

Melbourne Airport Submission
to the
Productivity Commission Review
of
Price Regulation of Airport Services

March 2001

Executive Summary

A wide range of services is provided at airports. Airports themselves provide many of these services in markets with varying degrees of competition from other suppliers and to customers with varying capacities to substitute or to exercise their own countervailing market power.

With the possible exception of those services directly involved with aircraft movement on the ground and processing passengers on and off international aircraft, airports possess little market power. They certainly possess less market power than warrants government involvement in commercial market conduct with all the risks that entails.

As Melbourne Airport's business plan demonstrates, economies of scale drive commercial operators of unconstrained airports to pursue strategies which seek profit through the reductions in average cost involved in rapid growth. This is achieved in the first instance through increased utilisation of existing assets followed by investment in new capacity – a process which involves short run reductions in returns, providing the appropriate pricing signals are in place.

The case for ending price regulation

This submission concedes that, at least in the short term and at the margin, it would be possible for airports to increase some of their prices – principally relating to their core landing and passenger services. Indeed they could do so substantially. We argue

1. If they did so, no material damage would be done to economic efficiency. The economic significance of the price change would mostly amount to a transfer of economic rent from airport customers – in this case airlines – to airports.
2. There are strong theoretical reasons for believing that, given their cost structure and the market opportunities available, airports' long-term interests are better served by seeking to grow their businesses, and that this will lead them to forsake opportunities to capture short term economic rents. As an empirical matter, this is Melbourne Airport's long term business plan – to grow business by aggressively serving markets with high quality airport services at competitive prices.
3. Price regulators will always have imperfect knowledge. Further the long-term efficiency consequences of regulating prices below their optimal level can be very grave. By contrast long term prices modestly above the competitive optimum involve low economic efficiency losses.
4. It is Melbourne Airport's view that the commercial incentives for airports in Australia are such that left alone to deal with users they will pursue pricing and investment policies that are likely to maximise economic welfare in the long run. In contrast, regulatory intervention through price controls is likely to reduce welfare in the long run.

It is the view of Melbourne Airport that the price regulation should cease on 30 June 2002.

If regulation is to continue, any future regulatory system should be restricted to the domain of services where there is a strong case that airports can and are likely to abuse their market position. For all but a few of the airports currently regulated, no such case could possibly be made.

Solutions that seek to transfer airport returns from one part of the market to others cannot be justified. In particular the ‘single till’ form of price regulation would cross-subsidise aeronautical services with the locational rent accruing to other airport activities. Such a policy is inconsistent with the National Competition Policy that seeks to constrain access and prices intervention to essential facilities of national significance. Economically it is also highly inefficient.

The current regulatory arrangements have led to real price reductions from a base that was probably inefficiently low to start with. The result is generating economy wide inefficiencies that will dwarf the windfall gains currently being enjoyed by airlines.

The necessary new investment (NNI) arrangements are a makeshift attempt to address the critical issue of under-investment. The limitations of this approach are apparent however. Poor administration and the scope for gaming by airlines raise risks and so costs for airports. Any resulting under-investment is likely to be felt most keenly by new entrants into the airline business. In other words a bottle neck in a part of the airline journey which amounts to around 4% of airline costs, and much less of value added, can substantially obstruct competition to drive prices and operations to their economically and productively efficient level for the remainder of the airline transport supply chain. The NNI arrangements will always be a poor substitute for proper incentives to invest delivered through simpler, more efficient prices.

Given the incentives for unconstrained airports to grow their business, the current regulatory system represents an axe when a scalpel would do.

This submission argues that, given the nature of the services in question, prices reflecting long-run incremental costs are likely to lead to efficient outcomes. Moreover we show that such prices lead to short run returns being below the cost of capital when utilisation is low rising over time as utilisation increases. As assets reach capacity, it is appropriate that short run returns are allowed to rise above the cost of capital. Regulatory activity tends to confiscate these returns. This increases risk leading to increases in the cost of capital for investors and delays in investment of facilities which are – according to those who would wish to regulate them, “essential facilities of national significance”.

The current pricing system will not deliver returns near to the cost of capital on existing assets at Melbourne Airport until 2010, let alone returns above cost of

capital to compensate for lower returns in earlier periods. Over the five years after 2002, significant new terminal and aircraft parking capacity will be required. Additional runway capacity is likely to be required shortly after. Current prices will not provide sufficient incentives to invest, with or without the necessary new investment arrangements.

If the Commission recommends the continuation of price regulation for some airports we invite it to grasp the opportunity before it of charting the course to more efficient price regulation. Such a system would see airports earning somewhat above their cost of capital at the point where investment is required. This is necessary if airports are to generate an efficient return on funds over the long term, as the new investment required will drive their short-term returns below their cost of capital.

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Glossary

ACCC	The Australian Competition and Consumer Commission, the regulator
ACI	Airports Council International, international airports trade association
Airports Act	<i>Airports Act 1996 (Cth)</i> , principle Act governing leased airports
APAC	Australia Pacific Airports Corporation, holding company for interests in leases and Melbourne and Launceston Airports
BAA	BAA plc, world's largest airport company, 15.1% owner of APAC
BARA	Board of Airline Representatives in Australia, trade association for international carriers operating in Australia
CAA	Civil Aviation Authority, airport regulator in the United Kingdom
DET	Domestic Express Terminal, terminals in Sydney and Melbourne used by new entrant domestic carriers
Direction 17	Direction issued by the Minister pursuant to the PS Act, the basis for the administration of the cap and NNI
DoTRS	Department of Transport and Regional Services, principle Commonwealth policy agency for airports, also refers to its predecessors
FAC	Federal Airports Corporation, former operator of Sydney, Phase 1 and Phase 2 airports
IATA	International Air Transport Association, international airline trade association
LRIC	Long Run Incremental Cost
NNI	Necessary New Investment, a device to encourage investment in the face of inefficient prices
Phase 1 airports	Airports leased in 1997: Melbourne, Perth and Brisbane
Phase 2 airports	Airports leased in 1998 and subject to regulation: Adelaide, Alice Springs, Canberra, Coolangatta, Darwin, Hobart, Launceston and Townsville
PS Act	<i>Prices Surveillance Act 1983 (Cth)</i>
The Commission	The Productivity Commission
TP Act	<i>Trade Practices Act 1974 (Cth)</i>
WACC	Weighted Average Cost of Capital

Chapter 1: Introduction

Melbourne Airport is delighted to have the opportunity to make this submission to the Commission's inquiry. It is our view that the approach adopted by successive Commonwealth Governments in relation to aviation policy in general, and airports policy in particular, has generated significant benefits across a wide range of areas.

The pricing policy put in place at the time of sale had noble objectives but now appears to be unlikely to provide the appropriate investment signals to airports to ensure adequate investment is provided in the future. This arises in part from the design of the system, in part from the approach of the regulator and in part from the conduct of airports and airlines.

The approach of this paper is broadly along the lines of the Commission's Issues Paper. First, the markets for various airport services are examined to determine the extent of airport market power and the extent to which airports are likely to abuse that market power in a way damaging to economic efficiency. We suggest that the case for ongoing regulation at all airports currently regulated is very weak.

Following that is a discussion of the most vexing issue in airport regulation, the single till. We then discuss the economic characteristics of the current system and show how if left in place it will lead to perverse investment signals.

Our solution to these problems is contained in the last two chapters. The first of these looks at the characteristics of efficient prices for airport services whilst the second makes some suggestions how any future regime could be given legislative effect.

We provide a number of Appendices that contain data to which we refer, two of which are confidential and are marked as such. We have not provided a detailed analysis of publicly available statistical data on traffic – we assume that the Commission will undertake its own analysis of that data to the extent it feels appropriate.

Chapter 2: Why regulate – airport market power

In this chapter we provide an analysis of markets for airport services. There is little evidence in the Australian experience, of airports seeking to abuse market power in regulated or unregulated markets. With the exception of Sydney Airport, investment in aeronautical services has been modest although can be expected to be more extensive in the future, as certain assets reach capacity. Australian airports are efficient by world standards and provide high quality services and have acted in a way to encourage entry.

Our analysis is summarised by the following claims.

- In those areas of aeronautical services where there may be some market power, and where arguably, Melbourne Airport provides essential services of national significance, both commercial and political considerations make a high growth pricing strategies preferable to monopolistic price ‘gouging’. In other words, there is little evidence to suggest that Australian airports will act in a way to reduce supply – the characteristic of market power abuse most likely to lead to social welfare losses.
- In other areas, there is little market power, no national significance and considerable ease of substitution for consumers.

These other areas are currently not subject to price regulation although some are subject to price monitoring. From the Commission’s Issues Paper we have formed the view that these are not the primary focus of the Commission’s concerns in this inquiry. Any market power that arises in these areas by and large can be seen as a result of scarcity of land and logistical constraints on expansion. In other words, the returns here are best thought of as locational rents and it is our view that it is not appropriate in this, or most other cases, to impose price regulation on rents.

Nevertheless, we have provided an analysis of these markets in Appendix 2.

Some thoughts on rents

It is clear that airport real estate in general, be it for on site maintenance facilities, car parks or retail space, derives substantial value from its special location. The same thing can be said for sites close to but not on the airport.

The same phenomenon of rent is observable in commercial real estate markets the world over. The question is, should these rents be seen as rents from market power? To the extent that they are one needs to ask the further question 'Should they be the subject of regulatory activity?'

Fundamentally the distinction between rents from market power and the rent one pays for quality land is that in one case the scarcity is imposed from outside the contracting parties. A landlord in the CBD will – generally speaking – be in competition with other landlords from the CBD. But the supply of what is being sold is limited by the laws of nature and by regulatory restrictions on land use – such as height and zoning restrictions.

To a substantial extent this is the case at Melbourne Airport. It is true that there is one supplier of real estate – at least at each terminal and at least within the airport rather than its surrounds. However, far from the airport seeking to restrict space, it is an aggressive expander of supply. Melbourne Airport, since sale, has been in an almost constant process of creating more car park and retail capacity and actively competing for cargo and maintenance facilities. This is hardly the conduct of a firm intent on the abuse of market power.

We would like to provide more space, but there are a range of issues to be considered which mean that expansions of space must – quite obviously – be carefully planned and integrated into the logistics of the airport. When licensing to our concessionaires, no undertaking is made not to build more retail space.

Accordingly it seems reasonable to conclude not that commercially imposed limitations on space drive up prices at the airport, but rather that the location drives up the value of sizes that can be hosted there. In this sense, as Khan reminds us, prices determine the rents that can be charged – not rents prices.

If even after this evidence some were to conclude that, to some degree at least, the rents enjoyed are those brought about by an *artificial* restriction of supply rather than one which arises *naturally and unavoidably* from the circumstances and the logistical demands of an airport, there are two rejoinders.

Firstly, the rents belong in the first instance to the owner of the freehold title of the airport, that is, the Commonwealth Government. Airports lease the site from the Commonwealth and paid the Commonwealth a premium over the value of the assets for the rights to access that locational advantage for 99 years. In the case of Melbourne Airport, this amount was approximately \$600 million. In this sense, if market power has been abused, it has probably been by the Commonwealth – particularly given its statement that it would not regulate prices for non-aeronautical services.

Secondly, even if the rents reflected – to some extent at least – some artificial constraint on supply, whatever rents enjoyed as a result are similar in kind to the rents enjoyed in any other successful property development – by for instance a prosperous shopping centre such as Chadstone.

Markets for aeronautical services

The core services provided by airports are currently subject to declaration under the PS Act. These are the services of provided runways, taxiways, aprons, terminals (including baggage systems, check-in desks, flight information display systems, public amenities, signage and so on) and public access roads.

Is the market for airline services part of a larger market for transport?

This Chapter addresses the competitiveness of the market for specific aviation services. However it worth noting at the outset that, as the Commission and its predecessors themselves have observed, one needs to place a focus on such markets within a context that is still wider. There are many aspects of the market for aviation services, which are more appropriately considered, for competition policy purposes, as sub-markets within more general transport markets. This is certainly the case with much freight and also with much tourist travel.

There are some domestic markets, where effective competition may exist. Tasmania is one where holidaymakers can be accommodated through either Hobart, Launceston, Devonport or Burnie and air travel is in competition with ferry services on Bass Strait¹. Southeast Queensland may be another example.

Other transport modes also act as a constraint on airport market power through providing substitutes for air transport services. This is predominantly provided by road transport (either through private cars or coach services) and obviously, the degree of competition depends essentially on the length of the journey and whether a car is required at the destination or whether intermediate stops are involved. Ferry services are particularly important in considering markets to Tasmania, especially from Melbourne. Rail seems to be less important than elsewhere in the world and this seems to have been borne out by the inability of proponents to bring high-speed rail projects to fruition.

What market power airports have in relation to these services arises for three reasons:

- strong economies of scale (at least up to short term capacity limitations) combined with sunk capital costs
- the planning approval difficulties that would be encountered in establishing a new airport.
- the level of sunk costs (terminals, route development costs etc) that individual users – particularly airlines - have in relation their consumption of services at the airport.

¹ Launceston Airport will make a separate submission on aspects of markets in Tasmania.

In general the more diversified and more isolated an airport is, - the less the price elasticity of demand - the greater will be its market power for aeronautical services. However, if an airport operates in a market where only two airlines are sustainable, the degree of countervailing power held by each individual customer is greater than if the airport's traffic base and general business is broader – this tends to be generally associated with the size of the airport concerned. The issue of countervailing airline market power is central to this argument and is dealt with at length below.

Aeronautical services in Australia can be characterised as exhibiting high levels of productive efficiency, high quality and low prices.

Melbourne Airport also sees the assessments of trade organisations and publications as relevant in demonstrating airport quality.

Airport operators are not the sole providers of some aeronautical services. There are examples where maintenance facilities are serviced by private taxiways. In Australia, Qantas and Ansett provide much of their own terminal infrastructure. Both Virgin and Impulse have from time to time indicated a desire and/or willingness to provide their own terminals. That said, the airport operator still has a significant role in, as much as, such projects can only proceed with the operator's consent. There are examples overseas of airlines and third parties (that is, parties other than airlines and the airport owner) providing terminals. This sort of competition for on-airport services is the subject of a discussion paper issued by the CAA².

Current arrangements for domestic terminals have led to excess supply. Whilst this leads to a reduction in capital efficiency, it also provides flexibility to facilitate entry. The following chart shows Melbourne Airport's forecasts for domestic

passenger gate demand. It should be noted that these are Melbourne Airports forecasts only and say nothing about the business plans of any carrier. What stands out is that the current level of demand by new entrants could have been accommodated within the capacity of the existing terminals. What also needs to be understood is that in relation to domestic terminal services, Melbourne Airport has competitors in Qantas and Ansett as well as other developers. In particular, if current users of the Domestic Express Terminal (DET) could come to an acceptable arrangement with either Qantas or Ansett, the DET could be bypassed and effectively a stranded asset given neither Virgin or Impulse have any on-going obligation to use the facility. The very fact that Melbourne Airport did not seek a take or pay style arrangement is an indication of a lack of market power or at very least, a lack of willingness to use it. It is interesting to note that in New Zealand, terminals are not subject to regulation, presumably for similar reasons.

The ability of users to substitute the services of one airport for another seems to be a key issue in determining the extent of airport market power. This ability to substitute, in turn, depends on the definition of the market.

Under a narrow definition, such as "the market for aircraft landing services for aircraft over 30 tonnes within thirty kilometres of Melbourne", we accept that Melbourne Airport has market power. However, under a broader definition, such as "the market for providing airports services upon entering or leaving Australia to international visitors visiting Melbourne", this is no longer true.

² CAA (2001).

In this regard, there seem to be significant differences between international and domestic services and freight services.

International Passenger Services

Market power depends on the availability of substitutes. In this market, the power of Melbourne Airport is mitigated by the ability of international carriers to fly to other international ports that have domestic links to Melbourne. Principal among these is Sydney and to a lesser extent Brisbane but Adelaide and Canberra also have the capacity to facilitate some of the international services currently operating through Melbourne.

Overtime, major airports have developed a strong sense of the different markets that they serve. Melbourne Airport sees its aeronautical market not just as Melbourne or Victoria but for international and long haul domestic services to encompass Tasmania, South Australia, the ACT and south New South Wales and potentially New Zealand and even Sydney for Europe and Asia. It sees its total market much more broadly and vigorously competes in the market for all transport services, which do, or conceivably could, involve Melbourne Airport.

