rewards and sanctions) based on KPIs;
- agreed information flows between purchaser and supplier;
- dispute resolution clauses and preventive measures to avoid issues arising; and
- the price for services provided.

A good example of contracts developed with suppliers in competitive markets is the case of inflight catering. The Ansett/Air New Zealand Group currently has contracts for the supply of inflight catering with Gate Gourmet and LSG Sky Chefs. These are complex contracts with a very real ability to impact either positively or negatively on our business according to supplier performance. In this respect, it is fair to consider them in the same 'strategic critical' supplier category.

A competitive market gives good incentive for suppliers to have the will and focus needed to successfully manage contract development and implementation. Even in an area such as catering, which is 'strategic critical' with high costs associated with switching suppliers, the competitive nature of the market ensures both parties have an incentive to recognise and focus on the importance of the various aspects of relationship management.

The Industry Commission's inquiry into *Competitive Tendering and Contracting by Public Sector Agencies* discusses many of the elements and processes for successful contracting.

Contrast this situation with Airports. The information provided and resources devoted by monopoly providers to managing relationships with the Ansett/Air New Zealand Group is in complete contrast to what occurs in competitive markets.

This situation highlights the issue of how the Commission should view and understand the importance of information to commercial businesses. In particular, the provision of information is often viewed as a wasteful cost, which should be minimised. For example, the cost of providing information to the regulator is often counted as a cost to society, which needs to be weighted against the benefits obtained. Whilst this is a reasonable premise theoretically, it should be considered in the real world environment when dealing with market situations which are less than optimal – such as airports.

[2] Just as the Ansett/Air New Zealand Group must comply will all relevant laws in providing RPT operations, conditions of supply also acknowledge and incorporate any laws applying to the supplier of goods and services to Ansett.

If airports operated in competitive markets, there would in fact be substantially greater flows of information between the airport and airlines, with improved outcomes achieved as a result. The information provided to the regulator (or in some cases in annual reports) is in many respects the only source of data we have regarding airport suppliers. Information is of course one category of measurement only, albeit an important one. We submit airports have no incentive to develop a greater level of commercial maturity in the absence of a regulatory environment which lasts longer than a transitory five year period.

In considering the market power question and indeed the countervailing power argument, it is instructive to compare outcomes obtained with suppliers in competitive markets against the current arrangements with airports. We have briefly discussed in the commercial in confidence box above, an example of the arrangements in place in a competitive environment.

In the case of airports, the conditions of supply (termed 'conditions of use') are determined by the supplier. Not surprisingly, they contain intricate detail on the obligations of airlines and rights of airports but offer no comment on the obligations of airports – indeed many refuse to provide, or seek to limit, warranties as to serviceability or fitness for purpose of the services and facilities provided.

Elements of such documents put to the Ansett/Air New Zealand Group along with any other user of the particular airport regularly include:

- rights to move our aircraft (Ansett /Air New Zealand operate aircraft which are individually worth hundreds of millions of dollars – agreement to this clause would potentially breach aircraft lease and insurance agreements);
- rights to impound our aircraft or property due to failure to pay (again, agreement to this clause potentially breaches aircraft lease and insurance agreements and one must seriously question the commerciality of any airport who seriously considers impounding aircraft worth perhaps one hundred million dollars. Either there is a serious administrative problem with the airport taking appropriate action to manage it's debtors or serious overkill);
- the ability to sell our aircraft due to failure to pay – *and* a caveat that the airport is not liable if they do not sell for a market price!;
- attempts to limit the extent to which airports can be held liable for negligent supply of services causing damage or injury; and
- willingness to negotiate a dispute *if in the airport's reasonable opinion* the airline has grounds for dispute.

Such contracts contain no specification of services provided, no KPIs, no commercial consequences based on the quality of the service provided and no information flows between the supplier and purchaser (except for the price the airlines are expected to pay and information airlines must provide to enable this).

Examples of conditions of use proposed by various Australian airports are provided in attachment B. The conditions of use Australian airports seek to apply clearly demonstrate the market power of airports.

Similar conditions of use exist for both regulated and non-regulated airports. Not surprisingly, as a purchaser of airport services, the Ansett/Air New Zealand Group has expressly rejected the conditions of use proposed by most airports – although most airports are attempting to deem use of the airport to constitute acceptance of these onerous terms – something we consider legally to be invalid. We are willing to work with airports to progress discussions on more balanced and reasoned agreements, which reflect more commercial relationships. However, we have not found this to be an easy process with many airports. Some airports are now, however, showing a willingness to progress these discussions.

