



**INQUIRY INTO PRICE REGULATION OF
AIRPORT SERVICES**

**THIRD SUBMISSION TO THE
PRODUCTIVITY COMMISSION**

NOVEMBER 2001

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Executive Summary

Northern Territory Airports (NTA) strongly supports the Productivity Commission's draft report. We agree that there is no case for maintaining either price regulation or price monitoring on any of our airports during what will be an extended period of intense difficulty for them commercially.

The dramatic events of September 2001 have changed circumstances so substantially that what were sound policies for the long term have required immediate reassessment for the short and medium term viability of our airports and the industry more generally.

Following the Ansett collapse and emergence of the terrorist threat to aviation (which affects both demand for our service and the costs of its provision) the fees we must charge to remain commercially viable have risen considerably.

In addition to supporting this position, this submission maintains that:

- compliance costs of any regime must be minimised. In the light of this, we request that the Productivity Commission specify in further detail in its 'fall back' option, how it can configure a price monitoring regime that is substantially less costly to administer than the price regulation which has just been temporarily abandoned.
- the ACCC submission appears to lack detailed analysis to support its claim that Darwin Airport has sufficient market power to warrant price regulation. We would request that Darwin be reviewed independently if the Productivity Commission decides to carry forward with its Draft Report findings that Darwin should be viewed in a different regulatory light than say Alice Springs and Townsville airports and requires ongoing price monitoring regulation.
- the countervailing market and political power of Qantas was very substantial before the collapse of Ansett, but is now greatly enhanced, further undermining the 'market power' argument for price regulation or monitoring of smaller regional airports.
- deregulation of domestic cabotage has become more important and urgent than before, following the withdrawal of several international services from Darwin. It remains a matter of key strategic importance for Darwin and a means by which it could generate substantially greater patronage and so lower the fees it needs to charge in the longer term. It would also increase the price elasticity of demand facing Darwin International Airport.
- CPI-X price control imposes significant risks on our airports in the face of flat or declining growth expectations into the medium and long term (as we argued in our second submission). It does not allow smaller airports to respond quickly to major shifts and shocks (for example as demonstrated in recent events) and is really only relevant for larger stable airports.
- NTA strongly endorses the Commission's finding that the NNI provisions failed to achieve envisaged outcomes. They were strongly counterproductive for NTA as outlined in earlier submissions and testimony.

- the collapse of Ansett and the international aviation crisis has immediately and materially impacted upon NTA's financial viability. As a responsible business NTA needs (and must be allowed) to respond to ensure both an appropriate service is maintained and is priced to achieve some commercial measure of return on its aeronautical asset investments.
- NTA will introduce interim price changes for its aeronautical services in line with the revised price oversight arrangements, in order to protect the short-term viability of the airport, having regard to both the operating shocks being experienced and the increased compliance costs associated with the new mandatory Federal Government security measures. These charges will be levied on a passenger movement based system (per PAX charge) rather than the previous method that was based on a Maximum Take Off Weight (MTOW) landing charge. This method is clearly preferred by all Regular Public Transport (RPT) airlines that operate from Darwin and Alice Springs Airports. We will review these interim prices early in 2002 to determine whether adjustments should be made to reflect the provision of additional (or reduced) airline services and service patronage.
- NTA will seek to negotiate longer-term commercial outcomes with airlines as soon as the current aviation crisis situation stabilises, expected to be before the end of the 2001/2002 financial year. The underlying premise for determining NTA's price position will be consistent with both the dual-till principles on which the Federal Government privatised the airports and the necessity to achieve a responsible return on its aeronautical assets over time. We would plan to complete the supporting analysis and negotiate these new arrangements for introduction in the next financial year.
- the current temporary prices oversight arrangements at airports (or any modification of these arrangements consistent with the Productivity Commission's final report) should remain in effect rather than be implemented in June 2003 as originally contemplated.