A passenger perspective

Melbourne Airport, like its competitors, is sensitive to passenger needs and requests. Some requests will have a positive revenue outcome, such as luggage storage. Others simply improve passenger amenity, - such as baby change rooms. Other more costly services need to be assessed against the breadth of demand, who will bear the cost of the service, and who will provide the service – portering is an example of such a service. Travellers are also sensitive to the quality of service provided in retail outlets, car parks and so on in the sense that if they have a poor experience, they will quickly bring it to the attention of the airport or airline concerned. That said, there is little evidence to suggest that the quality of airport experience is critical in determining which airports passengers use – this decision is left up to the airlines.

This suggests that an airport could use its market power – at least in the short term – to increase its profit by driving quality for passengers down. However this ignores a more profitable strategy for the airports. High levels of customer satisfaction drive greater turnover of discretionary expenditure in airports and this is highly profitable.

Growth Opportunities for Melbourne Airport

Melbourne Airport has recently undertaken a survey to identify international passenger market segments that represent potential growth opportunities. Using publicly available data from the Australian Bureau of Statistics and the International Visitor Survey, almost 2.4 million passenger journeys that could be undertaken through Melbourne were identified as being currently undertaken through other airports. This represents a potential passenger throughput equal to 80% of that achieved in 1999/2000.

	Potential Arrivals (‘000s)	Potential Departures (‘000s)
International visitors arriving MEL, departing elsewhere		165
International visitors arriving elsewhere and departing MEL	180	
International visitors visiting Melbourne arriving and departing elsewhere	462	462
US visitors to WA bypassing MEL	18	18
WA residents travelling to US and bypassing MEL	20	20
NZ residents travelling to Africa, Europe and Asia via Australia and bypassing MEL	120	120
SA, Tas and ACT residents departing MEL and arriving elsewhere	57	
Vic, Tas, SA and ACT residents arriving and departing elsewhere	374	374
TOTAL	1,231	1,159

Potential International Passengers Currently Bypassing Melbourne Airport

Source: ABS and International Visitor Survey

If Melbourne Airport is to exploit these opportunities, it will need to convince airlines that it is profitable to reconfigure their route structures so as not to by-pass Melbourne. This will be done with a combination of direct origin-destination marketing and pricing and investment decisions that reduces the cost of operations through Melbourne relative to other route options.

Bypassing Melbourne Airport is determined on the basis of the operational preferences and decisions of airlines, rather than the preferences of the travelling public. Whilst Melbourne Airport does not have any concrete evidence, our experience in dealing with travellers, airlines and tourist authorities suggests the following conclusions:

- International visitors tend to be indifferent to their place of arrival and destination but to prefer to arrive and depart from locations they wish to visit. In other words, if someone were just visiting Melbourne, they would prefer to arrive and leave Australia through Melbourne Airport rather than somewhere else, usually Sydney.
- Australians travelling overseas prefer to avoid transfers in Australia although they are not offered a choice at the time of booking even where they exist. There appears to be little difference in price between direct and transfer departures and arrivals. Indeed, airlines frequently price equalise between major airports

involving some degree of cross subsidy between passengers even where there is an obvious difference in their costs.

- Business travellers have a strong preference for direct services, largely because they are quicker.

An airline perspective

Airport charges account for about 4% of the cost base of airlines globally³. The fact that Australian airport charges are among the lowest in the world suggests further that Australian airport charges represent an even a lower proportion of an airline's cost base than elsewhere. This fact suggests that airlines should be relatively insensitive to airport costs although their vociferousness when confronted with any increase in airport prices suggests otherwise. This may well be because changes in airport charges whilst they appear to have little effect on pricing decisions – at least in the short term – affect airline profitability directly. Given the elasticity of demand – at least for certain core services – the principle economic significance of the price of airport services is to distribute economic rent between the buyer and seller of those services.

It is interesting to note that some international airlines have recently indicated that their decision to put more services into Melbourne rather than Sydney was in part due to Sydney Airport's new pricing proposal. On the other hand Impulse Airlines has supported Sydney Airport's pricing proposal in the hope that appropriate pricing signals may lead to better investment outcomes.

It is our view that competition between Australian airports is largely non-price based in the sense that the price of aeronautical services is not the driver. The critical buying factors seem to be:

- *Availability of infrastructure.* Airlines are concerned there they have sufficient access to gates, aerobridges, boarding lounges and so on. Branding issues, such as signage and CIP lounges may also be a consideration.
- *Turn-around times.* Airline profitability is fundamentally linked to capital utilisation which is dominated the proportion of time aircraft spend in the air. The longer aircraft spend time on the ground, the less profitable they are. Consider that airlines operating through Southeast Asia have a distinct preference for Singapore over Bangkok because it takes half the time to turn around an aircraft in Singapore. Access to infrastructure is an issue here along with congestion of aircraft movement areas, and efficiency of ground handling and air traffic control services.
- *Passenger processing.* The time taken to process passengers through check-in and the boarder agencies is an important contributor to reducing turn-around times. Airlines are also attracted by low transit times between international and domestic operations.

³ IATA (1998).

- *Market development assistance.* Much of the growth in international services, and certainly the price tension, has been due to new international carriers. Market development is expensive and is often recognised as a barrier to entry to new carriers. Melbourne Airport has been in active partnership with successive Victorian Governments in developing markets both to and from Melbourne.
- *Ability to integrate into Northern Hemisphere schedules.* Airline scheduling into Australia, especially from Europe, is determined by scheduling constraints in the Northern Hemisphere. The ability of Melbourne Airport to operate continuously is a key competitive advantage. This is true, not only because it allows better network integration but also because aircraft are not “grounded” by curfews or arbitrary capacity restrictions. It also significantly increases the capital efficiency of airports. Almost half the services added to Melbourne Airport since 1997 have been during times when Sydney Airport has been closed.

Dynamics of International Airline Scheduling

The general growth trend in international services since sale tends to mask the dynamics of international airline route development strategies. The following table shows not only entry and growth, but withdrawal, re-entry and reconfiguration and gives some insight as to how the dynamics of the industry work.

Airline	1997	2001	Notes
Air New Zealand	20	41	Prior to March 1999 had daily services to Auckland. After March 1999 went to double daily services to Auckland June 2000 went to triple daily to Auckland. December 2000 4 daily services to Auckland. Consistently have used a mix of B737, B767 and B747 aircraft
Air Pacific	2	3	
Air Vanuatu	1	2	
Alitalia	4	0	Withdrew services in 1998
Ansett	1	7	November 2000 introduced 4 direct services to Hong Kong
British Airways	7	5	Withdrew services in March 1999. Services resumed in March 2001
China Southern	0	2	Commenced December 2000
Emirates	4	7	In 2000 changed aircraft to increase capacity.
Eva Air	2	0	Withdrew services in 1998
Freedom Air	0	5	November 2000 introduced 1 weekly service to Dunedin
Garuda	7	5	
Gulf Air	3	6	
Lauda	3	2	January 2001 changed to 2 x direct Melbourne services, instead of via Sydney

Airline	1997	2001	Notes
Malaysia	7	14	
Merpati	3	0	Withdrew services in 1998
Olympic	3	2	Reduced capacity with smaller aircraft size in 2000. Also dropped one Melbourne service.
Polynesia	1	0	Will withdraw service from March to September 2001 and then re-commence next schedule
Qantas	54	72	October 2000 introduced direct daily services to Los Angeles – previously via Auckland. November 2000 introduced Melbourne to Bombay services, via Singapore direct – not via Sydney. In 2000 decreased services to Bali from 2 to 1, however increased aircraft size from B767 to B747 SP
Singapore	7	14	Slowly increased capacity while maintaining frequency – then increased frequency. In 1997 went from using A340 (265 pax) to B777 (300 pax). July 2000 introduced Rainbow aircraft B747 (385 pax)
Thai	2	12	In 1997 used B747 aircraft (400 pax) In 2000 use B777 – 300 aircraft (340 pax)
United Airlines	7	7	Changed route in 2001 - now via Auckland to Los Angeles (not direct)
Vietnam Airlines	1	2	In 2000 increased capacity with aircraft configuration changes – now all economy seating
Total	137	208	

Many of these apparent “quality” issues are actually issues about airline costs. It is likely that to the extent that the costs of operating through an airport are an important consideration to airlines, they take a total cost approach rather than being concerned with individual price elements. Although airline demand for airport use is unlikely to be elastic in relation to the price of aeronautical services, aggressive pricing action by airports may tip the balance in airline decisions regarding whether to add an additional service in one location. This is especially true where well-developed domestic networks enable easy on-carriage. Through an innovative marketing program, Melbourne Airport has been able to grow its international business by 8% per annum since privatisation. This has been in an environment significantly constrained by the Asian currency crisis.

Domestic Passenger Services

There is capacity for bypass in domestic markets although it is probably less than in international markets. For example, passengers to and from Tasmania from Adelaide, Perth, Brisbane and Canberra will for the foreseeable future need to change planes in either Sydney or Melbourne. Similarly, there are a number of options for connections to and from Perth and Darwin, and services from northern Queensland can overfly Brisbane and indeed Sydney to service markets in the south-east corner.

These network management issues apply mainly to Qantas and Ansett, whose scale, enables them to exercise a degree of network flexibility. As such, route decisions are more likely to depend on network and fleet economics rather than relative airport prices. In other words, the incumbents are likely to express a demand for airport services that is relatively price inelastic.

On the other hand the demand for airport services is likely to be more price elastic for entrants than that of the incumbents. Moreover, airports have reasonable incentives not to use market power to the detriment of new entrants. New entrants typically have a lower per seat cost structure than the incumbents and as such, airport charges are likely to constitute a larger proportion of their cost base principally because airport charges per passenger are similar across the industry. Thus, in the same way that airlines in general are relatively insensitive to the level of airport charges, incumbents are likely to be less sensitive than new entrants are.

Therefore, an airport that increases its prices is more likely to lose new entrant volume and, indeed, if an airport is too aggressive with respect to its prices, new entrants may bypass it much in the same way that international carriers can. Virgin Blue has been particularly vocal about the level of airport charges impacting on their ability to offer services both in Melbourne and Adelaide. The decision that airports then face is whether to drop price or not to gain business.

Why don't airports price discriminate?

Where a large proportion of costs is fixed and there are economies of scale, price discrimination offers a way of increasing demand and improving community economic welfare. Price discrimination is practiced widely in aviation and this is also true of airport pricing. However there are strict limits on the extent to which it can be pursued owing particularly to the countervailing power of airlines.

Additional traffic may be secured by lower than normal terminal charges, marketing programs, offers of financial support, tax concessions from State governments and so on. However incumbents, whose countervailing market power extends across a range of markets, often object to price discrimination. Adelaide Airport is a classic example of this where Qantas is reported to be threatening to withdraw from the Multi User Integrated Terminal project if Virgin Blue enjoys more favourable access prices than Qantas.

One can see Qantas' motivation as seeking 'fair' treatment. Yet Virgin's passengers are likely to be more price elastic than Qantas' as Virgin's and Impulse's whole corporate plans presuppose this. Moreover their entry into the market is predicated on growing the market, not just stealing their competitors' customers. Accordingly in this instance, Qantas' market power appears to be impeding the socially beneficial outcome of moving towards more efficient price discrimination in which more fixed costs were borne by more price inelastic users.

The project is strongly supported by Ansett⁴. It is interesting to note that if Qantas were to carry out this threat, the impact is likely to be felt not only by Virgin Blue and Adelaide airport but other domestic and international carriers who are keen to see the facility built.

Freight Services

Whilst there are both dedicated domestic and international freight services operating in Australia, 75-85% of freight is carried in passenger aircraft. As such, issues relating to passenger services mostly affect the market. To some extent, good freight markets can assist the development of passenger services, for instance, by providing incremental revenue necessary to make passenger services viable.

Dedicated freight services are impacted by the same sorts of issues that impact passenger aircraft – access to infrastructure and good handling agents, being able to operated at any time of day and so on. Freight service operators seem to be quite willing to change airports, which is a reflection that their businesses are driven primarily by the task of delivering imports to Australia rather than to any particular location or the carriage of export freight from a specific location. This is because what really drives the provision of freight services is the known availability of high

⁴ Milne (2001)

value cargo. It is this preparedness to move coupled with a general availability of airport capacity that gives airports little market power in relation to freight services.

In addition, as freight services require less intensive infrastructure than passenger services (freight terminals are simpler than passenger terminal, freight doesn't require food and beverage outlets or car parks and so on) secondary airports also provide competition. In the case of Melbourne Airport, Avalon provides services for long haul domestic and international freight operators whilst Essendon and Moorabbin can accommodate aircraft carrying small high value consignments (such as courier bags).

Countervailing power of users of airlines

Most regulated industries, electricity, gas, water and telecommunications for example, are characterised by a small number of large providers servicing a large diverse range of customers in the provision of not only key business inputs, but also basic consumer necessities. Regulation in these industries is to protect customers with little market power and indeed, one could form the view that the function of the regulator is, in part, to solve the collective action problem encountered by a diverse group of consumers.

The provision of aeronautical services is very different. Airports provide intermediate industrial services that constitute a small part of the prices paid by the ultimate consumer, that is the travelling public.

As we have indicated above, airports are unlikely to have significant market power in relation to services provided to non-airline users and as such, a discussion of countervailing power is not particularly relevant. Our discussion of countervailing power is therefore restricted to the market for aeronautical services.

We note the Commission's recognition of this issue in its Interim Report of the PS Act

“For economic reasons, prices oversight is required in only a small number of markets with natural monopoly characteristics and no close substitutes (such as parts of the utilities industries like telecommunications, electricity, gas and water), and during transition to deregulated markets. The existence of only one (or few) firm(s) in a market does not necessarily constitute a problem. This is because focussing solely on the number of competing firms in a market fails to take into account the full range of conditions on both the demand-side (for example, countervailing power of buyers and the availability of substitutes) which are important in accessing whether a market power problem exists.”⁵

⁵ PC (2000, p23)

The Effect of Monopsony

Even in those markets where an airport may have some market power, airlines possess significant countervailing market power. The consumers of these services are to a large extent highly organised corporations with multinational reach and significant political power. Their financial capacity can be seen in the fact that in 1998, the airlines using Melbourne Airport had combined revenues in excess of US\$60 billion as compared with Melbourne Airport's AU\$ 145 million⁶.

The notion of market power of monopsonists is established in the economic literature. This literature also addresses situations where both the sellers and the buyers command considerable market power. The discussion suggests that the outcome is indeterminate and analysis requires game theory to see how the surpluses might be divided between the two parties. However, one thing is clear; the outcome must lie, for each of the parties, between its fallback position or "bottom line" and the upper bound, which defines the maximum possible surplus.

In terms of this analysis, airlines can be expected to use all political and legal weapons at hand in order to limit the upper bound of the airport and therefore start from a position that is well above the bottom line of the airlines. In this context, economic regulation is another weapon the airlines can use to tilt the balance in their favour.

Degree of Monopsony Power

Approximately 80% of Melbourne Airport's aeronautical revenue comes from four customers. These same four customers account for 45% of the airport's total revenue⁷. At Launceston Airport, Qantas and Ansett account for 98% of aeronautical revenue. By contrast, airport charges amount to about 4% of airline costs⁸. Domestic landing charges account for less than 1% of a full economy return fare between Sydney and Melbourne, a route that accounts for 43% of Melbourne Airport's domestic market and 20% of Australia's domestic market. This is not to say that airports may not possess market power but rather, it is a demonstration of the countervailing market power possessed by airlines.

The break-up of the FAC significantly reduced the bargaining power of Australia's airports as a group. At the same time it enabled individual airports to compete with each other in ways described above. At the same time, airline ownership and operations have become more concentrated. In recent times, significant cross ownership arrangements have developed between major carriers. Airlines have put in place joint services agreements (Qantas and British Airways and Singapore

⁶ Airline Business (1999, p24-25.)

⁷ See Appendix 6.

⁸ IATA (1998).

Airways, Ansett and Air New Zealand) which have required authorisation under s90 of the TP Act because of their potential anti-competitive impacts, although it is noted that these authorisations have not covered joint purchasing activities. The development of the Star and oneworld alliances further concentrates airline activity. Less than 16% of Melbourne Airports aeronautical income comes from airlines that are not members of the Star or oneworld alliances.

To date, airline alliances have not tended to act as “buyer cartels” but rather have focussed on joint marketing, route integration and so on. That said, even these activities may involve airlines using leverage over airports as alliances choose where to concentrate their activities. In recent times, it has become obvious that Ansett and Air New Zealand are going to deal with airports, both in Australia and overseas, as a single entity. This must necessarily lead to increased buying power on the part of the group and a corresponding reduction in whatever market power is held by individual airports.