As discussed in Part 3, airports provide airline specific assets and services. Some airports in some instances have used this situation to exert market power over airlines such as the Ansett/Air New Zealand Group. We have chosen to work in an open way with airport operators, wherever possible.

One way in which we have directly experienced airport operators exercising their market power in the current regulated environment in Australia is the situation where the airport threatens not to proceed with some crucial issue specific to Ansett's operations unless we support cost recovery from airlines, including the returns and cost allocation for other projects being assessed by the ACCC under the NNI procedures.

The works we are required to support may have involved no consultation with the Ansett/Air New Zealand Group; or provide returns and cost allocations we would clearly not support under normal circumstances, hence the need for the threat by the airport not to proceed with crucial issues.

A commercial in confidence example is provided in box 1. We have no difficulty should the PC wish to discuss the commercial in confidence section with the Airport in question and ACCC (confidentially) as they are aware of our views of this behavior. As the PC may be aware, the Ansett/Air New Zealand Group has always chosen to provide to the airport in question copies of our correspondence to the ACCC, except recently where that policy was breached by an airport disclosing commercial in confidence information publicly.

This is not an isolated experience and illustrates the many means of market power airports may exercise in the complex environment of providing both core and airline specific facilities. It is also an experience, which has from time to time lead to us questioning the practice of being open and providing airport operators with copies of submissions and discussing those submissions with them before making our views known to the ACCC.

The Ansett/Air New Zealand Group views this type of behavior as a rather ordinary way for an airport to behave and as clear evidence that airports have no qualms about exercising their market power. It also highlights the

immature commercial relationships between some airports and their airline customers and so long as this behavior continues, the difficulty of moving relationships toward a more mature and commercial position can readily be understood.

Smaller non-regulated airports are also not averse to exercising their market power. An example is provided in box 2. We would also be happy to discuss other cases with the Commission.

Box 2 Pricing at Ayres Rock Airport

In April 2001, Ayres Rock Airport (AYQ) sought substantial increases in the Passenger Service Charge (PSC) to pay for a proposed redevelopment of the airport.

The Ansett/Air New Zealand Group sought further information on the proposed works and associated increase in PSC from AYQ, and received a one and a half page letter justifying some $20 million in expenditure.

After some further correspondence, AYQ agreed to meet with representatives from the Ansett/Air New Zealand Group and Qantas to discuss the proposed upgrade in further detail. Following this meeting, the Ansett/Air New Zealand Group provided to AYQ an assessment of the necessity and expected beneficiaries of each project. This then provided a basis for considering the allocation of costs between users and appropriate cost recovery mechanisms.

While the Ansett/Air New Zealand Group did not support all projects listed in the redevelopment, some projects were supported and full reasons were given as to why full cost recovery through the PSC could not be supported for other projects (for example, recovery of development costs of “initial commercial sites”.)

AYQ have replied to our assessment, stating that while they have reviewed our comments, they have decided to ignore all of them and insisted the increased PSC be implemented. Ansett is remitting the increased charge under protest.

Relevant correspondence is provided to the Commission on a commercial in confidence basis (attachment D).

The example of AYQ further highlights the difficulties with trying to enter into meaningful negotiations with unregulated airports. Indeed, on the basis of current outcomes, there appears to be little reason for the Ansett/Air New Zealand Group to spend further resources challenging the pricing at this and other unregulated airports.

Often the market power of non-regulated airports manifests itself in the airlines being required to agree to price increases to pre-finance projects that

provide little or no benefit to airlines. This can lead to the 'gold plating' syndrome where the airport needs a bigger better terminal/runway/other facility despite the protestations of airline users who must pay for that facility that it is not necessary. In the case of airports operated by local governments, this can extend to projects such as community swimming pools and creches or bolstering local council reserves. While not commenting on the value non-aeronautical projects provide to their users, the efficiency and equity consequences of having airlines and their passengers pay for such projects should be considered by the Commission.

At no airport in Australia or New Zealand does the Ansett/Air New Zealand Group currently have a contract for the supply of airport services that remotely resembles those obtained with suppliers in competitive markets.