1. Introduction

Northern Territory Airports is supportive of the findings and recommendations put forward by the Commission in its Draft Report, released in August 2001. We offer this third submission to the Commission for two reasons. Firstly, our second submission offered responses to the comments of some participants who were defending the existing price control regime particularly the ACCC. Owing to the lateness of their submission we were unable to get our submission to you until shortly before the release of the draft report. We appreciate the Commission's inability to give the matters raised the attention we believe they deserve and accordingly welcome the opportunity to draw the Commission's attention to these matters in this submission.

Secondly and more importantly, the global and Australian aviation industries as a whole, but even more so Australian regional aviation, have changed beyond recognition since the mutually reinforcing collapse of Ansett and the dramatic events of September 11, 2001.

The current situation is one of both fluidity and uncertainty. As the Commission is aware, on October 8th, 2001 the Federal Government introduced a substantial, but temporary deregulatory package that has the effect of (temporarily) removing both the price cap and price monitoring at Alice Springs Airport and the price cap but not price monitoring at Darwin Airport. This provided relief, which was quite simply imperative for some smaller airports to survive. Nevertheless it has – rightly – not removed the relevance of this inquiry as an input into government's decision making about medium term policy settings for the industry.

This supplementary submission is divided into the following areas:

1. NTA Response to the Productivity Commission's Draft Report
2. Collapse of Ansett – impact on NTA and relevance to Productivity Commission's Inquiry;
3. US Terrorist Attacks - impacts on NTA and relevance to Productivity Commission's Inquiry;
4. Proposed Increase in Aeronautical Charges;
5. Implications of recent events for priority issues previously raised by NTA in the PC Inquiry including: Countervailing Power, Cabotage and the structure of the industry, CPI - X and Necessary New Investment.

2. NTA Response to the Commission's Draft Report

In general, NTA strongly supports the Productivity Commission's Draft Report released in August. The Commission has acknowledged the need for a move to more commercial arrangements between airports and airlines. Recent events have simply accelerated the speed with which we must move.

The Draft Report also acknowledges the cumbersome nature of the existing provisions and highlights their ineffectiveness in meeting intended policy objectives. The Draft Report also acknowledges the limited potential of smaller airports such as Darwin and Alice Springs to use market power in order to drive airport charges above what is commercially fair and reasonable.

The Commission has also highlighted the failure of the existing system whereby special applications for variation from the CPI - X price cap on airport charges must be sought via Necessary New Investment applications to the ACCC. Based on our experience, these arrangements are unnecessarily cumbersome and on any reasonable interpretation of the circumstances of NTA's situation, detract from economic efficiency. We welcome the Commission's findings on these matters in the Draft Report.

NTA welcomes the Commission's unambiguous recommendation that the cap on airport charges be lifted in respect to both Darwin and Alice Springs Airports. This recommendation has, very properly we believe, been included in both options put forward by the Commission. We are comfortable that the charging regime of NTA post regulation will satisfy the price and conduct monitoring processes that the Commission has recommended be established for the next 5 years.

We have few major concerns about the nature of the Commission's findings and recommendations. Probably the most substantial concern we have would be with the content of the price monitoring arrangements as set out in the Commission's Option A. Whilst we would of course accept monitoring as the price of substantial deregulation, we nevertheless draw the Commission's attention to an indicative estimate in our second submission of the compliance cost of the current price regulation. We would respectfully urge the Commission to be as clear as it can about the price-monitoring regime to ensure that the compliance costs are minimised. This is particularly important for smaller airports such as Darwin where, as we believe our second submission demonstrated, it is exceptionally difficult to justify compliance costs of even 1% of revenue in terms of any allocative efficiency to which price restraint might give rise.

Despite our general support of the draft report, recent events make the task of regulatory reform far more urgent. The collapse of Ansett and the emergence of a much greater terrorist threat have had a major and immediate impact on the viability of our holding company Airport Development Group (ADG). As we confidentially informed the ACCC and the Federal Government at the time, a substantial and immediate increase in fees was the only mechanism we could see that would enable us to continue trading.