In addition to these arrangements, when considering the question of airline countervailing power, one should also consider the bargaining conduct of airlines. In practical negotiations, Ansett, Qantas and BARA, representing international carriers (including Qantas and Ansett), are encountered together. Whilst this may reduce transactions costs for airports, the preference of airlines is to negotiate together, if not for anticompetitive reasons then certainly to use their combined strength to pursue their mutual interests. The starkest example of this is the actions currently in the Federal Court being brought against Sydney Airport, collectively, by the airlines.

This is not an isolated conduct incident. In 1981, 19 airlines funded action against BAA in relation to charges at Heathrow whilst more recently, airlines acted collectively under the IATA banner to bring their case against the funding arrangements for the development of new facilities in Hong Kong.

Both Virgin Blue and Impulse are not members of these industry organisations and have shown a strong preference for negotiating with airports on a one-to-one basis rather than collectively.

Test for Monopsony

The ACCC has become concerned with the potential for anti-competitive conduct to arise from on-line procurement joint ventures both through co-ordinated conduct by competitors and the general development of monopsony power. Commissioner Ross Jones has indicated that such arrangements may be anti-competitive if

- The buyers are competitors
- The market in which they compete is fairly concentrated
- The suppliers are small
- The goods and services procured have strategic value

- The buyers control the infrastructure and have access to trading information
- Alternative portals are not available to suppliers and non-members⁹.

The first four points are directly relevant to those markets for aeronautical services. It is also certainly the case that airlines seek detailed information about airport trading activities. Moreover, to a significant extent, alternatives are not available to non-members (that is, new entrants).

If these characteristics are signals of anticompetitive conduct in on-line procurement, then surely they should be an issue in any market where there is a concentration of buyer power. Even if they are not a concern from the point of view of Part IV of the TP Act, they must be a strong indication of a degree of market strength on the part of buyers, which could restrain any use of market power by a supplier.

Political Considerations

Political power of airlines is also a relevant consideration. Airlines as a group have global political reach. They employ hundreds of thousands of people and provide both essential and discretionary services (that is tourists) to nations and regional communities alike. Airlines deploy substantial resources to a wide variety of activities designed to influence the way in which they are perceived. They have huge advertising, marketing and public relations budgets at the same time as providing media services directly to their consumers. They also maintain significant government relations' teams to influence national policy and to enlist the support of sub-national governments. They also have an effective international organisation in the form of IATA. Airlines are prepared to threaten service reductions publicly if they do not get the policy outcomes they desire and, through their networks, have a capacity to target such action in the areas of greatest political sensitivity.

Airports, on the other hand, have a relatively weak political position. Their marketing, and public relations budgets are tiny compared with airlines. Indeed, many of the services they actually provide airline travellers are 'branded' with airline identities. They tend to be much smaller organisations with much less capital and their capacity to threaten action without destroying their business is very limited. Indeed in Australia, given the obligations under the Airports Act to operate the airport and the provisions of Part IIIA of the TP Act, there really is no credible political threat available to airports. This disparity in political power must be seen as part of the countervailing market power of airlines.

⁹ Schmidt (2001)

Even where their users are more diffuse – as is the case with taxi access to Melbourne Airport – there are strong political pressures on the airport not to recover quite legitimate costs which are incurred in supplying services to taxis.

Further, any market power enjoyed by Melbourne Airport turns into a disadvantage vis-à-vis the airlines in this case. Much of the airlines' investment in servicing Melbourne is mobile (quite literally in this case!). Melbourne Airport's value added is derived largely from the services of fixed sunk investments. Melbourne Airport has virtually nowhere else to take its business to enhance its negotiating position with host governments and/or if it were to become unviable to provide its service from Melbourne.¹⁰

Airport market power – what to do about it

Owning a kitchen knife is not a concern to policy makers. Stabbing someone with it is. By the same token, Australian trade practices law generally considers that it is not an offence to have market power. Rather it is an offence to use it for purposes proscribed by law. Those purposes are damaging a competitor or preventing entry into the market concerned or any other market

We have argued above that in relation to a wide range of services provided on or by airports, there is a wide range of substitutes for consumers and as such, airports possess relatively little market power. The appearance of high returns does not of itself constitute any abuse of market power but rather the valuation placed on these services and the relative scarcity of sites.

The standard analysis proceeds along the lines that the monopolist would increase prices above the market clearing levels, transferring surplus from consumers and leading to deadweight social losses, from contraction of supply and demand. The most telling reason for Melbourne Airport not proceeding down this track would be the lost opportunity of growing our business by doing what we do well, doing it very competitively, and thus profiting from substantially lowering our average unit costs.

It is our view that whatever market power airports possess is countered by strong customers in the form of airlines. If this countervailing power does not balance whatever power airports may have then certainly, the residual balance is likely to be sufficiently small not to warrant regulatory intervention especially when the clear commercial incentive to grow airport business is taken into account.

¹⁰ Agmon and Hirsch (1973) discuss a similar phenomenon of sunk investment becoming hostage to fortune in developing countries.

What would the Poms do?

In the 1997 MMC report on Manchester Airport, the following criteria were cited for the purposes of determining whether an airport should be subject to price regulation

- the market position of the airport and the extent of competition;
- any prima facie evidence of excessive profits or abuse of a dominant position;
- the scale and timing of the airport's investment programme; and
- the efficiency of the airport's operations and its quality of service.

Applying these standards, the CAA did not declare Luton (bigger than Adelaide) or BAA's Scottish Airports (slightly smaller than Melbourne). Stansted (about the same size as Brisbane), the largest single regulated airport in the UK, is only regulated because of its common ownership with Gatwick and Heathrow.

Given what we know about Australian airports, it is interesting to speculate whether the CAA would both to regulate any of them.

Chapter 3: Dual till approach

Airports are multi-product businesses. In some markets for their services they enjoy some degree of market power. In others they face multiple competitors and a variety of easy substitution possibilities for consumers. If price regulation is imposed on such an entity, the question arises, “should it be imposed upon the whole operation, or only upon those services which exhibit some natural monopoly characteristics.” The former option describes a ‘single till’ model of price regulation; the latter a ‘dual till’ model.

Melbourne Airport believes that the answer is reasonably straightforward. If one is concerned about the possible abuse of market power, in the market for the provision of a particular service, then one should regulate the market for the provision of that service, and that market alone. The costs and revenues of other services, provided by the same company, should not be the concern, let alone the target of regulators. This is especially true when the other services are far from being natural monopolies. The dual till approach can be viewed as regulation with a scalpel and the single till approach, as regulation with an axe.

The Case Against the Single Till

It is our view that sound policy dictates that regulation should only extend to those services where market power exists and is likely to be used in a way that damages economic efficiency. This should lead on its own merits to the dual till approach being favoured over the single till approach. Beyond that, we believe that the single till should be rejected because

- single till pricing does not conform to government policy;
- that while a number of problems exist in the implementation of the dual till approach, these are either not applicable in the case of Australian airports and in any event are not solved by the single till approach; and
- the arguments in favour of the single till approach generally advanced by the airlines centre on issues of distribution of profits from airports’ retailing and parking businesses. There is no evidence, empirical or theoretical, to suggest that such transfers enhances economic efficiency.

The Government's Policy

The Australian Government has chosen not to mandate the single till approach to airport pricing. In fact, at the recent ICAO Conference on Aeronautical Charges, it was a leading advocate of having ICAO's guidance changed to reflect a dual, rather than single till approach.

The Minister for Transport and Regional Services recently re-iterated the Government's view on the single till :

“The pricing policy framework clearly states the Government would not mandate the use of a single till approach to aeronautical pricing and it does not expect that approach to be mandated by regulatory control. To do so would clearly be at odds with the Government's objectives in privatising the airports”¹¹.

The objective is to provide “airport operators with sufficient incentive to invest in new infrastructure and to use airport infrastructure efficiently.”¹²

Rather than using the single till approach, the Government has adopted a price cap covering those services subject to declaration under the PS Act.

The choice between single and dual till prices surveillance is not a regulatory issue that is peculiar to airports. Indeed, we suspect it is an issue dealt with daily in relation to the regulation of the telecommunications industry, where it is known as “unbundling”. Regulators dealing with electricity distribution know it as “ring fencing”. If anything is unusual about airports it is the credence that seems to be given to the “single till” approach, given that most other regulated industries have long abandoned its equivalents, if they were ever entertained at all. It is also interesting to note that in the United Kingdom (which has a fairly rich mix of regulatory experiences and where the formal regulation of private airports has the longest tradition), the abolition of the single till approach is being given very serious consideration by the CAA¹³.

It is important to understand precisely what the current Government policy on the single till approach is. The Government has indicated it will not mandate a single till approach. In doing so, however, the Government has not banned the single till approach. Rather it has sought to ensure that the airports have the maximum flexibility to determine the prices they charge to airlines, other businesses and

¹¹ Anderson (2001)

¹² *ibid*

¹³ CAA (2000c)

consumers, for their ever-changing range of services, subject to the ACCC ensuring that no abuse of market power occurs.

It is helpful to consider briefly what economic views are implied by this policy. The first is that, individual services should, wherever possible, be priced separately given the costs, risks, and demand characteristics of the business. Moreover, imposing regulation where it is not necessary may damage efficiency. The second is a reflection of the traditional information asymmetry problem of regulation where the regulated firm will always have more information than the regulator, and as a result is better able to determine efficient market clearing prices for contestable services than a regulator.

Issues Relating to Implementation of the Dual Till

The principle problem for the regulator in the administration of a dual till arrangement is information. There is a need to be able to separate the costs and revenues of the regulated activity from the non-regulated activity. There is a rich literature on this problem and its possible solutions. As noted above, it is a problem that regulators regularly grapple with.

Professors Gans and King recently made some comments on this matter.

“These information problems can be partly mitigated if the regulator can compare the firm’s reported costs and service quality to those firms in other jurisdictions. This type of benchmarking might enable a form of yardstick competition; whereby, regulators in several jurisdictions pool information to gather a more accurate picture of a firm’s characteristics.”¹⁴

It seems to us that the ACCC finds itself in a fairly favourable position in this regard. The airport industry structure in Australia strongly militates against this problem, in the way envisaged by Gans and King. The ACCC is in a position to examine audited accounts, prepared in accordance to regulations in a consistent way, for a range of airports and has a number of years of historic data for these airports. Thus it should be relatively straightforward for the ACCC to effectively employ the benchmarking technique outlined by Gans and King.

This is one of the four issues that the paper prepared for the ACCC by NECG sees this debate depending on¹⁵. We largely agree with this position. The other issues are:

¹⁴ Gans and King (2000, p11)

¹⁵NECG (2000, p9)

- the ability of airport consumers to substitute non-aeronautical services for services outside the airport;
- the price-sensitivity of air travellers; and
- the risk of the Averch-Johnson effect occurring in practice.

The question of the ability of airport consumers to substitute consumption of non-aeronautical services, between on-airport and off-airport locations is addressed at length in Appendix 2. The argument of NECG seems to be that because airports may earn significant profits from the provision of these services, then there must be some exercise of market power, in relation to these facilities, and they should therefore be regulated. On this issue, the CAA has noted :

“... that the single till arrangement does not normally place constraint on the commercial side and therefore does not protect consumers of those services. Moreover, any rents on the commercial side are likely to reflect locational advantages, rather than market power of the order to suppose full economic regulation¹⁶”

This comment raises a number of points. First, if market power is being abused, the single till approach does nothing to protect those being abused. It merely acts to redistribute the benefits of the abuse elsewhere.

Secondly, that the source of the rents is not related to the exercise of market power but rather, to locational advantages, which property and real estate markets will efficiently reflect in higher rental values as discussed in Chapter 2.

NECG is also concerned about the sensitivity of travellers to the price of aeronautical services. They are worried that if passengers are highly sensitive to the price of aeronautical services, efficiency losses may result from an increase in airport charges. The Commission’s own work shows that demand by Australians for international air services is relatively inelastic whilst the demand by non-Australian residents depends on the market segment concerned¹⁷. We are not aware of any similar estimates for domestic services.

However, airport charges account for about 4% of airline cost bases and a much smaller proportion of the price of a ticket. Even if movements in airport charges were passed fully through to end users, they would have little impact on demand for travel¹⁸.

¹⁷ CAA (2000a, p33)

¹⁷ PC (1999, p24)

¹⁸ This must be the case as the elasticity of demand for travel with respect to the price of aeronautical services is the product of the own price elasticity of demand for travel and the elasticity of fares with respect to aeronautical charges.

On the question of the Averch-Johnson effect, it seems to us that as long as the allowed rate of return is equal to the firm's actual cost of capital, there is no problem, irrespective of whether there is a single or dual till system. The problems associated with higher or lower rates being allowed are essentially the same, irrespective of whether a single or dual till approach is adopted.

In summary, normal regulatory considerations would seem to indicate that there is little justification for regulating non-aeronautical activities, or for including them in the regulation of aeronautical activities. What then is the argument for the single till approach?

The Airline Case

The principle proponents of the single till approach are airlines who argue that aeronautical charges should be determined as a residual. At the same time, airlines argue that they should only pay for the services they use, although they expect the revenue derived from others to be used to subsidise their activities.

The result of these arrangements is to produce a situation where the prices charged for aeronautical services bear no relationship with the costs (total or incremental) of providing them or the value placed upon them by the consumers of the services, these being the airlines. Under this arrangement, the pricing mechanism no longer serves to equate supply and demand in the market for aeronautical services. The result is economic inefficiency. To require the use of the single till approach would be to effectively say that airlines should be subsidised by others and receive services at prices (possibly) below long run incremental cost.

The CAA cites the airlines view as

... airlines should benefit from the commercial revenue from passengers that they bring to the airports¹⁹

A range of objections can be raised against this approach. Firstly, the single till approach simply transfers rents from airports to the airlines. On the transfer of rents, as Professor Kahn observes:

“Economists have for two centuries recognised that such true economic rents, reflecting the superior convenience or productivity of infra-marginal location, do not determine efficient prices but are determined

¹⁹ CAA (2000a, p31)

by them ... There is also a tradition of long standing that appropriation of those true rents . . . would in no way interfere with the efficiency of the market²⁰”

In other words, there are no efficiency implications, and in particular no efficiency gains, to be had from such a transfer. Secondly the single till is fundamentally at odds with the whole spirit of National Competition Policy which focuses upon intervention in markets only where necessary for essential facilities of national significance. The formula of restricting intervention to essential facilities of national significance rightly constrains intervention to those areas where it is most likely to deliver cost beneficial results. As the Commission itself has noted

“The appropriate role for prices oversight in the current environment is to prevent firms with significant market power from charging prices that significantly exceed costs, as a policy of last resort. . . . [P]rices oversight is likely to be required in only a small number of nationally significant markets with natural monopoly characteristics, no close substitutes, and barriers to entry...²¹”

Airlines argue that other businesses only use the airport because of the airlines flying to the airport. If the non-airline businesses were not present, then airlines would pay full price. How is efficiency enhanced by airport charges being less than the cost of the provision of services? Ultimately this debate is largely about alleged historic rights and profits and predictably different perspectives on what is ‘fair’, not economic efficiency. For the sake of responding to this perspective, but not because it will or should influence the Commission in its deliberations, we suggest the obvious alternative perspective: Airlines only have passengers because they are delivered to and from them by airports, or indeed taxis!

That said, there is a situation where single till pricing may be efficient. If the demand for non-regulated (non-aeronautical) services is sufficiently responsive to the price of regulated (aeronautical) services then it may be efficient to price aeronautical services below incremental cost. Professor Kahn notes:

“The critical condition for such a cross-subsidisation (pricing one of the complementary services below its separate incremental cost) is that the cross-elasticity of demand for the complementary service will be high enough to compensate for the out of pocket losses on the sales of the first of these, considered in isolation.²²”

²⁰ Kahn (2001, p20-21)

²¹ PC (2000, p35)

²² Kahn (2001, p17)

This is a question of fact. The demand for non-aeronautical services (principally retail space and ground access services) is derived from the demand for travel. As there will be some dilution (increases in demand for aeronautical services will not fully flow on to non-aeronautical services), the cross elasticity of demand for non-aeronautical services, with respect to the price of aeronautical services, must be less than the elasticity of demand for travel with respect to the price of aeronautical services. We have shown earlier in this chapter that the demand for travel relative to the price of aeronautical services is likely to be low. Thus, it would seem that on the basis of the facts and Professor Kahn's argument, that single till pricing is not efficiency maximising.

If dual till pricing were allowed, and the relevant cross-elasticities were high, the airport would find it profitable to price on a single till basis. In other words, if single till pricing is efficient the airport will do it without coercion from the regulator. Considering this, mandating a single till approach appears to increase costs (the risk of regulatory failure) without any benefits.