Interestingly, of the key 'strategic critical' supplier groups to our business, either no commercial form of contract exists (or in the case of fuel a limited form only). These suppliers are those with the strongest monopoly power and in some respects the greatest strategic importance to our business – airports, air navigation and fuel. We are unable to operate without services from these providers. There is either no alternative (airport services and air navigation) or a very limited market (fuel).

In New Zealand, the current pricing model employs so-called 'light-handed' regulation. It seems a misnomer to describe as light-handed the ability for a supplier to impose unilaterally on a purchaser a price for goods, subject only to consultation. This model is apparently favored by many major Australian airports for future pricing. It certainly offers minimal regulatory oversight. Its benefits otherwise seem few.

In New Zealand, in each of the consultations experienced to date, negotiation proceeded fitfully and with low levels of trust, as submissions to the Commerce Commission inquiry demonstrate beyond question. In all major airport discussions under the present system, no negotiated outcome occurred. Instead, prices were unilaterally imposed; and court action has now ensued in one case.

Neither party deserves any credit for this, but – taking the shopping mall/anchor tenant model as a guide – it would be extraordinary if in that environment a negotiated outcome did not develop. It is less than surprising it did not occur in the New Zealand Airport environment -negotiation requires trust and this is unlikely to be evident where one party to negotiations has all the power.

The Ansett/Air New Zealand Group submits there is clear evidence of the market power of airports in their dealings with airlines. It also demonstrates that neither the CPI-X regime nor the 'shadow regulation' approaches to airports has generated results consistent with those obtained in competitive markets.

Countervailing power

Airports suggest that their charges are a small proportion of ticket prices – implying, as the PC appears to suggest separately (in its draft report on access), that it may not cause too much damage (to efficiency) if its prices are allowed to rise, even beyond reasonable returns.

This is an odd claim, in an economic sense. It suggests exploitation of market power is OK in small doses. How this contributes to efficiency is unclear.

It is also inconsistent with other claims, particularly countervailing market power. We believe the Commission should seriously consider whether, if airport charges *are* a small proportion of the ticket price, any countervailing market power is by definition ever likely to be used. The only power available to an airline is not to serve the port.

However, the countervailing power of an airline to exercise the strategic decision not to increase services to Sydney (for example) is counter-intuitive. If the market is competitive, the loss of market revenue has far greater commercial downside than the proportionately small cost saved. Countervailing power is thus a myth, short of a level of increase that outweighs the strategic impact.

Even the threat of withdrawing services - if it did prove to be a sensible course of action – is constrained for Ansett in respect of regional airports. In particular, as part of the buy out of Ansett by Air New Zealand, the Commonwealth Government required that

> "There will be no significant reduction in regional airline employment resulting from changes to Ansett's regional network or as a result of deliberate management strategies during the next three years."

And,

> "No regional destinations currently served by Ansett or its subsidiaries will lose service although service changes within the current Ansett network will be acceptable. The Minister for Transport and Regional Services will be fully consulted prior to the implementation of any changes".

The quantum of charges is not small – the scope to err is similarly not small

In considering the future regulatory regime for airports, if any, both the CC and PC must satisfy itself there is sufficient market power on the part of airports to warrant government intervention. In considering this issue, the Ansett/Air New Zealand Group notes the PC in its Position Paper on the *Review of the National Access Regime* argues that given the potential scope for regulatory failure, 'there is a strong case to 'err' on the side of investors'. Thus implying that the costs of getting it wrong are, relatively, small.

Not surprisingly, as users of major infrastructure assets such as airports and air navigation suppliers, we do not endorse this conclusion.

The magnitude of the charges in themselves may be construed as small, in its effect on each consumer. Similarly, the magnitude of waterfront delays or bank fees on individual consumers is small. However, failure of a regulatory system to constrain the ability of parties within those systems to exploit consumers has led over time to deep consumer disaffection; and to action by Governments.

Airports are perhaps the most significant individual piece of infrastructure in any major city's economy. Over-pricing of that asset may not affect consumers readily, particularly where charges are not transparently exposed (although we submit this is not the case). However, of itself it is surely poor public policy – certainly poor from the point of view of the *credibility* of public policy - to allow such an important asset to be mispriced.

The costs of 'getting it wrong' are also perhaps not as small as some may imagine. In New Zealand, under a minimalist approach, the compliance costs (legal and 'consultation' expenses) for airports and airlines have been well into the millions over the past two years. This is solely directed towards ensuring an adequate process is followed. The actual costs of excessive investment or higher than necessary pricing are separate.