Revenue from landing charges has been massively reduced, retail revenue at airports has plummeted, cost increases from security upgrades have been substantial, large debts from Ansett are likely to go unpaid, and our insurance costs are sky rocketing. Without the direct intervention of the Federal Government allowing for immediate temporary relief from the existing regulatory framework, the future of many Australian airports – and certainly those for which we are responsible – would have been in serious doubt.

In framing its final recommendations to government, we feel it is critically important for the Commission to take into account the current and in many cases unique and different circumstances that Australian airports now find themselves in.

Should the price cap on airport landing charges be removed in line with the Commission's draft recommendations, any new monitoring regime introduced by the Commonwealth should take into account the cost of compliance, particularly for small regional airports like Darwin and Alice Springs.

We made some observations about the process of the inquiry in our second submission. In particular we felt that the ACCC's view that Darwin was in the class of airports that had sufficient market power to warrant price regulation was not clearly supported by their tabled analysis.

Accordingly we request that before the Productivity Commission determines that Darwin should be viewed in a different regulatory light than say Alice Springs and Townsville Airports; it undertakes (or direct others to undertake) a specific review of Darwin's market power and the costs and benefits of regulating Darwin Airport.

3. The Collapse of Ansett – Impact on NTA and relevance to Productivity Commission's Inquiry

While it is still not yet clear exactly how much lasting damage the collapse of Ansett will inflict upon the Australian tourism and aviation sectors, it is clear to us that the Northern Territory will be particularly badly hit. The loss of Ansett has resulted in immediate and very substantial losses in capacity on routes to both Darwin and Alice Springs.

In the case of Alice Springs, Ansett was responsible for 40% of aeronautical revenue or \$625,000 in the last financial year and at Darwin, Ansett represented approx. 27% or \$1.3 million of aeronautical revenue last financial year (including Flight West). The collapse of Ansett domestic capacity immediately reduced capacity by 211,000 passenger seats at Alice Springs and 312,000 seats at Darwin. To date Qantas have restored approx. 74% of the combined Ansett/Qantas October 2000 seat capacity to Darwin and 60% of the October 2000 seat capacity to Alice Springs. NTA's has consequently suffered substantial and immediate losses in all areas of airport revenues.

The revision by the Federal Government of pricing oversight regulation has provided welcome and much needed respite to airport operators but even this support will not return airport operations to prior to September 11, 2001 trading circumstances. There are a number of reasons for this.

First, the loss of Ansett will reduce competitive pressure on Qantas to offer discounted prices on flights servicing the Northern Territory. The immediate increase in air ticket prices and the lack of seat availability has forced many consumers to reassess their travel arrangements for the interim period and consequently the recent provision of discount seats

by Qantas has had little effect on customer perceptions and forward bookings appear soft. This has led to a consequent fall in passenger numbers to both Darwin and Alice Springs. This will potentially further reduce the revenues raised by NTA in the short to medium term across all sources.

Second, there is little prospect of any rapid move by alternative carriers other than Qantas to pick up the capacity vacated by Ansett. While Virgin Blue has previously announced its intention to commence flights to Darwin from Brisbane at the beginning of March 2002, there are considerable hurdles involved and is little or no guarantee that this start date can be brought forward. The Federal Government has just recently announced that Virgin Blue will commence a single daily service to Darwin before Christmas but the provision of required passenger processing and ground handling services including facilities has not been determined. We also understand that these services are only underwritten until January 2002 and the potential change in Federal Government reduced the surety of this service actually starting. No such support has been announced for Virgin Blue to commence operations to Alice Springs and together with the community, we are very concerned about the ongoing level of patronage and competition to this regional airport. The quantum of Virgin Blue services proposed will not compensate for the number of lost Ansett services.