The single till is likely to lead to aeronautical prices below efficient, market clearing, prices. As demonstrated in Chapter 5, not only does this lead to both short run and long run efficiency losses, but the long run efficiency losses of this approach are actually greater than the loss that would occur if a monopolist priced above market clearing levels by the same amount.

Chapter 4: Current prices regulation

The Commission's Issues Paper provides significant detail on the institutional arrangements for price regulation. Thus, there is little need to dwell on those facts, although for the sake of completeness, a detailed description of the economic regulatory system, as it applies to airports, is provided in Appendix 5.

We acknowledge the importance of a set of arrangements to smooth the transition to private ownership to minimise windfall gains and losses in the immediate post-privatisation period.

The Government established arrangements intended to prevent abuse of market power. Not only was the potential and incentive to abuse market power misplaced, the arrangements have been captured by airlines in order to achieve further short-term financial transfers beyond those already implicit in the price cap. As a result, windfall gains have accrued to airlines, not airports.

It is concerning that the ACCC has allowed itself to be involved in a process that has degraded regulatory credibility by either flouting or opportunistically interpreting Government policy. The effect of this is two fold. First, airlines have perceived they will always get a better deal from the regulator and as such, the move to more commercial arrangements is retarded. Second, the ACCC's failure to implement what was generally accepted to be government policy at the time of sale, a policy that remains unchanged, substantially increases investors perceptions of regulatory risk. This perception of what is effectively sovereign risk will inevitably flow on to other sectors where regulation is an important issue, lowering the value of infrastructure assets, raising the cost of capital to fund them and jeopardising investment in a range of infrastructure sectors.

As we have argued elsewhere in this submission such opportunistic conduct is fundamentally at odds with the notion that what is being regulated is an essential service of national significance. If that is the case, then exposing investors in the facility to heightened sovereign risk is surely of much greater (negative) economic significance than the relatively marginal short term economic benefits to be had from (under the most favourable assumptions imaginable) the imposition of perfect pricing by the ACCC. Of course the risk is not just that the ACCC is trading short term gains for substantial long term losses, but rather that, because of its lack of information the ACCC's actions also generates costs in the short term.

Government Policy – the truth is in the eye of the regulator

During the airport sales process, the Government represented to potential bidders that a light handed regulatory system would be put in place to encourage them to grow their businesses and develop normal commercial arrangements with their customers.

<i>Government Policy</i>	<i>ACCC Action</i>
Airports will have access to new revenue streams outside the cap such as fuel throughput levies and ground access charges. <i>OAS(1996)</i>	ACCC has put ground access charges in the cap and tried to do the same with fuel throughput levies only to be turned down by the Government
Pricing guidelines to strike a balance between protecting users and creating conditions for commercially driven decisions. <i>Costello(1997)</i>	Airline negotiators have regularly indicated that they “understand how the regulatory system works so why should we agree to anything”.
The Government will not mandate the single till. <i>DoTRD (1996), Anderson (2001)</i>	Despite the ACCC’s protestations to the contrary, it has adopted a single till methodology in its Draft Decision on Sydney Airport’s Pricing Proposal. It also alluded to the appropriateness of the single till approach in relation to Melbourne Airport’s DET.
Over time, the Government wants to see airport operators negotiate directly on pricing and investment. <i>Costello (1997)</i>	The ACCC is the effective decision-maker in all pricing and investment decisions. When Melbourne Airport and Impulse Airlines reached a pricing agreement in relation to the DET, the ACCC intervened on behalf of one of Impulse’s competitors. So little regard did the ACCC have for this agreement, the ACCC did not even mention it in its Draft Decision on this matter.

Our general view of the broad structural characteristics of the current system is as follows. The adoption of a dual till and the use of a tariff basket for the price cap, were sound, from the point of view of providing incentives to airports to grow their business. These are critical design issues for any future regulation. However, significant problems have occurred in relation to starting prices and new investment. If not corrected, they will lead to significant problems in the long run, requiring significant attention in any future regime.

Policy objectives

When reading the original Pricing Policy Paper, one forms the view that it was the intention of the Government that the cap should be “a genuine constraint on prices”.

Intentions of the pricing policy

The following three statements sum up the Government’s policy intention at the time of sale and we believe these remain unchanged. They are consistent with the quotes provided in the Commission’s Issues Paper

1. For airlines, the overall price direction for the next five years will be downwards. For passengers, the restraint on airport prices should help keep airfares down.²³
2. The pricing oversight guidelines provided to the ACCC are designed to strike a balance between protecting airport users and creating the conditions for commercially driven decisions on the part of airport operators. Over time, the Government wants to see airport operators and their customers negotiating directly on pricing and investment decisions but with the ACCC remaining empowered to prevent monopoly pricing.²⁴
3. The price cap is designed to be as simple and straight forward as possible, in the interests of minimising costs of regulatory oversight for both the ACCC and the airport operators, while ensuring appropriate outcomes.²⁵

The cap, both by its stated intention and clearly from its design, is not a device for regulating airport profits. Indeed, given the information provided in the ACCC’s monitoring reports, nor is it a device for ensuring airport shareholders receive normal returns on their regulated businesses. The purpose and effect of the cap is to ensure airlines enjoy the benefits of real productivity gains through prices for services that decline in real terms.

It is Melbourne Airport’s view that whilst many of the benefits envisaged by the reform of Australia’s airports have been delivered, pricing regulation has not met the standards set out in the above aspirational statements. The arrangements have led to some perverse outcomes and airports have been involved in a process of almost continuous activity and contest with regulators and airlines about how the regulatory regime should work. This generates uncertainty with adverse effects on investment and other business decisions.

²³ Sharp (1996).

²⁴ Costello(1997).

²⁵ DoTRD (1996).

Is the pricing policy right

The CPI-X price cap, was applied to a set of prices that were already inefficiently low, as part of a “deal” to secure acceptance of the privatisation process, from both the airlines and the general community. The political need for such transitional arrangements has now past. Moreover the period of time during which, by limiting windfalls, they could conceivably make a positive economic contribution has now ended also. There is no reason why they should continue as, if persisted with they will reduce investment in quality and capacity.

In Chapter 5 we argue that the long run costs of providing insufficient incentives to invest in infrastructure greatly outweigh the long run costs of incentives being too generous. Recent experience demonstrates this very well. Melbourne Airport along with other airports around the country has recently invested in infrastructure to allow two new entrants to the airline market greater access to domestic airport terminals.

The New Entrant Story

In December 2000 substantial increases were recorded over December 1999 levels on the top 3 routes, Melbourne - Sydney, Brisbane - Sydney and Brisbane - Melbourne with increases of 18.7, 48.2 and 33.3 per cent respectively. The Adelaide - Brisbane route, boosted by the introduction of services by Virgin Blue on 7 December, grew 71.6 per cent over December 1999 albeit on a smaller base²⁶. It is unlikely that airport revenue derived from these increases could have been achieved through pricing policies that abused market power with respect to these airlines. Moreover, it is likely none of this would have happened without Sydney or Melbourne Airports putting in place new terminals.

It is of course conceivable that the prices to which the ACCC agreed are too generous to the airports. Virgin Blue has argued as much and Melbourne Airport supported by the other entrant, Impulse airlines, would vigorously contest this. If so then theoretically the right (lower) price would yield greater welfare for the Australian economy. However the alternative underpricing would be no terminals at all. Obviously the competition that the new terminal facilities bring about which drives competition within the much larger market for domestic aviation.

The current arrangements fail to provide an environment in which normal commercial arrangements, between airport operators and airlines, will emerge. Airlines see the opportunity to involve the ACCC in every matter, as the source of better short-term financial outcomes than they could achieve through commercial negotiations. They effectively seek to game the process. In a situation where they have nothing to lose (other than the asset not being provided at all) why would they

²⁶ DoTRS (2001)

do otherwise? It must also be added that airlines (we suspect at the urging of IATA) often see any regulatory decision as having the potential to be a global precedent, and therefore often argue points that they privately concede, have no merit.

The high degree of concentration of buyers is relevant here. In most regulated industries such as electricity and gas distribution and telecommunications, buyers are small and widely dispersed. However, in a situation that could be characterised as oligopoly-oligopsony, there exists the potential for regulatory capture on both sides. The arguments for regulatory capture by a regulated firm are well known (and not repeated here in detail). Regulators, simply through constant contact, get “too close” to regulated firms. In the Australian airports context, with the same group of airline officers, dealing with the same group of regulators, in relation to a number of airports (and indeed Airservices Australia), it would seem that airlines will have much more contact with, and are therefore “closer to” regulators than airports are.

Another issue that is often raised in relation to regulatory capture is information asymmetry. The regulated firm will always have more information about its business than the regulator. The regulator is reliant upon the firm for much of the information it uses. However, the ACCC has come to rely heavily on information provided to it by airlines, as often as not, on a confidential basis. Qantas generally makes submissions on a commercial- in- confidence basis. However, the most glaring example of this was in relation to Melbourne Airport’s Domestic Express Terminal where the ACCC was in possession of passenger and schedule information for Virgin Blue that the airport had no access to. In other cases, the ACCC has been provided with information by airlines, which has simply been wrong. An example of this was in relation Melbourne Airport’s NNI application where in the first instance, the ACCC accepted that an asset had been completed prior to sale when it was clear that it hadn’t been.

Indeed, one could form the view that because airlines and the ACCC deal with all airports, and that airports are required to undertake significant information disclosure, that it is individual airports that may actually possess the least information in these processes.

The DET also serves as an example of the Government’s desired “commercial negotiation” approach being followed, only to be interfered with, by the ACCC. In issuing its Draft Decision, the ACCC did not even mention the agreement that was central to the project proceeding. Impulse’s submission was quite short - simply indicating they had an agreement with Melbourne Airport. Virgin Blue, on the other hand, had no such agreement and we understand made a very lengthy submission. This submission was never made public, not even to Melbourne Airport. However, it contained information that was material to the ACCC’s decision process, and indeed, to Melbourne Airport’s business. Here, gaming was more influential than agreement. Ultimately an agreement was reached but only

after significant cost and potential termination of the project and with Melbourne Airport deciding to undertake no further aeronautical investment without prior ACCC pricing approval. This seems to be another example of how, in the pursuit of

lower prices, the ACCC quite happily puts government policy to one side and thereby degrades regulatory credibility.

As long as the ACCC can be involved in a matter, it seems that airlines will lack the incentive to negotiate either because they feel a better result is achievable from the regulator, or that by using the ACCC's processes they can delay and frustrate processes beneficial to their competitors. In effect, the ACCC provides a free arbitration service for airlines and it is not surprising they seek to use it.

It seems that the ACCC must be removed for the general operation of pricing processes. Instead it should only have a role when there is a legitimate issue with the abuse of market power, rather than a mere suspicion that it may exist. Beyond that, significant changes are required to ensure that prices are set to follow paths that encourage efficient investment.

Economics of the current system

A single till in all but name, but maybe worse

The current regulatory system started off with a set of prices based, effectively, on a network-wide single till. Applied to these has been an aggressive price cap that has seen already inefficiently low prices reduced even further in real terms. The only relief has been a set of rate of return based investment arrangements which have not even compensated investors for their expenditures during the current regulatory period.

In effect, there has been no transition to dual till pricing and as such, little progress has been made in improving efficiency by way of better pricing signals.

Starting point prices

The starting point prices for both the Phase 1 and 2 airports were those prices prevailing under FAC management as at 1 January 1997. For most of its life, the FAC priced on a single till basis across its network. In other words, the revenue from each airport was pooled to pay for the expenditure of the whole corporation. Charges were largely uniform across the network, although there was some movement away from this towards the end of the life of the FAC.

It is interesting that the ACCC has not allowed airports to recover the costs of investment that occurred between 1 January 1997 and the time of sale, effectively giving airlines free use of the new services. Indeed, in some cases, the ACCC has not even allowed recovery of expenditure undertaken by the new owners on the

basis that these investments were known at the time of sale. Any existing inefficiency in starting prices has been exacerbated by the ACCC's administration of the NNI processes in this regard.

As we have argued above, prices set under a single till approach are likely to be inefficient and those set on a network-wide basis even more so. A cursory examination of airport regulatory accounts shows no airport has yet reported earnings on its regulated assets above the bond rate. In many cases losses have been reported. This is in our view not only evidence that prices have been inefficiently low, but that the level of starting prices has been a major contributing factor to the problems associated with the administration of the NNI arrangements.

Incentives under the price cap

Under the current price cap, strong incentives exist for airport owners to reduce costs and more importantly in Melbourne Airport's view, to grow volume whilst airlines benefit from falling real (and currently nominal) charges. These characteristics are largely independent of both starting prices and the NNI arrangements.

Depending on the competitive environment an airport finds itself in, it has a capacity to encourage business growth through its own actions, especially in relation to international traffic and new entrant domestic carriers. Downstream benefits for passengers and regional economies are delivered through a greater range of aviation services and by placing competitive pressure on incumbent airlines through the efforts of airports to attract new carriers and services and therefore grow revenue. In the case of Melbourne Airport, the result has been greater capacity and increased frequency of services. This not only enhances both inbound and outbound tourism but also makes those areas serviced by Melbourne Airport more able to participate in global markets for other traded goods and services.

The alternative approach is a revenue cap as is in place in most regulated industries in Australia and the UK, including airports. In these cases, a price path is calculated on an assessment by the regulator of a fair return on capital, depreciation and operating costs over a regulatory period (usually 5 years), with an allowance given for capital expenditure. Incentives here arise largely from the ability of the regulated firm to retain the benefits of efficiency improvements achieved during the regulatory period, exceeding those expected by the regulator although these may be appropriated at the next review.

It is our view that whilst the price cap itself has achieved its goals, problems have been encountered with what services are actually in the cap and necessary new investment.

Scope of regulatory domain

The Government has made its policy position with respect to the single till approach clear both at the time of sale²⁷ and more recently²⁸. There has been an ongoing debate as to precisely which services are declared and therefore included in the cap. This debate has revolved around fuel throughput levies and ground access (and in particular taxi) charges.

A case can be made that there is market power with respect to refuelling services but the case for ground access charges is weak. Irrespective of the merits of the market power arguments, bidders were told that these charges were not declared and therefore outside the cap. For regulators to seek to reverse this position, particularly in a non-transparent way and without reference to Government raises serious issues of sovereign risk.

The ACCC has undertaken an inquiry into fuel throughput levies and made recommendations to Government. Refuelling services remain undeclared and have not been included in the cap despite the ACCC recommendation to the contrary²⁹. Irrespective of the merits of the matter, at least the ACCC has proceeded in this instance in accordance with due process.

To the best of our knowledge, the ACCC has made no recommendations to Government in relation to market power issues relating to taxi charges. Indeed, Commissioner John Martin indicated publicly at the 2000 Aviation Outlook Conference that if the Government were to clarify the situation, the ACCC would act accordingly. Despite a senior DoTRS officer publicly clarifying the situation at that conference, the ACCC has not reacted. It is understood that the ACCC feels obliged to act on legal advice that charges for taxi parking and related services are charges for landside roads, or at least charges for “passenger processing facilities” and therefore declared. If this is the case, then surely the Minister is obliged to amend the relevant instruments so as to give effect to the policy intentions and representations made at sale by the Government?

However, it does seem that the ACCC is set on placing further downward pressures on prices for aeronautical services. It has indicated that it will assess each airport’s ground access services on its merits in relation to the declaration. Yet, to date, it has formed the same view everywhere. In relation to Melbourne Airport, it continues to advance the argument that existing and proposed areas that provide parking (for several hours), queue management and other services (toilets, prayer rooms, shade etc) are in fact landside roads and indeed passenger processing

²⁷ DoTRD (1996)

²⁸ Anderson (2001)

²⁹ ACCC (1998a).

facilities even though the services are enjoyed by commercial ground transport operators rather than the travelling public. These services are very different to the rank at the front of the terminal.

The ACCC's conduct in relation to ground access charges has been very different to its approach to fuel throughput levies. In relation to fuel the ACCC conducted an inquiry and made recommendations, in relation to ground access charges it has proceeded on the basis of threatening prosecution, under the PS Act, against those airports who are simply acting in accordance with Government policy.

If there is to be ongoing price regulation, there must be a clear, well-understood, processes for resolving these sorts of issues. Part of the problem has been that the agency responsible for the instruments, the Treasury, has no ongoing interest in the policy questions confronted by the industry. We understand that DoTRS has asked Treasury to have the relevant instruments in relation to ground access charges amended. However, Treasury has taken no action. This may be an argument for conducting any ongoing price regulation of airports under the Airports Act, rather than the PS Act.