We also doubt the quantum is so small in aggregate to justify the removal of regulatory oversight. It may be illustrative for the CC and PC to note the magnitude of payments to monopoly suppliers at Australian and New Zealand Airports (including Airservices Australia and Airways Corporation location specific charges but not enroute charges) Discussion of the payments made by the Ansett/Air New Zealand Group is provided in tables 1,2 and 3 on a commercial in confidence basis.

The Ansett/Air New Zealand Group argues that the total level of payments to airports, rather than the impact on any one passenger, is the correct basis for assessing the extent of airport market power, and the final impact on a ticket price is but one aspect of this. This is because it is the *total monopoly rents* an airport can obtain that is the appropriate basis for determining if government intervention is warranted.

Hence, while it is correct that a large increase in the price of airport services may have a relatively small impact on the final price of a ticket to or from a specific port (and that impact will differ between ports), the reality is such an increase can allow airports to obtain substantial monopoly rents. Further, the cumulative impact on the cost of travel would be significant – particularly for countries such as Australia and New Zealand where geographical conditions mean air travel is an important commodity.

Why must there be a regulatory presence?

The Ansett/Air New Zealand Group submits the quantum and magnitude of aeronautical revenues paid to airports justifies ensuring ***someone*** has sufficient incentive to scrutinise these costs.

In the case of the regulated Australian airports, the current economic regulatory regime provides the Ansett/Air New Zealand Group with an incentive to scrutinise the costs and prices of airports. This is because the regime allows the airlines to have sufficient influence over these costs to justify the resources required to scrutinise them (we do not suggest the current regime is the only way this incentive can be created and this is discussed further below.) As such, the airlines essentially act in the public interest – as an advocate for the consumer by questioning these charges but also as an operator in a competitive environment attempting to ensure its input costs are efficient.

This helps to ensure the project is supported by the aeronautical users of the airport; the costs incurred are efficient; and that a reasonable and a not excessive return is achieved by the airport, particularly if viewed across the full range of products and services sold by the airport and the fact that an airport is a long-lived asset with its earning potential measured in decades.

In the case of the smaller unregulated airports, the existence of procedures followed by the regulated airports also encourages the provision of airline resourcing for examining their costs and prices. In effect, the scrutiny provided is at marginal cost to us and to the public interest. We can apply the principles approved for use elsewhere. However, if there were no principles, the moral suasion of encouraging non-regulated airports to show commonsense in deciding the type, scale and scope of projects to be funded by the airlines and their passengers would be ineffective and not worth the effort. The propensity for goldplating (bigger than necessary terminals, longer and wider runways whether there is user demand or support for these projects or not) would proceed without scrutiny.

In the Ansett/Air New Zealand Group's view, if there is no credible framework which allows the airlines to have some influence over airport costs, then there is no rational basis for airlines to act in the public interest, as they currently do, by scrutinising and, wherever possible seeking to ensure airport price increases are for efficiently incurred investment in works which have user support.

No other party takes this role. In essence, we submit the Commission must decide if it is worth someone scrutinising the efficiency and appropriateness of the hundreds of millions of dollars paid to airports each year, if there is no prospect of any outcome other than that the increase ultimately proceeds

This is the reality of so-called light handed regulation in New Zealand. Negotiation can only proceed effectively where each party has a reasonable opportunity to satisfy its interests. Leaving aside whether the parties are

mature enough to act reasonably, a system which severely limits the opportunity to reach a mutual solution is the antithesis of sensible policy.

If the Commission decides economic regulation of airports should cease, it is likely to be more cost effective for the airlines to simply accept increases in costs and charges by airports and simply pass these costs on to our customers without dispute, as long as our competitors face similar costs. Airport costs would be shown on the face of the ticket as a dollar amount for airport charges. This will make it plain to passengers who is responsible for these charges, and will mean passengers or their elected representatives would be the ones who then have the responsibility of challenging inefficiency, gold plating or simple monopoly rent extraction issues. Airlines will simply act as a collector of funds on behalf of the airports. Resources previously applied to scrutinising the efficiency of airport charges would be applied to the accounting processes and systems needed to manage the volume of charges recovered via direct ticket charges.

The Ansett/Air New Zealand Group believes it is in the public interest to ensure airlines have sufficient incentive to scrutinise the costs and prices of airports. This will not occur without some form of economic regulation, which contains enough balance to make the effort of challenging airport pricing behavior worthwhile.