The Ansett administrator has shown little interest to date to recommence any Ansett Mark 2 services to the NT and the complete lack of dialogue with any of the interested parties in Ansett would suggest that no one is contemplating the resumption of Ansett services to the NT.

Third, international tourist traffic to Australia has plummeted. Again the impact is particularly severe for NTA. We have the highest ratio of tourism passengers serviced of any of the airports subject to the PC review. Further we are dependent upon domestic connections for the vast bulk of our international travellers. Nearly half (around 47%) of international visitors to the NT arrived in Australia at Sydney Airport whereas only 16% of international visitors to the NT entered the country at Darwin Airport. There is now substantially less choice – and so more inconvenience – as well as higher effective domestic prices for the 47% of NTA's international passengers who currently travel to the NT by a domestic flight to Darwin on their international trip to Australia.

In summary, the collapse of Ansett has done significant damage to the financial position of many Australian Airports, particularly those like Alice Springs and Darwin which have few options for replacement capacity and who rely heavily on international tourists arriving indirectly on domestic routes. While we are confident that other carriers, particularly Virgin Blue, will over time take up some of the lost capacity, we doubt whether this will commence before the end of the year. Irrespective of Virgin Blue, proportionally revenue losses are now being sustained across all operations at both Alice Springs and Darwin.

In the context of the matters being considered by the Productivity Commission, NTA believes the collapse of Ansett reinforces the need for flexibility in the airport-charging regime applying at Australian airports.

4. US Terrorist Attacks: Impacts on NTA and relevance to Productivity Commission's Inquiry

There has never been an event, which has caused such damage to the worldwide tourism and aviation industries as the September 11th catastrophe. As an Initial Analysis by the World Tourism Organisation says, "The attacks on US citizens have made more of an impact than any crisis in the past. The situation is exceptional and past experience can only partly help analyse the consequences of such tragic events".¹

In the United States since September 11th, airlines have laid off some 100,000 staff. This is 14.7% of the total employed in the industry (based on a total of 679,967 full-time equivalent employees in the US airline industry).² This is despite an unprecedented injection of some US\$15 billion in an urgent relief package passed by Congress the week before last.³ To put this figure in perspective, consider that the US airline industry generated US\$129.5 billion in total revenues, in the year 2000.⁴ Thus this relief package amounts to 11.6% of the total revenues generated by airlines in the year 2000. On top of the very significant challenge of convincing passengers to fly again following the terrorist attacks, airports face massively increased insurance costs and costs associated with federally mandated security improvements. Currently Los Angeles Airport (LAX) is losing US\$1.8 million per day⁵ and Washington National is losing US\$500,000 a day with losses being incurred across all areas of operation.⁶

The North American Airports Council International estimates that US airport revenue losses will reach some US\$3 billion by next year.⁷ Airports in the United States are currently seeking some US\$1 billion in assistance from Congress to cover increased costs associated with lost revenue from reduced airline traffic, mandated security upgrades, and insurance premium increases.⁸ There is also serious discussion about financial analysts downgrading the credit rating of airports in the wake of the terrorist attacks.⁹

Aviation as a whole is being caught in a cost/demand squeeze. Costs have risen whilst demand has fallen – in both cases by amounts, which cannot easily be determined. Tourist aviation demand is falling whilst the security costs of flying are soaring.

¹ "The impact of the attacks in the United States on International Tourism: An initial analysis," World Tourism Organisation, Madrid, 18 Sept. 2001 p.3

² 2001 Annual Report, Air Transport Association, Sept 2001.

³ "Congress Passes \$15 billion Airline Bailout," Washington Post, 22 Sept. 2001.

⁴ 2001 Annual Report, Air Transport Association, Sept 2001.