Necessary New Investment

Whilst the price cap itself has been straightforward to administer, the necessary new investment procedures have been a huge problem. The ACCC now scrutinises every aeronautical business related investment decision where a price increase is involved. This is in an environment where most airports have negative earnings. Where they are positive, the ratio of those earnings to the assets involved has not exceeded the bond rate. The ACCC determines what expenditures are to be considered for price increases, whether those expenditures are acceptable and how prices are to be calculated. It bases its decisions on its view of the adequacy of discussions between airports and airlines. All this takes a minimum of three months (excluding any time for consultation with airlines).

The NNI arrangements are required in the current regulatory system because the prevailing prices for services are so low that they will not sustain investment in new capacity and services. In other words, current prices are generally below *ex ante* incremental cost. In broad terms, the NNI arrangements seek to distribute the costs of new capacity. The NNI arrangements are effectively rate of return regulation on new investment.

Many of the problems that have occurred with the NNI arrangements have been resolved over time. Whilst it would have been desirable for this not to have occurred in the first place, there is now a reasonable understanding of the procedures on the part of most parties. Having said this, gaming and at least as importantly, delays still occur.

The major problem that remains is the treatment of major capital replacement. Some airports have needed to undertake major refurbishment of runways and taxiways and sought to recover these costs through the NNI process. The ACCC has held that in general this is maintenance expenditure associated with an existing asset and as such not recoverable. Melbourne Airport has indicated in the past that the ACCC's approach is consistent with our view of the intention of the arrangements. However, it is entirely understandable that faced with these major costs airports would seek cost recovery, especially given the very low returns on maintenance expenditure. It must be emphasised that whilst we agree with the ACCC's interpretation, it must be seen as a correct interpretation of a policy that is not efficient, sustainable or desirable.

The NNI processes have imbedded in them a range of incentives that in the long run will be distortionary.

- As a result of the gap between the return on expenditure on maintaining existing assets and new assets (be they aeronautical or otherwise) there is a clear incentive to sweat the existing assets. This is compounded by gaming over the distinction between maintenance and investment. Both phenomena lead to degradation of existing assets, reducing their capacity and entrenching the competitive position of incumbent operators.

The calamity of classification – sweating assets

The secondary runway in Perth has for a number of years been used by wide-body jets although the runway is not designed for the frequency of use that it has been put to. As a result, the surface has been damaged and a new overlay is required to repair the damage caused by this higher frequency and to put it in the condition necessary to accommodate the frequency required by airline users.

The required works are estimated to cost around \$2.7 million and Perth Airport has sort a price increase under the NNI arrangements on the basis that this work is necessary to increase the capacity of the runway. Airlines have argued, an argument accepted by the ACCC, that whilst the works are necessary, they constitute maintenance, not investment and therefore prices should not be increased to fund the work.

As a result, restrictions have been placed on the use of the runway. Minor repairs have been made to make it safe for use by smaller aircraft but the capacity of the airport to handle wide-body aircraft has been limited.

- The mere opportunity to get a price increase on existing assets provides an incentive to airports to put up any project, in the hope that it may some how be approved.
- The ACCC has indicated that for expenditure to qualify as investment, it must lead to an increase in durable assets. Thus, new services that are the result of increase operating expenses (for example, the provision of additional

information officers) are not eligible for recovery. This creates a bias to capital intensive solutions.

Checked Bag Screening – Regulatory Capital Labour Distortion

The ACCC has adopted a position in relation to security services that sees capital earn a rate of return around 1.5% below the rate allowed for other NNI projects and has imposed cost reconciliation arrangements in order to give affect to what it believes is meant by “direct costs” associated with investment. The airlines suggested the assets should be funded at the bond rate. Realising that airports are not agents in sovereign right, the ACCC’s initial position was the assets should be allowed a rate of equal to the airport’s cost of debt. In other words, airport shareholders will provide equity for the price of debt.

Obviously, this led airport operators to respond by minimising the capital invested in the project. Some airports entered into leasing arrangements. Melbourne Airport’s response, coupled with industrial relations concerns threatening delivery by the time required by the Government, was to put in place arrangements for checked bag screening which used more labour than is optimal. These arrangements delivers a quality of service that in the long run will probably be inferior to the preferred, capitally more intensive solution.

What is perverse, however, is that the more capitally intensive solution, if funded under the normal NNI arrangements, would not only deliver a higher quality of service but would also be cheaper for users. Melbourne Airport has recently proposed to do just this but the airlines rejected the offer It can be assumed therefore that airlines have wider issues in relation to security services at Melbourne Airport than price and quality.

- The ACCC has adopted a position that when an asset reaches the end of its declared useful life, the price for the service concerned should simply reflect the ongoing operating costs. When the asset is to be replaced, it can then be the subject of another NNI proposal. We note the contradiction with the ACCC’s preferred “Building Block” Approach, under which all assets in use receive a return based on their ODRC valuation. The NNI approach substantially diminishes any incentives for the airport operator to properly maintain assets or to actively manage the maintenance/ replacement cycle. This not only entrenches rate of return regulation but also ensures the ACCC’s involvement in future asset replacement decisions.
- The NNI process takes a minimum of three months to complete for any substantial investment. This severely impedes the ability of airports to rapidly respond to the changing needs of their customers and, in particular, the needs of new entrants.
- The ACCC processes are open to gaming by users. There is a real potential for incumbents, who possess significant resources to use these processes to frustrate investments by airports that would facilitate entry or expansion by competitors.

- There is often little consistency between decisions dealing with like issues. This adds significantly to regulatory risk.

A Tale of Two Terminals

To facilitate the entry of new domestic carriers, both Sydney and Melbourne Airports had to build new terminals for which pricing approval from the ACCC was necessary.

In May 2000, Sydney Airport had a price of \$1.75 per passenger (excluding GST) approved for a facility that was expected to cost \$6.8 million. In June 2000, the ACCC released its draft decision in relation to Melbourne Airport's \$7.8 million investment of \$1.16 per passenger. The final decision in August subsequently increased the price to \$1.50 per passenger.

Two other facts are relevant

- The terminal in Sydney could be expected to process more passengers than Melbourne's.
- The ACCC assigned a lower cost of capital to the Sydney facility.

Thus it is impossible to find a plausible explanation as to why on any objective basis the apparent price differential can be justified.

It is our view that the current set of arrangements will not deliver the incentives, price signals or commercial environment necessary to deliver the appropriate infrastructure as and when it is required. Beyond that, there are some legitimate questions that need to be asked about the fundamental policy objectives.

Quality of Service Monitoring

The Airports Act enables the Minister to make regulations to keep certain information and conduct surveys of quality. The requirements are more extensive for Phase 1 airports than Phase 2 airports. The ACCC also conducts a survey of airlines using an airport, and seeks certain information and views from Airservices Australia and the Australian Customs Services. The ACCC consolidates and reviews this information, seeks comment from airports, and together with certain financial information, publishes it in its annual regulatory reports.

Quality of service monitoring is important and even if the law did not require it, Melbourne Airport would undertake it in some form or other. The survey of passengers is the only point at which the travelling public becomes involved in the regulatory system. This seems to us to be a weakness in the system, particularly if consumer benefits are important. The CAA has observed that there may be a divergence between the interests of airlines who dominate the demand side of these

discussions and the interests of end consumers³⁰. The situation in Australia is made worse because there is no equivalent to the Air Transport Users Council to represent the interest of the travelling public.

Whilst we are generally comfortable with the principle that airports should be required to provide information on quality (and indeed prices and financial performance), we are less certain about the current form and its administration. In the first instance, despite the Minister's direction to the ACCC, it appears to us that the ACCC pays little attention to quality in assessing NNI applications. In other words, the information is not particularly relevant to regulatory decision making. This prompts the question "Why is it being collected".

In the period around the time of sale, there was significant discussion between the ACCC, policy makers and airports about how quality of service monitoring was to work. The outcome of that has been a passenger survey at Melbourne Airport that is highly robust in a statistical sense. In addition to the ongoing costs of its operation discussed below, it involved significant initial set up costs. It can be seen to be reliable because Melbourne Airport uses it for business decision making.

The same cannot be said for the ACCC's airline survey. In 1998/99 five airlines were surveyed. This number rose to eleven in 1999/2000. It seems to us that individual airlines use this as a device to have a "free kick" at airports and often use it as a forum for a "pay back" against an airport for taking a particular line in a commercial negotiation. The same can be said of the Australian Customs Service. This form of gaming seems to be encouraged by the ACCC's tendency to focus on particular complaints rather than measures of central tendency.

If quality of service monitoring is to be a feature of any future regulatory system, which we believe it should, the scope of monitoring and its objectivity needs to be seriously examined. Any new set of arrangements must be auditable, systematic (rather than ad hoc and anecdotal), and possess safeguards against gaming.

Compliance Costs

Regulatory compliance costs fall into three categories: Regulatory Accounts preparation, NNI preparation and Quality of Service Monitoring.

The process of Regulatory Accounting has and does involve a significant investment in establishing and maintaining an accounting costing system that will comply with the requirements of the ACCC. Every transaction that is processed needs to be coded appropriately. With approximately 10,000 invoices processed per annum, the accounting processes and procedures in place to ensure accuracy are substantial. The regulatory accounts must be audited and signed off by directors.

³⁰ CAA (2000b, p21).

The highly precedent-based nature of the ACCC's process effectively requires airport operators to involve themselves in the NNI processes of other airports, in an effort to ensure that decisions that the ACCC makes do not adversely impact on future outcomes for their airport. A generally less intrusive system would reduce these costs.

At Melbourne Airport, a significant proportion of time of the Manager Strategy (who reports to the Chief Executive Officer) and the Taxation and Corporate Strategy Manager (who reports to the Chief Financial Officer), is spent in attending to the preparation of the regulatory accounts and NNI applications and more generally dealing with regulatory issues. These officers also carry out these functions for Launceston Airport.

Quality of service monitoring is undertaken to meet both statutory requirements and general commercial purposes. Costs include the direct staff costs, the costs of BAA assisting with the program and indirect labour and overheads. Whilst statutory monitoring does lead to additional costs, Melbourne Airport uses much of the data for key business decision making so the marginal regulatory cost is well below the full cost. How much could be determined to be a compliance cost is difficult to say but as a guide, the marginal cost for the DET alone appears to be in the order of \$20,000.

A conservative estimate of the costs of these regulatory compliance activities would be \$500,000 per annum for Melbourne and Launceston combined.

It is important to note that these costs are obviously much more burdensome for smaller airports than larger ones although it is acknowledged that quality surveys are not required at smaller airports. These costs are often not born by the airports with which smaller regulated airports compete. For example, Devonport and Burnie do not incur these costs whereas Launceston and Hobart do.

Chapter 5: Efficient prices for airport services

Long run incremental cost pricing

Prices for aeronautical services, in Australia, are well below those that prevail in most other countries. There is evidence to suggest that Australian airports operate with relative productive efficiency. However, returns on the regulated assets of Australian airports, at current prices, are below that which is necessary to ensure sufficient investment occurs. As a result, quality and capacity could be compromised. To rectify this, procedures have been put in place to ensure that, at least new investment receives an appropriate return. However, those arrangements themselves are likely to create long run efficiency problems. In this sense current prices are inefficient.

If one accepts that airports have relatively little market power, or at least little incentive to use it, then there is little reason to regulate prices. If one further believes that airlines possess a similar degree of countervailing power, then price regulation begins to look doubly unnecessary. Any rents that exist in the industry will be distributed between the industry players through negotiation, and that distribution is unlikely to have any significant efficiency implications. Indeed, the outcome may be more efficient than in a regulated environment because the bargaining process will reflect the valuation placed on the services by users, in a way that cannot not occur with regulatory approaches such as the building block approach.

As a basic principle, economic efficiency is maximised in competitive markets when the marginal cost of a service equals the marginal utility of the user consuming the services. The price at which exchange occurs is the market-clearing price and is efficient in the sense that it maximises social welfare.

The difficulty in adopting this approach for airport regulation is twofold. First, as mentioned above, user valuations are not known. Users are able to form a much clearer picture of their own valuations than a third party, such as a regulator. Indeed, users may seek to game the regulator for short-term financial gains by arguing prices are too high. In other words, users will be inclined to understate their actual valuations to the regulator.

Secondly, the short run marginal costs associated with the provision of many of the services in question (runways, taxiways, aprons, and terminals) are relatively low, especially at non-congested airports. If prices were set at marginal costs, virtually no return would be earned on assets and investors would abandon the industry.

Further, even if investors continued to provide funds, prices would be highly volatile. As Professor Kahn notes

“Short run marginal cost will vary from one moment to the next, in a world of perpetually changing demand. It could be prohibitively expensive for sellers to put into effect the highly refined and constantly changing schedules reacting instantaneously to and reflecting those constantly changing costs, and that kind of pricing would be highly vexatious to buyers. The kind of averaging over time and the greater degree of stability provided by prices based on LRIC (long run incremental cost) are likely to have considerable value in terms of minimising supplier costs and customer vexation.³¹”

The practical problem this creates is what increments would be appropriate. In his landmark text on economic regulation, Kahn notes:

“The practically achievable benchmark for efficient pricing is more likely to be a type of average long run average incremental cost, computed for a large, expected block of sales, instead of SRMC, estimated for a single unit of sale. This long run incremental cost ... would be based on (1) the average incremental variable cost of those added sales and (2) estimated additional capital costs per unit, for the additional capacity that will have to be constructed if sales at that price are expected to continue over time to grow. Both of these components would be estimated as averages over some period of years extending into the future³².”

This varies from the approach the ACCC has adopted for NNI in that, rather than looking at the sales that arise from the incremental capacity in relation to the costs of the increment, the NNI procedures spread the costs over all volume. Whilst this generates the same amount of incremental revenue (in present value terms), it results in prices for services still being below incremental cost. Obviously, this would be avoided if current prices were equal to incremental costs. Such a situation has the obvious attraction that price increases would not be necessary to fund investment.

As noted in Chapter 4, the NNI arrangements were part of a legitimate scheme designed to avoid windfall gains and losses in transition to private ownership. However, this needs to be administered efficiently and in a way consistent with the reasonably formed expectations at the time of privatisation. However, for long run efficiency to be achieved, it NNI must be replaced over time by a more sustainable long run incremental cost approach. Any deviation from this generates relatively modest short-term windfall gains, but at the cost of very substantial economy wide

³¹ Kahn, A.E. (1991, p14).

³² Kahn A.E (1988, p85).

losses in the form of the degradation of regulatory credibility – illustrated in the diagrams in the next section.

LRIC based-pricing does not necessarily lead to an airport earning its cost of capital at all times. Rather, investments could be expected to earn less than their cost of capital early in their lives, when they are operating below average utilisation, and earning above it when operating at or near utilisation. Indeed, one would envisage the return on the asset, in any given year, to rise steadily over time assuming no downward volume shock.

This is demonstrated in the following diagram. The investor will be prepared to invest at time t_0 accepting returns below WACC in the early years of the life of the assets if the present value of those returns is equal to returns above the cost of capital as the assets reaches capacity.

The problem of regulatory confiscation

For such an approach to be acceptable, as a regulatory system, investors would need to be certain that regulators would not seek to confiscate returns during those periods when they are above WACC, otherwise returns on assets will be on average below WACC.

Investors have to deal with an added ‘regulatory risk’ in excess of the normal market risks for the airport industry. If they feel that there is a chance that the regulator may step in after they have made their investment and in effect seize their ‘fair’ returns they may delay investment (or not invest at all) or require additional expected returns to entice them to take on this added risk.

The next diagram shows the way in which expectations of regulatory behaviour will affect investment behaviour – in particular the time at which investment takes place. T_0 represents the point at which investment should take place from a social point of view. It is also the point at which it would take place if an investor had complete confidence that the regulator’s subsequent pricing decisions did no more than require prices that were economically efficient in the long run. Here the investor invests, and tolerates a return below his WACC in the knowledge that it will be compensated by a period during which returns will exceed the WACC.

The length of the period between investment and reaching the point of average returns (t_2) will be such that the net present value of the losses against the WACC (the triangle below the WACC line) are equal to the net present value of the surplus profits above the WACC (the triangle above the WACC line).³³

³³ Note the area under the WACC is less than the area above it. The NPV of the two areas is equal and opposite however when deflated by the discount rate.

If the investor fears regulatory confiscation however the future returns above the WACC will be discounted. This delays entry to that point at which the NPV of the above and below WACC returns are equal (and opposite) with an additional discount for the above WACC returns reflecting in this case, not just time, but the risk of regulatory confiscation. This point is represented by t_1 .

If the investor is risk averse, or the risk of confiscation is very high, no investment will take place until capacity utilisation is such that returns meet the WACC from the commencement of operation. This delays investment still further until t_2 .