An essential element of any future regulatory structure is an appointed arbitrator or similar person, with at least an equivalent level of regulatory backing to that available to airports. Thus, for example, in New Zealand, where airports have the ability to set charges, an arbitrator should have the ability to alter or set aside charges if considered appropriate.

PART 5: Economic regulatory options

The Ansett/Air New Zealand Group believes it has presented a convincing case on the need for economic regulation to provide sufficient incentive for the airlines to scrutinise airport costs and prices. The purpose of this section is therefore to identify and assess the economic regulatory options available. However, while the Ansett/Air New Zealand Group provides an in-principle assessment of the different classes of regulatory options, we believe it is the proper role of the Commission to further explore potential options and provide detail on a preferred option.

Industry objectives and outcomes

Any economic regulation should be based on a clear set of objectives and outcomes. Clearly defined objectives and outcomes provide greater certainty for the regulator, airports and airlines. The Ansett/Air New Zealand Group believes appropriate objectives for the economic regulation of airports could include:

- an efficient and cost-effective regulatory regime;
- encourage airlines and airports to reach individual commercial agreements;
- prevention of monopoly rent extraction by airports;
- an environment that fosters an efficient level of investment in airport infrastructure;
- an environment which fosters efficient operation and maintenance practices by airports;
- an environment which fosters efficient use of existing infrastructure;
- reasonable recognition of pre-existing policies of government in respect of the aviation sector; and
- reasonable regulatory accountability through transparency and public disclosure of regulatory processes and the basis of regulatory decisions.

The key output flowing from such a structure is a contract between the airlines and airports for the supply of airport services, consistent with what the airlines can achieve with suppliers in competitive markets. The key elements of such a contract were discussed in Part 4. It may be that in the case of common user assets, industry wide agreements could be developed, with potential movement to individual agreements in the future. Airline specific assets clearly need individual agreements between each airline and the airport, and this is reflected in the objective statements.

Economic regulatory options

Potential forms of economic regulation range from minimalist price monitoring and duty to consult to the heavy-handed options of rate of return and CPI-X (table 4).

The spectrum of economic regulatory options can be distinguished by:

- if recourse to a regulator/arbitrator is available; and
- the mix of commercial negotiation vs regulated outcomes for the identified approaches.

The Ansett/Air New Zealand Group recognises that there is a degree of overlap between different economic regulatory models depending upon the detail of their implementation. However, for the purposes of assessment, the options are classified as either heavy handed regulation, light handed regulation or arbitration.

Table 4 Regulatory options

Type of regulation	*Outcome*
Extent of Market Power (High)	
CPI-X, revenue capping, Rate of return	Regulated prices or revenues. Approved investments by regulator
Arbitration	Most outcomes negotiated without direct government involvement, but within an agreed framework and with recourse to arbitration
	Natural monopoly characteristics of airports may mean never reach next level of light/no regulation. But seek to reduce reliance on regulator
Price monitoring	Commercial negotiation between parties. Spectre of regulation (shadow regulation)
Duty to consult	
Low)	
No regulation	Commercial negotiation. General business conduct laws.

Compliance Costs

The Ansett Air New Zealand Group is in a unique position to comment on the issue of compliance costs under the Australian CPI-x and the NZ 'shadow regulation' regulatory environments. There are substantial differences between the two and as an initial comment, the cost of compliance in NZ is higher by a magnitude which is quite remarkable. Details of compliance costs incurred by Ansett and Air New Zealand in both Australia and New Zealand are contained in Box 3 and are provided to the commission on a commercial in confidence basis

It is worth considering that in the New Zealand environment, despite the cost of engaging in the 'consultation' process – which in reality is a stage managed process the likes of which would simply not occur in a commercial environment –airport companies have the right to, and do, unilaterally set prices at the 'end' of the process. The only avenue to dispute this is a legal one – generally, meaning issues of process during the 'consultation' are as much if not more in question as those of substance. Again, this is an outcome one simply does not see with critical supply contracts in the commercial world

It is worth noting in Australia (with the notable exception of the Sydney Airport proposal) the majority of cost for this airline in managing airport charging proposals under the current CPI-X regime has been internal management cost and is not substantially different to that Ansett would expect to incur in contracts of a similar magnitude in a commercial environment.