⁵ Testimony by David Z Plavin (President IAC-NA) to US Congressional Sub-Committee on Transportation and Infrastructure, 25 Sept. 2001

⁶ Nation's Airports are Planning to Seek up to \$1 Billion in Aid," Wall Street Journal, 19 Sept. 2001

⁷ "Airports Council International – North America Calls on Congress to Focus Attention on Airports," ACI Media Release, Washington DC, 27 Sept. 2001

⁸ "Nation's Airports are Planning to Seek up to \$1 Billion in Aid," Wall Street Journal, 19 Sept. 2001

⁹ Nation's Airports are Planning to Seek up to \$1 Billion in Aid," Wall Street Journal, 19 Sept. 2001

Loss in International Tourist Visitors

The final extent of this adverse impact will depend greatly on the nature of the anti-terrorism response and any subsequent terrorist attacks. Already, peak bodies in the Australian tourism sector have noted substantial cancellations and a fall in forward bookings.¹⁰ According to the initial assessments by the Australian Tourism Export Council, it is estimated that Australia could lose approximately 1 million international visitors over the next year or around 20% of the current level.¹¹

The likely impact is made worse by a number of key factors.

First, the US terrorist attacks have come on top of a global economic downturn, and (along with the Ansett collapse) they have occurred in the lead-up to what are traditionally Australia's peak months for international visitors. In other words, the losses we are now incurring as a consequence of recent events will be substantially magnified because they come at the worst possible time.

Second, tourists from the United States make up a large and growing proportion of the international tourists visiting the Northern Territory. As such, the impacts of the terrorist attacks will be more profound in Darwin than at other smaller airports in Australia. As discussed above, the dependence of American visitors to the NT on domestic connections, mostly via Sydney is an added disincentive to visit Darwin or Alice Springs.

Third, while international visitor losses are likely to be highest from the United States following the attacks, they will not be limited to North America. The attacks will have an impact worldwide on demand for tourism and together with the commencement of hostilities in Afghanistan and with the prospect of the conflict spreading further; we are expecting substantial losses in key Asian and EU markets from which we get the vast bulk of our direct international traffic. It is widely anticipated that Australia will suffer because of an expectation that more tourists will holiday closer to home. It is possible that some of this effect can be offset by Australia's reputation as a safe destination, but it seems unlikely to us that this effect will be large.

Fourth, there is currently no plausible case to suggest that any trend for domestic tourism to substitute overseas travel will be sufficient to compensate airlines and airports for the loss of international visitor business. On the contrary, we anticipate a fall in domestic demand at NTA as a consequence of events in the US, a trend that is being further exacerbated by the collapse of Ansett. The Northern Territory Tourism Council has boosted its marketing

¹⁰ "Tourism Impacts Update One," Australian Tourism Commission, Sept. 2001; "Tourism Impacts Update Two," Australian Tourism Commission, Sept. 2001; "Export Tourism Industry in Government Talks," Australian Tourism Export Council Media Release, Sept. 2001; "US and Ansett Crises Start to take Effect on Tourism," Australian Tourism Export Council Media Release, Sept. 2001

¹¹ "Export Tourism Industry in Government Talks," Australian Tourism Export Council Media Release, Sept. 200, Australia Cracked 5 Million in International Visitors," ATEC Media Release, 20 Feb 2001

campaigns by \$100,000 since the two crises, the centrepiece of their response being a campaign aimed at persuading Northern Territorians to travel within the NT.¹²

While this is a welcome development for the local tourism industry, which has suffered significantly as a consequence of recent events, we do not anticipate that it will make any real difference to the adverse consequences being experienced by our airports. In so far as recent events change holiday plans, they are likely to lead to a substitution of air travel for road travel, something that would clearly diminish the tourist prospects of NTA as well as the Northern Territory as a whole.

For reasons including those covered above we anticipate a major loss in international visitor numbers and a substantial loss of domestic travellers. As noted above, the ratio at Darwin Airport of international tourists to those travelling on business or visiting friends and relatives (VFR) is very high relative to other airports. As a consequence, any significant fall in forward bookings by international tourists as a result of the terrorist attacks will be more keenly felt by NTA than most other airports.