One further adaptation is possible. Investors may require a higher rate of return to compensate for the risk of capricious regulation. This delays investment still further to the point t_3 .

All of these delays can be expected to result in reduced quality and less competition between airlines (particularly from entrants) as a result of restricted airport capacity leading to higher prices and lower quality amongst airlines. This reduces development opportunities in dependent industries such as tourism and air freight intensive industries.

Without regulation the market will provide the necessary return to investors to ensure that necessary new investment takes place.

What this would mean for airport returns as a whole, would depend on the timing of investments. However, in general, one could envisage periods of rising returns to levels above cost of capital, followed by sharp drops as new assets are put in place with returns then rising again at times such as t_1 and t_2 .

It is our view that current prices are inefficiently low. For an airport approaching capacity, if Depreciated Optimised Replacement Cost (DORC) represents the effective cost of second-hand assets, the Building Block Approach favoured by the ACCC and utilised by Sydney Airport, is probably going to generate a set of prices that are fairly efficient³⁴. This valuation could generally be expected to give rise to prices around average cost.

For unconstrained airports, the problem is much more complicated. If a regulator were to set LRIC prices, an investigation of each capacity increment would be required. How these increments would occur would differ from airport to airport and through time, as airports developed.

As we have indicated, returns on aeronautical assets are low, although given the general presence of surplus capacity at Australian airports (excluding Sydney), this may well be appropriate at this stage of the capacity cycle. However, if prices are not generating returns a little above WACC by the time that new capacity is required, new investment is likely to be compromised with all that means for

³⁴ SACL (2000, pp51-56).

efficient competition between airlines and the development of Australia's cities and their regions. If price regulation is required in the future, the challenge will be delivering a system that will enable prices to increase to the point where investment in new capacity becomes available as and when it is required.

The following chart shows expected return on existing aeronautical assets for Melbourne Airport. It assumes CPI-4 for the period 1997-2002 followed by nominal price maintenance (CPI-CPI)³⁵. Returns are not expected to achieve cost of capital until around 2010. In other words, if prices were efficient, they would indicate investment certainly isn't required at least until 2010 and probably later than that.

Melbourne Airport will need to undertake significant investment in terminal and aircraft parking infrastructure in the period 2002-2007. Issues relating to new large aircraft (such as the Airbus A380) may increase this investment task and gaming of the current system by airlines may see projects planned for the remainder of the current period deferred until post 1 July 2002 in the hope of more sensible arrangements. In the period 2007-2012, Melbourne Airport will probably have to undertake substantial planning for a third runway. It is our view that an efficient pricing outcome would see returns on existing assets at least at the top end of the "WACC zone" somewhere around 2005.

The economic consequences of regulatory underpricing

The analysis below draws on and extends a submission to the Productivity Commission's Review of National Access Arrangements on behalf of a large number of regulated businesses, including APAC³⁶. The authors of the submission were NECG, the ACCC's consultants regarding the 'dual till' issue at Sydney Airport.

Given considerable uncertainty about what constitutes efficient costs, it will be rare for regulators to get the answer exactly right. In such circumstances it behoves policy makers to consider which kinds of mistakes they prefer. There are two kinds of mistakes a price regulator can make.

1. The regulator errs on the side of reducing monopoly rent. The risk here is that there is insufficient incentive to invest in infrastructure.
2. The regulator errs on the side of ensuring that sufficient incentives exist to provide adequate investment. The risk here is that monopoly rents are not fully squeezed out of airport pricing.

³⁵ This implies a value of X of 3 beyond the current price cap.

³⁶ NECG (2001)

The first kind of mistake is more damaging to long term community welfare. There are several issues that should be distinguished. Firstly, other things being equal, the transfer of rent from one party to another has no efficiency implications. This is not to say that distributional issues are unimportant although it should be noted that the distribution here is between airline and airport shareholders and as such social equity considerations are likely to be minor.

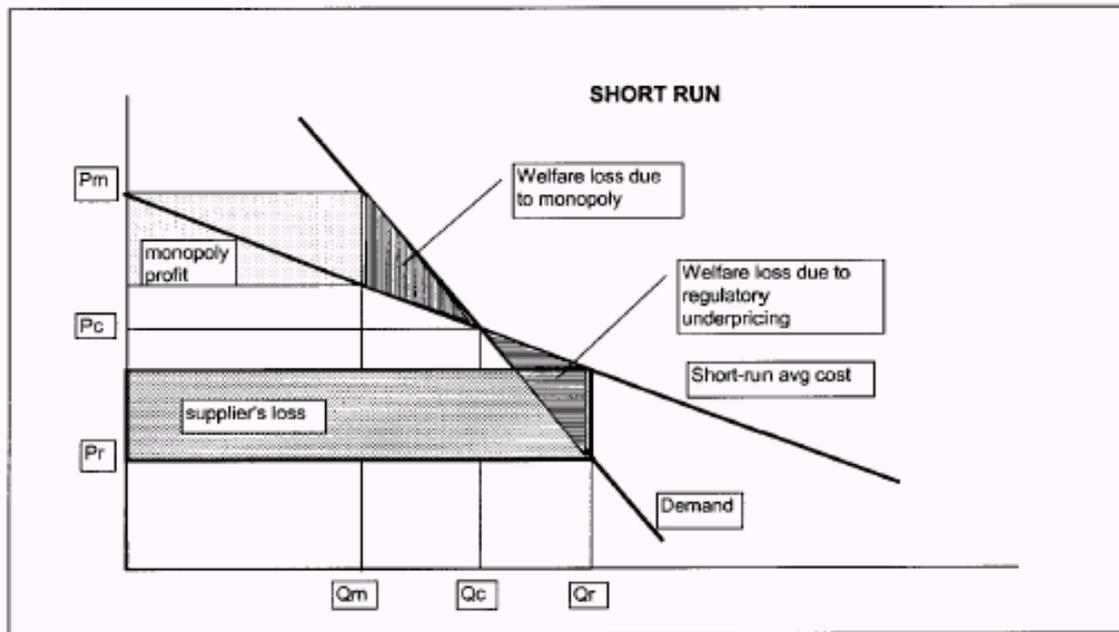
Focusing on economic efficiency rather than distribution however, the economic costs and benefits between these approaches differ markedly between the long and the short term. NECG have contrasted the two situations by juxtaposing the two diagrams that follow. We believe that the NECG contribution is extremely valuable. However we argue here that it may even have underplayed its hand – that there are additional reasons for concern at the efficiency effects of regulatory underpricing.

The short run

In the first diagram the short run demand and supply curves are represented by two downwardly sloping curves. The demand curve is steep reflecting low elasticity of demand. The supply curve is downwardly sloping – as is typical in the short run when as is often the case, infrastructure is not at capacity. Both curves are linear for simplicity.

Here monopoly pricing generates allocative inefficiencies – by constraining supply below its optimum. Likewise, allocative inefficiencies arise from regulating prices below their optimal level as some consumers consume resources that they value less than their cost of supply.

In this scenario, the welfare losses of both under and over-pricing are qualitatively symmetrical and, courtesy of the simplifying assumption of linearity, they are quantitatively symmetrical as well. The conclusions drawn here are not affected if instead, the short run average cost curve has an increasing slope.



In the above diagram P_c represents the competitive price level at which the supplier earns zero economic profit. P_m represents the monopolistic price, at which the supplier earns monopoly rents and there is a deadweight welfare loss to society equal to the area of the upper triangle (vertical hatching).

If instead the price is set at a level P_r , which is as far below P_c as P_m is above it, then clearly the supplier will make a loss in the short run. This loss is significantly greater in magnitude than the monopoly profit, which would have been made at P_m . (Note the supplier's loss is given by the rectangular area that partly overlaps the lower triangle.)

At P_r there is also a deadweight welfare loss, given by the area of the lower triangle (horizontal hatching). Under the assumptions used here, (i.e. linear demand and supply curves, and $P_m - P_c = P_c - P_r$) this welfare loss is equal to the monopoly pricing welfare loss. In this case the welfare loss arises because some customers ($Q_r - Q_c$) are supplied even though they value the service less than it costs to deliver – scarce resources are being diverted from the supply of services that customers value more highly.

In some ways this presentation is too balanced a picture of the short run. In fact, if we stick rigorously to *the short term* it is not clear that there is a loss in underpricing down to marginal or variable cost. Because the investment has already been sunk,

then *in the short term* the only costs borne in servicing consumers are the variable costs and so, for simple theoretical reasons, if there were only a short term the optimal price would be marginal or variable cost.

But this is a world without time that is incapable of investing for the future. The kind of short-term gains involved are precisely the kind of short-term gains involved in other 'surprises' that are performed on economies either in theory or in practice – like lump sum taxes or unanticipated inflationary finance.

The short-term gains come precisely from traducing the implicit regulatory bargain with the investor that regulation will allow a commercial return for an efficient operator. The provider of the infrastructure now has a 'stranded asset'. The investor cannot meet its long run costs and so cannot fund proper investment in maintenance and/or expansion into the future. The party will soon over to be followed by a lengthy hangover.

The long-run

In the long run, the welfare effects of overpricing versus underpricing are not symmetrical. Firstly, it is no longer true in the long run that a supplier would continue to provide service when the regulated price is below its average cost. In the long run, all costs are variable. Accordingly a regulated price that is below average cost would be below variable cost.³⁷

Secondly, the long run average cost curve may, at the point it is intersected by the demand curve, have a declining, level, or increasing slope, notwithstanding the short run economies of scale of some assets.

If the long run average cost curve were downward sloping or flat (as may be the case with airports with large amounts of surplus capacity), then the consequences of a regulated price which is below the equilibrium level would be very serious from a welfare perspective. There would be no level of output greater than zero at which the supplier could recover its long run variable costs (equal to long run average costs). Faced with this situation, the supplier would either exit the industry when reinvestment was required, or would attempt to modify its long run average cost curve by degrading service quality or investing in assets with low capital cost and

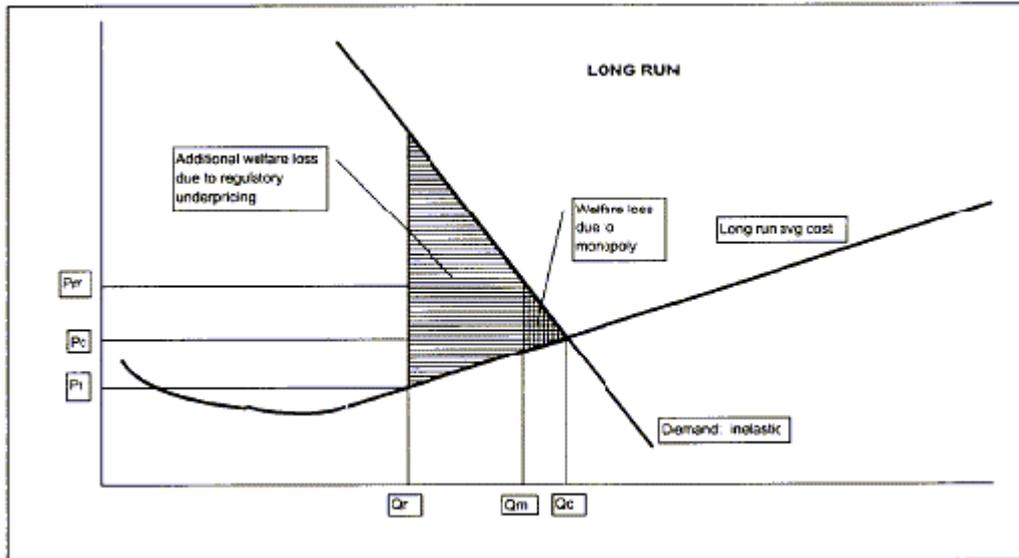
high operating costs. If the output level is reduced to zero, then the welfare losses will be maximised.³⁸

Accordingly to produce any output from the supplier in the long run the familiar, though probably less realistic, assumption must be made – that the long run average

³⁷ In practical terms, a supplier faced with a regulated price below average cost may not exit the industry immediately. Some alternatives include declining to invest in asset renewals when required, allowing service quality to degrade, or investing in new assets with lower capital cost but higher operating and overall life-cycle costs. Both intuition and recent experience suggests that the welfare losses associated with such conduct are likely to be substantial. Indeed this follows from any acceptance that the facilities in question are essential facilities of national significance.

³⁸ Note here that while the diagram depicts the demand curve as downwardly sloping and linear, the 'law' of diminishing returns suggests that, near the origin the curve would most likely rise very steeply indeed. The last few customers left unsatisfied in the market for essential services would value those services very highly indeed.

cost curve is upward sloping. In these circumstances, the supplier continues to operate into the long run, but at a lower level of output than competitive equilibrium level by an amount needed to align long run average costs with the regulated price. This situation is depicted in the diagram below. In this diagram, as in the short run diagram, the demand curve is steep reflecting the low elasticity of demand for aeronautical services. In contrast, the slope of the supply curve is gentle. Accordingly, supply must be wound back substantially before supply cost falls to a level consistent with the regulated price.



Relative to the competitive equilibrium price, P_c , monopolistic pricing P_m would lead to a welfare loss equal to the area of the smaller triangle with cross-hatching. However this welfare loss is small compared to the loss arising from underpricing P_r , which is as far from P_c as is P_m . The welfare loss due to P_r is given by the large triangle (which overlaps the small triangle). The net welfare loss relative to monopolistic pricing is equal to the horizontally hatched trapezoid.

Thus in the long run, for a pricing error of a given magnitude, the welfare loss will be significantly greater if the error is in pricing too low rather than too high. This conclusion holds wherever the demand schedule is steeper than the supply schedule, a situation that would seem very likely with services subject to declaration.

As has been noted above, the welfare losses associated with low prices are not immediately apparent, in contrast to the short-term transfers enjoyed by consumers. Nevertheless, economic analysis suggests that these future welfare losses are likely to be extremely high.

This conclusion is surely consistent with every-day experience. When under-investment leads to poor quality of service or unreliable supply, the flow on effects to other businesses and the economy broadly are often extremely serious. One only has to remember instances in the past twenty years of blackouts and brownouts, gas supply disruptions, train derailments, or water contamination incidents to appreciate the severe consequences of service interruptions. The breakdown of infrastructure can be particularly costly, because users have got into the habit of relying on it and have not developed the kinds of backup systems, which they would have done if the infrastructure were not there.

Again, it is possible to contrast the optimism of the short run with pessimism about the long run even more strongly than the NECG's illustrations do. For the cost of policy opportunism towards the owner of sunk infrastructure investments is not just the under-provision of services into the future as a result of sub-optimal returns on yesterday's investment.

Perhaps even more seriously, regulatory opportunism also degrades the capacity of investors to rely on the integrity of the regulatory structure into the future. We have argued elsewhere that the ACCC does not pay sufficient attention to the sovereign risk issues that arise from its regulatory decision making processes³⁹. After all, the investor has invested in good faith believing that provided they are efficient, they can earn a commercial return on funds. When the regulator has bitten once, investors can be expected to be twice shy. To attract investment into the future, the very thing which regulation seeks to prevent may become necessary. Sustained supernormal profits for a monopoly investor.

There is also a political dimension to these matters. Erring on the side of overzealousness about monopoly rents will also be politically popular as taking advantage of the investor's sunk costs creates a 'free lunch' in the short term. Again the parallel can be drawn with opportunistic economic policies in other areas. Unanticipated inflationary policies will often be popular, until the full costs emerge over time. When they do, repairing the damage is all the more difficult because of the damage done to policy credibility in the meantime.

Optimal pricing outcomes err on the side of investment

In the short term and at the margin, it would be possible for airports to increase some of their prices – principally relating to their core landing and passenger services. Indeed they could do so substantially.

If they did so, only minor damage would be done to economic efficiency. The economic significance of the price change would mostly amount to a transfer of economic rent from airport customers – in this case airlines – to airports.

In addition to the potent threat of regulation, there are strong theoretical reasons for believing that, given their cost structure and the market opportunities available, airports' long-term interests are better served by seeking to grow their businesses. This will lead them to forsake opportunities to capture short-term economic rents. As an empirical matter, this is Melbourne Airport's long term business plan – to grow its businesses by aggressively serving markets with high quality airport services at competitive prices. It is the pursuit of this policy that encourages the entry and development of airline services

³⁹ APAC (2001)

Price regulators will always have imperfect knowledge. Furthermore, the long-term efficiency consequences of regulating prices below their optimal level can be very grave. By contrast long term prices modestly above the competitive optimum involve low economic efficiency losses. It follows that, should price regulation be considered necessary for whatever reason, it is important for price regulators to avoid imposing underpricing on airports. They should, if necessary, tolerate the possibility of erring slightly on the side of pricing above the competitive optimum.