It is also worth noting that despite the issues which have been raised from time to time by airports regarding the ACCC, in general, it would be fair to say the relationships between the Ansett/Air New Zealand Group and airports in Australia are better than those experienced in New Zealand. The ACCC process has often resulted in disagreement between airports and airlines. It has also resulted in:

- Greater levels of discussion and debate;
- Bitter rifts not developing - where the parties disagree, an independent third party makes a call – meaning there is a re-balance of the power arrangement when one contrasts the situation in New Zealand;
- As co-operative relationships are emerging, speedy turn around by the ACCC of NNI proposals is being seen; and
- A greater level of airline support for airport proposals as we are increasingly, being engaged by the airport instead of – as occurred in the early days of the regime – seeing proposals for the first time when the ACCC advised us of their existence.

Given the ability of airports in New Zealand to unilaterally set prices (provided they have 'consulted substantial customers') it is fair to view the entire amount spent by both airport and airline as dead weight cost. The airports incur this cost to fulfil their consultation obligation and, to date, the airlines, in the hope

of changing airport charging proposals have spent large amounts – as it has been shown, to no avail. The dead weight cost of this to the New Zealand aviation industry is enormous and is something the Commission should bear this in mind in considering the merit of the 'shadow regulation' approach.

Based on our experience, we would have very serious concerns were this approach to be replicated in Australia and we have grave concerns about the impact if the current 'shadow regulation' regime is continued in New Zealand. In this regard, we again draw the Commissions attention to the comments made in part 4.

Assessment of economic regulatory options

Having identified three broad classes of economic regulatory options, an in-principle assessment of each option is undertaken, with the merits of each option assessed against its ability to promote the stated objectives of airport price regulation.

Heavy handed economic regulation

Under a heavy handed approach to economic regulation, all pricing and investment decisions must be ultimately decided by the regulator – however the incentive based nature of the CPI –x regime has avoided some of the issues associated with traditional cost based regulation. This is the current situation prevailing for core regulated airports in Australia.

Heavy handed regulation can be considered the most 'risk averse' in terms of controlling the market power of airports. As discussed above, the CPI-x regulatory regime has in our view had a number of positive outcomes – and indeed those outcomes were close to what the Government was seeking to achieve in this transitional period.

However, it is fair to say that for a variety of reasons (including industry maturity generally) heavy handed regulation has not achieved contractual relationships consistent with those the Ansett/Air New Zealand Group obtains with suppliers in competitive markets. Neither is the approach particularly conducive to airlines and airports reaching individual agreements on airline specific assets. It must be said however that on balance, the CPI-x regime has moved airline – airport relationships and behaviors more in a positive way in the opinion of the Ansett/Air New Zealand Group.

The limitations of heavy handed regulation noted by the PC in other environments, are in part likely to be a consequence of the differences between airports and other forms of regulated economic infrastructure. Most heavy handed economic regulation has been designed in the context of the electricity and gas industries. Hence, such regulation appears ill equipped to incorporate the distinguishing characteristics of airports into the regulatory framework.

The Ansett/Air New Zealand Group therefore contends that while heavy handed regulation can satisfy the public interest requirement of controlling the

market power of airlines and provide sufficient incentive for airlines to scrutinise airport costs and prices, other options may be available. However, heavy handed regulation is a preferred option to a situation of no or light handed regulation, as discussed below.

Light handed economic regulation

Light handed economic regulation can be classified as any economic regulation that does not have direct recourse to a regulator or arbitrator.

It may be argued that light handed economic regulation is the most appropriate way to encourage improved commercial relationships between airlines and airports. Indeed, some have contended that it is the presence of the regulator and regulated outcomes, which is inhibiting such commercial relationships developing. While undoubtedly there is capacity for any regulatory system to be gamed, this does not provide a serious basis for rejecting regulation in its entirety, if there is no adequate alternative which protects the public interest. The public interest requires an active (rather than passive) mechanism via which misuse of market power can be discouraged. Airline scrutiny of charges currently forms part of this mechanism but is unlikely to continue in the absence of ***an even handed system***.

In considering this issue, the key question is be addressed is why would any monopolist with market power voluntary enter into commercial agreements which replicate competitive outcomes? In particular, what incentive is there for an airport to move away from the current 'conditions of use' towards a set of arrangements which would make them more accountable for service provided and outcomes achieved?

The answer to these questions is none. Our attempts to enter into meaningful negotiations with non-regulated airports demonstrates this fact.