Such a pricing approach would be consistent with the sort of business conduct that would arise from Melbourne Airport's general approach; an approach that is likely to maximise profit for most uncongested airports. We would argue similarly that if the Commission was to form the view that such a pricing approach is the optimal one from the airport's point of view, and that the chances of regulatory error exist, then no regulation may well lead to the most efficient outcome as it is likely to get closer to efficient prices than would be set by the regulator.

This argument may be represented in the following diagram. Here the long-run profitability of the asset is mapped against price. Profitability exhibits both a local and a global optimum. By definition, the profit maximising price for an asset with some degree of natural monopoly is above the price that would be charged in a competitive environment (P_c).⁴⁰ If it were not, there would be no natural monopoly. Nevertheless, the nature of the asset's cost structure is such that there exist two profit optima. One is motivated by exploiting the monopoly by raising price to P_{M2} . The other focuses on growth mindful of the proportion of the asset's costs that are fixed, and accordingly the extent to which increased activity can lower average costs. This growth oriented monopoly price, P_{M2} , the global monopoly optimum for the asset is not far above the socially optimum price. It is also approximately the price at which a regulator properly concerned with long run efficiency rather than short-term price control would regulate prices.

⁴⁰ Note however that even this language is paradoxical. The very phenomena which give rise to natural monopoly – that is economies of scale – also make perfect competition with its many competitors inefficient.

Chapter 6: Legislative Framework

Problems with existing legislative framework

APAC has made submissions to the Commission on both its inquiries into the PS Act and the National Access Regime. In those submissions we drew attention to the problems that have encountered with the operation of the PS Act and the lack of suitability of Part IIIA of the TP Act as a device for regulating non-vertically integrated businesses. Section 192 of the Airports Act is also relevant here. As such, we provide a very brief summary of these issues and refer the Commission to those early submissions for further detail.

PS Act

- The PS Act was put in place as part of the Prices and Income Accord in 1983 and was not really intended to be the basis of on-going industry regulation.
- The PS Act has weak enforceability characteristics
- Under the PS Act, the only practical form of appeal is a political one, namely, a declared firm must defy the ACCC and then encourage the Minister not to give the ACCC a remit to conduct an inquiry.
- It lacks any sound economic basis for assessment of proposals.

Part IIIA of the TP Act

- Part IIIA is predicated on there being a dispute between an access provider and an access seeker in the circumstances of the provider competing with the seeker in some other market – the provider is an integrated firm. As we've argued, in the case of uncongested airports, aggressive pricing by an airport is unlikely to be profit maximising, denying access doubly so.
- Part IIIA is predicated on there being a single access provider in dispute with a single customer. It seems to us that if Part IIIA were to be relied upon, airports could face the possibility of being constantly in arbitration with airlines and the ACCC.
- The pricing principles under Part IIIA are not clear.
- Even if an airport is pricing in accordance with the price cap, a user may seek to have the ACCC arbitrate on a declared service.

Section 192 of the Airports Act

- No airport has been able to secure an access undertaking under s192 and only a few have tried. The general perception is that the ACCC sought to extend its role in this area well beyond what was intended. For example, it is unlikely that the Parliament ever intended the ACCC to enquire into airports' credit policies or access to the airfield by emergency vehicles.
- S192 brings within the scope of the arbitration provisions of Part IIIA services that would not be declared under the primary declaration provisions of Part IIIA. For example, it is unlikely that general aviation apron at Townsville Airport would pass the national economic significance test. Similarly, a dispute about where off-airport car park buses park at Melbourne Airport would have not have progressed as far as it did if the matter was subject to the declaration provisions under Part IIIA
- The appeals mechanism against a declaration decision by the ACCC is very weak – it requires at least one House of the Parliament to disallow it.
- Allowing the ACCC to effectively declare services and then arbitrate on disputes in relation to those services seems to be contrary to the checks and balances in Part IIIA where declaration and arbitration are administered by separate bodies.
- There is evidence of s192 enabling users to use the ACCC as a general corporate arbitration service. Virgin has recently sought to have Melbourne Airport's DET declared not because access was denied, not because of price (Virgin agreed the price) but because they are unhappy with one clause in the licence agreement – an agreement that places no obligation on Virgin to use the terminal at all.

Proposed solution

Obviously, the most important task for policy makers is to get the right policy solution and then ensure the proper legislative framework is in place. It is our view that there currently is no adequate legislative basis for airport price regulation, were it is found necessary, available to the Commonwealth.

We would suggest that s192 be repealed and replaced by an arrangement whereby those airport services that are considered to have market power sufficient to warrant price regulation may be regulated under a “pricing undertaking”. Where airports were considered not to require regulation, or services provided at larger airports were considered contestable, regulation would be undertaken under the standard provisions of the TP Act.

The services subject to declaration should be restricted to runways, taxiways, apron, international terminals and public access roads (but excluding access charges to ground transport operators).

The “pricing undertaking” would consist of a number of features

- A tariff-basket style price cap that would lead to the sort of efficient prices discussed above;
- A commitment to meet certain well-defined, auditable quality standards;
- An obligation to consult with users; and
- Reporting on capital expenditure relative to an agreed broad program.

Such an arrangement would have to be approved by the Minister on a case by case basis and would have the effect of an access undertaking for the airport as a whole. In other words, if a service is not subject to the pricing undertaking, it can be assumed that no market power issue exists. This has the desirable characteristic of preventing spurious declaration applications.

A pricing undertaking should have a maximum duration and we would suggest in the first instance, five years would be appropriate.

Contracting

If an airport contracts with an airline to provide an existing service at a price lower than is normally charged, the volume in question would be reported for compliance purposes at the normal price.

If an airport and an airline (or group of airlines) agree on a price for a new service (say a new terminal), this should occur beyond the price cap. If a situation develops as did with Melbourne Airports DET where a user agrees to a price and another thinks a lower price appropriate, the only interference that should come from regulatory authorities should be from the ACCC in the event that it interferes with competitive outcomes. In such a case, the normal arrangements in Part IV of the TP Act can be relied on.

Compliance

The ACCC already collects and publishes financial information under Parts 7 and 8 of the Airports Act. Reporting under this proposed arrangement would simply require the current regulations to be amended. The ACCC would obviously have the opportunity to report on airport activities in the same way it does now.

If non-compliance were to occur, two options could be made available to the Government. The first, the Minister could cancel the undertaking thus allowing aggrieved parties to pursue the airport concerned under Part IIIA. This would have the advantage of providing a reasonably transparent and accountable process going forward.

Secondly, assuming the PS Act was still available, an inquiry could be ordered or the relevant services or even a wider range of services could be declared. We have argued that the threat of re-regulation will act as a power disincentive to abuse any market power airports might have.

We appreciate our comments here are brief. This is largely a reflection of our view that consideration of these issues is best left until the policy issues are resolved.

Appendix 1: Business Overview

Ownership

Australia Pacific Airports Corporation (APAC) is an airport management and ownership company. It has four shareholders:

- AMP Henderson Global Investors (49.9%)
- Deutsche Funds Management Australia (25%)
- BAA plc (15.1%)
- Hastings Funds Management Limited (10%)

APAC owns Australia Pacific Airports (Melbourne) Pty Ltd (APAM) which acquired a 50-year lease (with a 49-year option) on 2 July 1997 from the Commonwealth Government to operate Melbourne Airport. APAC also has a 90% interest in Australia Pacific Airports (Launceston) Pty Ltd (APAL) which acquired a similar lease over Launceston Airport on 29 May 1998. The Launceston City Council has the remaining 10% interest in Launceston Airport. These interests were acquired for \$1,307 million and \$17.1 million respectively. APAC maintains an active interest in further airport acquisitions and service provision where it feels it is able to add value to the businesses concerned.

Operating profit

Since sale Melbourne Airport has enjoyed significant improvement in its operating performance, largely as a result of increased traffic volumes, development of retail and property opportunities and restraint on cost.

Revenue

Melbourne Airport's revenue in 1999/00 was \$167 million, up 9% from the previous year. Of this, 33% was from aeronautical services⁴¹, 40% retail and 27% property and other items. More details on aeronautical revenue sources are provided whilst information on property and retail income, and a breakdown of revenue by customer is provided in Appendix 6.

⁴¹ Including security recharges

Aeronautical Revenue

Aeronautical income in 1999/2000 was \$55m, an increase of 5% on the previous year. This was due to volume growth being strong enough to offset an average nominal price decrease of 2.3%. It should also be noted that the revenue categorised as “aeronautical” in the regulatory accounts represents about 60% of the total revenue that Melbourne Airport receives from airlines. Other revenue streams arise from rentals of lounges, offices, check-in desks, domestic terminals and freight and maintenance facilities.

Aeronautical income can be conveniently broken down into 5 categories.

New entrant carriers and checked bag screening operated for only about a month in 1999/2000 so in coming years, other domestic income and security recovery can be expected to be higher in dollar terms in future years. New entrants are also likely to lead to an increase in domestic landing fee income although how this will effect the above shares is difficult to tell.

Operating Costs

In 1999/2000 Melbourne Airport incurred operating expenses of \$45 million. Roughly a third of these are direct wages and salaries for staff and another third is accounted for by utility costs. Depreciation and amortisation charges amounted to \$33 million.

The aeronautical business accounts for half these costs although it should be noted that it accounts for only about one-third of the revenue. As would be expected capital charges feature heavily in the cost breakdown of both businesses. In addition, salaries should generally be viewed as a fixed cost, especially in the aeronautical business, as is witnessed by the fact that despite significant growth since privatisation, staff numbers have not increased. The higher proportion of salaries in the aeronautical category is a reflection of Melbourne Airport’s role as an operator of terminals and the airfield as compared with the non-aeronautical business which has more the flavour of a landlord and facility provider (such as in relation to the Qantas and Ansett domestic terminals).

The following table provides a breakdown of the cost structure of the aeronautical and non-aeronautical businesses

Aeronautical	Non -	Total
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		aeronautical	
Salary	25%	12%	18%
Depreciation	37%	29%	33%
Amortisation	0%	17%	9%
Services & Utilities	15%	22%	18%
Maintenance	7%	4%	6%
APS	7%	0%	4%
Other	9%	16%	12%

Cost Structure of Melbourne Airport's Business

The Commission was interested in its Issues Paper with the question of direct and common costs. The table provides a breakdown of Melbourne Airport's expenses across expense categories.

	Aeronautical			Non-aeronautical		
	Direct	Common	Total	Direct	Common	Total
Salary	30%	37%	67%	7%	26%	33%
Depreciation	31%	24%	55%	26%	19%	45%
Amortisation	0%	0%	0%	100%	0%	100%
Services & Utilities	25%	14%	39%	19%	42%	61%
Maintenance	17%	48%	65%	12%	23%	35%
Protective Services	100%	0%	100%	0%	0%	0%
Other	5%	30%	35%	31%	34%	65%
Totals	25%	24%	49%	18%	33%	51%

Allocation of Direct and Common Costs

This again demonstrates the difference between the airport as an operator in aeronautical services and a landlord in the non-aeronautical business. The intangible asset that is being amortised is the "lease premium" – the difference between the purchase price of the airport and the market valuation of the physical assets in place at the time of sale.

Assets

Asset Structure

Melbourne Airport's assets are valued at \$1.3 billion and are dominated by property, plant and equipment (\$723 million) and the lease premium (\$599 million). The aeronautical business accounts for around 60% of the property plant and

equipment and the lease premium is allocated entirely to the non-aeronautical business.

The following table provides a broad indicative breakdown of asset values by their use.

	Aeronautical (\$m)	Non Aeronautical (\$m)	Total (\$m)
Aprons	84.0	13.0	97.0
Runways and taxiways	151.6	0.0	151.6
MA Operated terminals	83.6	66.9	150.5
Leased terminals	0.0	19.8	19.8
Services	4.6	14.4	19.0
Roads & Car Parks	24.0	57.6	81.6
Land	51.9	58.7	110.6
Other Buildings	3.5	59.9	63.4
Other	24.1	5.7	29.8
Amortisation	0.0	599.5	599.5
<i>Total</i>	<i>427.3</i>	<i>895.5</i>	<i>1,322.8</i>

Indicative Asset Valuation by function as at 30 June 2000

Capacity

Airport capacity is determined by the interaction of a range of individual elements including runways, aprons, check-in desks, screening facilities and baggage systems. Overlaid on this is the mix of aircraft types and uses plus any

operational restrictions imposed for safety or environmental reasons such as curfews or movement caps.

The largest single asset of an airport is its runway system. Melbourne airport has a pair of intersecting runways 45 metres wide and 3.7 and 2.3 kilometres in length. 23 metre wide parallel taxiways run the length of both runways with high speed turn-outs that increases runway efficiency.

Current runway capacity is between 30 and 70 movements per hour depending on weather conditions and the mix of aircraft using the runways. In good weather, simultaneous operations are possible for certain categories of aircraft. There are no

restrictions on runway use for environmental reasons⁴². The following chart shows the distribution of movements through the day.

In addition to three international freighter parking stands, aircraft parking and services is undertaken at four different terminals at Melbourne Airport. The details of the various elements of those terminals are set out below.

⁴² Melbourne Airport does voluntary operate noise abatement modes when whether or capacity demands permit

	International	Domestic Express	Qantas	Ansett
Check-in desks	72 (+16 service desks)	12	27	22 (+8 electronic kiosks)
Security screening points	2	1	3	3
Baggage reclaim units	4	1	4	2
Outwards immigration desks	18	n.a.	n.a.	n.a.
Inwards immigration desks	26	n.a.	n.a.	n.a.
Departure lounge seating	1800	275	?	?
Parking stands serviced by aerobridges	10	-	16	11
Parking stands not serviced by aerobridges	4	5	5	9
<u>Estimated Terminal Element Capacity</u>				

Details of when the various elements of the International Terminal and the Domestic Express Terminals are expected to reach capacity are provided in Appendix 7. If the Commission is interested in similar information on the terminal operated by Qantas and Ansett, it will need to source that from those airlines.

Capital Expenditure

Melbourne Airport has spent around \$100 million on capital projects in the first three years after sale whilst its business partners have spent around \$130 million. Details of these projects are shown below.

	Melbourne Airport (\$m)	Business Partners (\$m)
Qantas domestic terminal	51.7	65.0
BOC (Menzies) Freight Facility	7.0	7.0
DHL Freight Facility	3.4	
International Terminal	13.8	
Domestic Express Terminal	9.7	
Car Parks	11.8	
Hilton Hotel	0.3	55.0
BP/McDonalds		1.0
Environmental & Road projects	1.0	

Airport Infrastructure Investment: 1997-2000

In the next two years (2000/01 and 2001/02) Melbourne Airport expects to spend around \$100 million on a range of projects including expansion of aircraft parking areas, domestic and international terminal infrastructure, retail and carparking projects, cargo facilities and a new building for boarder agencies. Beyond 2002, it is expected that capital expenditure will be around \$30 million per annum in current prices.

Appendix 2: Markets for non-aeronautical services

Markets for handling services

Airlines require a range of ground handling services to facilitate their operations at airports. These include check-in staff, baggage handling, ground engineering, aircraft pushback and towing, cleaning and catering.

In Australia, these services are provided by both airlines (for their own aircraft and other carriers) and by independent suppliers. Airports do not supply these services although in other countries, airports are monopoly providers of these services, which has led to competition concerns⁴³.

Airports do have a role here. In addition to licensing operators (mainly for safety and security reasons) they provide office space and parking for equipment⁴⁴. Sites for catering facilities may also be provided by the airport but in the case of Gate Gourmet, the largest independent caterer operating at Melbourne Airport, their kitchens are located at a location near to but off the airport.

Melbourne Airport has encouraged operators to conduct operations such that airlines may have greater choice in a market that was dominated by the two major domestic carriers. At the moment, there are 3 independent ground handlers operating at Melbourne Airport and a range of subcontractors providing services such as cleaning as well as dedicated ground handling services to new entrant domestic carriers.

Markets for aeronautical-related real estate

These services include what, in Australia, have traditionally called “aeronautical related services”. They are currently subject to price monitoring under the PS Act. An analysis of market power in relation to monitored services is contained in Appendix 3. It is important to note that in relation to a number of these it is possible for users to develop facilities either at other airports or in close proximity to the airport concerned.

Heavy maintenance facilities serve as useful examples. They serve to demonstrate how the market for sites can be local, national and indeed global. Ansett has significant maintenance facilities located just beyond the airport boundary in

⁴³ The European Commission has issued a directive on competition in ground handling services

⁴⁴ The market power of airports with respect to these services is addressed in Appendix 3.