Recourse to a regulator is not the primary cause for the lack of satisfactory commercial relationships between airlines and airports which replicate those achieved with competitive suppliers. Rather, a monopolist with market power has little incentive to voluntary move to a set of commercial relationships that replicate competitive outcomes.

The threat of regulation (shadow regulation) does not provide sufficient incentive for the airlines to scrutinise airport costs and profits. This is because the limited ability to influence such costs does not justify the investment in resources to challenge them.

Instead, the light handed approach is likely to produce outcomes similar to that obtained with no economic regulation. Airlines will have little incentive to scrutinise costs and instead will simply pass such costs on and make it plain to passengers the extent of such costs.

The failings of the current light handed approach is New Zealand provides further evidence on the inability of light handed regulation to promote improved performance and outcomes within the air transport industry. Duty to

consult requirements in New Zealand have lead to artificial, highly staged managed and closely documented processes — which have compliance costs for both airlines and one suspects airports — totally disproportionate to any benefit or constructive outcomes.

The New Zealand experience highlights the problem of trying to adopt light handed regulation to organisations, which have substantial market power. The likely outcome is the continual movement between light and heavy-handed regulation. Such a situation does little to promote the long term prosperity and productivity of the air transport industry.

Because of its inability to adequately promote the stated objectives and outcomes for the air transport industry, the adoption of light-handed regulation is not considered practical or desirable.

Arbitration – an even handed system

The arbitration approach seeks to strike a balance between controlling the market power of airports, while encouraging the majority of decisions between airlines and airports to be decided through commercial negotiation.

The three key features of the arbitration approach are:

- broad specification of the elements to be contained in the contractual agreements between airlines and airports;
- recourse to arbitration only if agreement on an individual elements cannot be reached, but with clear mechanisms to discourage unnecessary recourse to the arbitrator; and
- powers and procedures of the arbitrator.

The arbitration approach has the advantage that it has the flexibility for airports and airlines to reach individual agreements, incorporating all the necessary elements of robust contracts for the supply of airport services. Hence, it provides a practicable way of moving away from the current heavy handed approach, while still promoting the public interest by providing a framework and mechanisms to moderate the market power of airports.

However, the arbitration approach to addressing market power issues has been challenged. This is on the basis that in any system in which an arbitrated outcome is available, one party will ultimately initiate the intervention of the arbitrator. In such situations, the arbitration approach essentially becomes heavy-handed rate of return regulation. The Productivity Commission in its draft report into *Telecommunications Competition Regulation* (PC 2001) argues:

- high volume (and revenue) services are more likely to go to arbitration;
- larger firms will be more likely to go to arbitration; and
- disputes are less likely when there are a number of providers of the service (or a credible threat of bypass).

In the case of the air transport industry, agreements are necessarily going to involve high volume and revenue services between larger firms with no credible threat of bypass. The Commission may therefore decide, wrongly in our view, to reject the arbitration approach on this basis.

The Ansett/Air New Zealand Group considers the criticisms of the arbitration approach to relate to the mechanisms and conditions under which either party can take an issue to arbitration, rather than undermining the approach generally. The Ansett/Air New Zealand approach recognises the difficulty in designing a system which strikes a balance between encouraging commercial negotiation and providing a credible constraint on the market power of airports. The market has solved these problems and can do so again, if there is a structure promoted where neither party (ie airport or airline) has an absolute power to determine the result.

Other criticisms of arbitration eg collusion (as raised in the ACCC's submission) could be addressed through transparency provisions, such as lodging negotiated outcomes with the arbitrator. Criticism of arbitration on this ground is also counter-intuitive, if the alternative is no scrutiny by airlines. There will be no need to collude – instead, the absence of regulation will simply involve a passive acceptance by airlines and passage of the costs on to customers, as occurs now at numerous small regional airports.

Conclusion

In this submission the Ansett/Air New Zealand Group has sought to highlight the nature of the market power associated with airports, and provide evidence of this market power. We have also provided evidence on how attempts to establish commercial negotiations with unregulated airports have largely failed.

Having established a case for government intervention, we have classified and evaluated the various forms of economic regulation. The Ansett/Air New Zealand Group considers that light-handed regulation is a misnomer and does not provide sufficient incentive for airlines to scrutinse airport cost and prices.

While, heavy-handed forms of regulation can satisfy the public interest of controlling the market power of airports, it is considered superior options are available. On this basis, we urge the Commission to explore further explore regulatory options, with the objective of establishing an even handed approach, conducive to effective negotiation, such as an arbitration framework.