Melbourne. Qantas has recently chosen to locate a major maintenance facility in Brisbane rather than Melbourne or Auckland and it important to realise that Qantas took an active decision to relocate this activity away from Sydney. In such markets, individual airports have little market power especially as location decisions seem to be driven largely by industrial relations issues, availability of skilled labour, and government incentives.

The main service in this category that is not price monitored is terminal office space. The requirements for core accommodation occupied by airlines and CIQ agencies, is the result of operational requirements. As such there is little capacity for users to substitute to other sites. The situation is complicated in that these users compete for space in terminal building which has alternative operational (baggage reclaim, plant rooms) or commercial (retail) uses.

Customs are to some extent protected from market power abuse by the *Customs Act 1901* and in general, CIQ agencies can be expected to be able to rely on their official status. Qantas and Ansett have access to space in their own terminals. As far as international airlines are concerned, Melbourne Airport has not increased rents since privatisation. We see office rents as part of the overall package of services provided to airlines using Melbourne Airport and would expect that rents would be part of an airlines overall assessment of the relative attractiveness of airports.

Markets for non-aeronautical real estate

Many Australian airports occupy sites that are larger than what is required for the development of their core aeronautical businesses. It is the existence of these “land banks” that, in part, explains the high earning multiples achieved in the sales processes. These areas are suitable for a wide range of commercial and industrial development that may or may not be related to airport activity.

Airports are in direct competition with other developers and landowners but in a number of respects are hampered by institutional constraints:

- Airport land is leasehold that can be unpopular with investing institutions.
- There are difficulties associated with the headlease between airports and the Commonwealth.
- The planning and development processes of the Airports Act place constraints on airport operators that are not experienced by developers subject to state law.
- Airport operators are required to provide and maintain infrastructure and services often provided by local authorities whilst at the same time, being required to pay rate to those authorities.

Clearly, airports possess no more market power in these markets than any other participant does.

Markets for retail outlets

A wide range of retail services are provided at airports including food and beverage, advertising, specialty shops, duty free and car rental. Melbourne Airport and other Australian airports themselves are not retailers; they are providers of retail space. Thus, it is appropriate, at least in the first instance to consider the market for retail space. The space for retail activities is typically provided in common with terminal facilities⁴⁵. The scope and design of those facilities is principally determined by their primary purpose - processing passengers and accommodating the aircraft that they are travelling on. Thus, in a real sense, the supply of space is fixed in the medium term although it is conceded that retail issues are becoming more important in terminal design, especially as passengers expect better retail offerings and airports respond. Thus, airports' income from these sources is best seen in economic terms as a rent.

Returns to retail space in airports are perceived to be higher than other retail precincts. However, this is to be expected for a number of reasons

- International travellers dominate the retail market and are typically more affluent than the population as a whole. Twenty percent of departing international passengers using Melbourne Airport have incomes over \$100,000.
- On-airport retailers offer products at the higher end of the price and quality range to appeal to the lifestyle and aspirations of the travelling public.
- Airports retail opening hours are much longer than in other locations (6am to 2am in the case of airside retailing at Melbourne Airport).

When these factors are considered the returns to airport retail, say on a revenue per square metre per opening hour basis, are not dissimilar to what we believe to be the case for other premium shopping precincts. In 1999/2000, the retail outlets in the International Departures area of Melbourne Airport generated sales per square metre per hour opened of \$1.80 as compared to Chadstone's (a major quality shopping centre in an affluent part of Melbourne) \$1.79 and Highpoint's (a major shopping centre servicing middle income and poorer suburbs in Melbourne) of \$1.57⁴⁶. Noting Chadstone includes supermarkets and department stores that will tend to suppress this measure, it may be the case that in the range of merchandise sold at Melbourne Airport, Chadstone actually achieves higher turnover per square metre per hour opened.

Further, one of the principal constraints on monopoly power is the ease with which people can substitute consumption elsewhere for the consumption they engage in at the airport. Melbourne Airport occupies the same sort of specialist 'space' in the

⁴⁵ Or sometimes other facilities such as car parks.

⁴⁶ Melbourne Airport Retail Department, *Shopping Centre News* (1999 p28-59)

retail market enjoyed by shops like '711' supermarkets. Its prices are typically higher than experienced in dedicated supermarkets, but this reflects their specialist nature. People use them to meet specific needs for convenience, not to do their weekly shopping.

Whilst some sales are unlikely to occur off-airport, such as food and beverage and last minute purchases of reading materials, there is significant potential for most other transactions to occur off-airport. In addition to the five on-airport car rental operators, there are six operators without premises on Melbourne Airport that provide services directly to travellers using Melbourne Airport. Recent changes associated with the introduction of the New Tax System, including the Tourism Refund Scheme, has seen the range of outlets where travellers can effectively purchase goods, below normal prices, extend beyond traditional on-airport retailers and those authorised off-airport retailers. Indeed, with the growing emphasis being placed on retailing not only by airports but also by airlines themselves, it seems that the duty free market is now a global market rather than one focussed on an individual airport. That said, both Melbourne and Sydney Airports have pricing policies that guarantee consumers that on airport sales will occur at similar prices to off-airport sales. Melbourne Airport's retail pricing policy is presented in Appendix 4.

Markets for ground access

Markets for ground access have been an area of some controversy since the time of sale. Two issues have arisen – the declaration of certain services by the ACCC under s192 of the Airports Act and the question of whether charges levied on taxis in a variety of locations are in effect charges for declared serviced and therefore lie properly in the price cap. At Melbourne Airport, there are a wide range of options for people to access the airport using public roads (provided by the airport on its leased premises and other parties to the airport boundary). These include

- Private vehicles using the kerb
- Staff busses servicing staff car parks.
- Metropolitan public bus services
- Taxis
- Tour coaches
- Private limousine hire cars licensed by the Victorian Taxi Directorate
- Private limousine hire cars not licensed by the Victorian Taxi Directorate
- Courtesy busses operated by hotels, universities and other organisations
- Privately operated buses servicing off-airport carparks
- Private vehicles using airport provided short and long term carparks
- Private vehicles using airline provided valet carparks

- Private operated buses servicing off-airport car rental operations
- Privately operated buses servicing regional centres
- Comcars
- Skybus
- On-airport car rental operations

Of these, the last seven pay for the access they enjoy to the services provided by the airport. Melbourne Airport intends that users falling into all categories other than the first three will pay for the access they enjoy to conduct their commercial activities on the airport. In setting prices, Melbourne Airport considers the costs it incurs in providing services, the amenity provided by the service (both to the operator and in respect to the proximity to the terminal complex of pick-up and drop off), and the relativity of prices for competing services.

Melbourne Airport generally accepts that it has a degree of market power with respect to the kerb in front of the terminal complex but also argues kerb users being levied charges are either

- using a range of other services provided by the airport (for example, taxis have access to parking for many hours, queue and rank management and dispatch services, toilets, shade and prayer rooms) for which they should pay; or
- are in competition with users providing similar services (such as car rental and car parking) for which access is paid for in another form.

The extent of competition for ground access can be seen from car parks. Less than 20% of passengers using Melbourne Airport use car parks provided by Melbourne Airport. In addition to the three public car parks provided by Melbourne Airport, Qantas and Ansett provide valet parking and there are at least 6 off airport car park operators. Thus in relation to car parks, airports have little market power and we note the ACCC shares our view⁴⁷.

⁴⁷ ACCC (1998 p34)

Appendix 3: Analysis of market power for price monitored services.

Service	Market Power Issues	Likely to be declared Under s192(5) ⁴⁸
Aircraft refuelling	As noted above, there has been some concerns raised in relation to the market power of refuelling services. However, this may also result from the highly concentrated nature of the refuelling industry. It is noted that domestic and regional carriers have some capacity to by-pass any given refuelling location.	Case by case assessment
Aircraft maintenance sites and buildings	Recent events would indicate that other than ramp maintenance, the market for maintenance facility locations is at a minimum national if not global. It should also be noted that whatever market power an airport may have with respect to sites, it does appear that the availability of skilled labour, industrial relations issues and State Government assistance are the principal determinants of location decisions. It seems unlikely that airports could abuse market power here.	No (assuming this refers to heavy maintenance sites)
Freight equipment storage sites	Terminal operators, handling agents and airlines store a good proportion of this equipment on their leased premises. The remainder is stored in common "GSE" areas on or adjoining aircraft parking aprons free of charge. It is interesting to note some users have approached Melbourne Airport seeking to pay for dedicated sites because of the inefficient use by other users of common user sites. Some form of charging may improve efficiency. There is currently no abuse of market power here and little likelihood as long as land for leased sites remains available.	Yes
Freight facility sites and buildings	There is significant competition between airports for international airfreight facilities. Abuse of market power is unlikely at airports where apron and land is available for expanding cargo facilities because it will always be profitable for airports to expand activity and existing tenants are protected under contract. If land is not available, the issue won't arise and existing tenants are well protected by contract.	No
Ground support equipment sites	See freight equipment storage sites	Yes

⁴⁸ ACCC (1998b, pp (ix), 34)

Check-in counters and related facilities	Currently, check-in counters are subject to a long-term contract that fixes airport revenue. This amount is then distributed among users on a time based usage charge. Accordingly, users are protected by contract and presumably this is the reason why these services were specifically excluded from the declaration.	Yes
Car Parks	At last count, there were 8 off-airport car parks servicing Melbourne Airport in addition to the three provided by the airport and the valet car parks provided by Qantas and Ansett. In addition, people may access the airport by taxi, chauffeur hire car, self drive rental vehicle, Skybus, regional buses, urban public transport buses, tour coaches, corporate and hotel hospitality vehicles and by being dropped off and picked up by others. As a result, significantly less than one-quarter of all passengers use airport-operated car parks and demand growth is strong. Despite this, Melbourne Airport sets its prices in relation to a benchmark set of CBD car parks. We understand similar market conditions and pricing policies occur in Sydney. As such, there seems limited capacity to abuse market power because of competition and absolutely no evidence that market power has been abused.	No

Appendix 4: Melbourne Airport's Retail Pricing Policy

Melbourne Airport is committed to a policy of providing goods and services at Value for Money prices.

The positioning of the price guarantee for Concession Areas:

“Competitive prices guaranteed or we will refund the difference”

The Concessionaire will support the price guarantee and undertakes to offer competitive prices on all products and services and agrees that competitive prices are defined as:

- 1 Manufacturers RRP or the price charged by comparable retail outlets whichever is the lower.
- 2 If the Concessionaire operates a Concession Area off Airport the prices must be the same as the off Airport store.

The Melbourne Airport pricing policy is intended to underpin each retailer's own guarantee.

The mechanics of operating under this guarantee are:

- 1 Melbourne Airport will provide a refund to a valid comparison where:

If a customer purchases a product from an airport store and confirms later that the product could have been purchased elsewhere in Australia for a lower price at the time of the purchase, Melbourne Airport will seek to obtain a refund from the Concessionaire for the value of the refund. In all cases the customer is to be sent the refund within seven days of submitting the price comparison.

- 2 The Concessionaire will reduce the price of a product where:

A customer has confirmed that the same product is for sale at an established Concession Area in Australia, providing that the customer can confirm the exact product, the price, the premises name and location.

Appendix 5: Australian Airport Regulatory Structure

Economic regulation of airports arises from four principle statutes of the Commonwealth Parliament

Air Navigation Act 1920

Contracting states to the Convention of International Civil Aviation are required to ensure that charges levied by airports on aircraft of other contracting States are no higher than those levied on the aircraft of the state in which the charge is levied.

Trade Practices Act 1974

Regulated airports are corporations and are therefore subject to this Act. In general, any conduct which may be anti-competitive or abuses market power can be dealt with under Part IV. In addition (as a result of the passage of the *Competition Policy Reform Act 1995*) Part IIIA provides a regime by which access to essential infrastructure services can be sought. Part IIIA makes provision for arbitration on terms and conditions of access (including price) by the ACCC.

Airports Act 1996

The *Airports Act 1996* is the principal Act for the regulation of airports. It covers a wide range of planning, development and regulatory issues as well as containing the following economic provisions:

- Part 3 - restrictions on airports ownership (foreign ownership, ownership by airlines, cross ownership of certain airport pairs);
- Part 7 - lodgement of certain accounts with the ACCC;
- Part 8 - quality of service monitoring by the ACCC; and
- Section 192 – declaration of airport services for the purposes of Part IIIA of the TP Act. These provisions are in addition to, rather than in place of, the general declaration provisions of Part IIIA.

Prices Surveillance Act 1983

Price regulation under the PS Act comes in two forms:

Prices Surveillance

The Minister for Financial Services and Regulation has issued three declarations pursuant to s21(1) of the PS Act in relation to airport services that are currently in force. These declarations are substantially the same. Declaration 87 applies to the Phase 1 airports, Declaration 88 to Phase 2 airports and Declaration 89 to Sydney (Kingsford Smith) Airport.

The declarations declare

- aircraft movement facilities and activities; and
- passenger processing facilities and activities.

No formal definitions of these are given although a number of items specifically included are listed and a number, which are subject to monitoring, are specifically excluded.

It is interesting to note that these declarations are broadly consistent with the definition of “airport charges” in s36(1) of the United Kingdom *Airports Act 1986*, those being:

- charges levied on aircraft operators in connection with the landing, parking or taking off of aircraft at the airport (including charges determined by reference to numbers of passengers carried); and
- charges levied directly on aircraft passengers in connection with their arrival at, or departure from, the airport by air⁴⁹.

Indeed, one could reflect if these had been adopted for use in Australia, given they express the intention of Government policy, the debates about fuel throughput levies and taxi charges would have been avoided.

Operational effect is given to the price cap for Phase 1 and Phase 2 airports through the Minister’s Direction 17. The price cap is a weighted tariff basket of annual changes in prices for aeronautical services⁵⁰ where the weights are given by the revenue shares in the previous year. The cap requires that prices for the services declared in Declarations 87 and 88 should rise by no more than CPI-X where the CPI is the measure of Treasury underlying inflation as published by the Australian Bureau of Statistics and the value of X is specified in Direction 17. Price increases

⁴⁹ CAA (2001b, p17)

⁵⁰ In the case of Melbourne airport two charges, the landing charge and the international passenger charge, account for over 99% of revenue within the cap.

resulting from NNI are not subject to the price cap. The starting point for prices was those prevailing under the FAC on 1 January 1997. Direction 17 makes provision for the handling of over and under charging relative to the cap in any given year.

In the case of the Phase 1 airports, and most of the phase 2 airports, the value of X has exceeded the underlying rate of inflation since privatisation. This means that compliance with the cap involves a reduction in nominal prices. There is no power in the PS Act to force a reduction in prices but there has been a general pattern of compliance. It is not the PS Act or the ACCC that is causing cap compliance but a view that compliance with the cap was a condition of sale. In other words, a commercial arrangement between two parties (the Commonwealth and the airport owner) is the source of falling nominal airport charges.

Direction 17 provides for prices to be increased outside the cap in three regards:

- 100% of direct costs associated with mandated security requirements are to be passed through the cap;
- Charges employed as part of a demand management scheme are to pass through the cap; and
- Prices for declared services are allowed to increase in excess of CPI-X as a result of necessary new investment. A number of criteria for assessing increases associated with necessary new investment are set out.

The ACCC monitors the price cap at each airport and publishes its findings in the annual regulatory reports.

The Minister's Direction 18 sets out arrangements for Sydney Airport. Whilst there is no price cap, the matters that the ACCC must consider in approving increased prices are identical to those contained in Direction 17. The ACCC in its recent draft decision on Sydney Airport has indicated that the Unit Cost Direction may also be relevant⁵¹.

Price Monitoring

Direction 19 sets out a range of services that are to be monitored for the purposes of s27A of the PS Act for Phase 1 and 2 airports and Sydney airports. The ACCC publishes the results of its monitoring in the annual regulatory reports. These services are:

- aircraft refuelling;
- aircraft maintenance sites and buildings;
- freight equipment storage sites;
- freight facility sites and buildings;
- ground support equipment sites;

⁵¹ APAC (2001)

- check-in counters and related facilities; and
- car parks (including public and staff parking but excluding valet parking).

The general purpose of price monitoring is to monitor services where there are concerns that there may be some potential for the abuse of market power although, as mentioned above, these services are specifically precluded from prices surveillance. To date, the ACCC has undertaken one inquiry into market power issues for these services and that was in relation to fuel throughput levies at Brisbane and Perth. Whilst it recommended fuel throughput levies should be included in the cap, and therefore declared, the Government has yet to act on this recommendation. An analysis of the market power issues associated with these services is contained in Appendix 3.

Appendix 6: Distribution of revenue by customer and revenue type

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Appendix 7: Capacity utilisation forecasts

COMMERCIAL IN CONFIDENCE

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