Security Costs

The costs associated with increased aviation security requirements are also having a substantial financial impact on airlines and airports the world over. In the United States, there has been a massive increase in federally mandated upgrades in airport and airline security.¹³ The Australian Government has also expressed a desire to upgrade security on airlines and at airports, however, the cost of these changes is not yet clear.¹⁴

The costs already being sustained by NTA as a consequence of mandated security upgrades since the terrorist attacks is significant. Since September 11, NT Airports have received seven revisions to the Additional Security Measures from DOTARS Aviation Security Branch for implementation at Darwin and Alice Springs. The cost of implementing some of these ASM's is significant. For example, the requirement for increased security at Alice Springs of General Aviation, Regular Public Transport, and commuter aprons (effective September 15, 2001) was costing an additional \$5,500 per week or \$300,000 annually. On October 8 this Additional Security Measure was upgraded at an annualised cost of \$1,000,000 plus per annum. This amounts to nearly 65% of Alice Springs airports budgeted aeronautical revenue. We intend to recover all mandated safety and security costs on a 100 % pass through basis from the airlines in a transparent manner. This is consistent with the Federal Government's direction No. 24 for Phase 1 airports.

The other security related cost increase relates to insurance cover. Since September 11th there has been a massive increase in the cost of insurance coverage for airlines and

¹² "Ansett Australia Update," NTTC Media Release, 21 Sept. 2001

¹³ "Airports Council International – North America Calls on Congress to Focus Attention on Airports," ACI Media Release, Washington DC, 27 Sept. 2001

¹⁴ Transcript of the Press Conference by the Prime Minister, Sydney, 2 Oct. 2001; "Armed Guards to be 'randomly' placed on Australian flights: PM," ABC News Story abc.net.au, 2 Oct. 2001

airports. While airline insurance has received the bulk of attention in media coverage, airports face a similar if not even more serious situation. While insurers have substantially raised coverage for aircraft causing some government intervention to assist in underwriting, there are indications that some types of airport coverage may become unavailable at any price. In any event, we anticipate that insurance premiums for airport owners, if available at all, will increase dramatically from their current level. Prior to the US terrorist attacks, NTA had already suffered a 30% increase in insurance premiums this financial year. Despite a government commitment to underwrite third party war cover for surface damage to airports, we anticipate substantial additional increases in premiums following on from the terrorist attacks. This is further exacerbated by reports that class action lawsuits may be pursued by victims of terrorism against airports in the wake of the attacks in the US.¹⁵

5. Proposed Increase in Aeronautical Charges

Following the Federal Government's decision to revise the price oversight arrangements applicable for Darwin and Alice Springs Airports, we intend to introduce increased aeronautical charges, on an interim basis only, to be effective from December 1, 2001. The new charges have been determined as necessary to provide temporary relief for the financial circumstances that the suspension of Ansett services and the reduced global demand for aviation services has imposed upon our airport operations. Our interim prices take into account the revised Qantas service schedule, as published, the planned commencement of Virgin Blue services in December 2001 and the various cuts in international services to Darwin, as announced to date. The increases in airport charges is not an indication that airports are risk-free, but rather that aeronautical charges were set at such a low level that the airports were unable to withstand shocks to the system.

In addition we will transition from a landing charge based upon a per landed tonne of Maximum Take Off Weight (MTOW) basis to a per passenger (PAX) basis. We have decided to do this after extensive consultation with all regional, domestic and international RPT airlines that operate into Darwin and Alice Springs airports. They all expressed a clear desire to have the charges levied on a per PAX basis.

We will also segregate the total charge into two components. One is the Safety and Security Charge that will reflect the mandated security measures in force at Darwin and Alice Springs airport for either domestic and international services - this charge will reflect actual costs only and will be levied on a "100% pass through" basis to all RPT airlines that utilise the security and safety measures. The second component is our Airport Services Charge for the provision of airport services - in the case of international passengers, this will incorporate the existing International Terminal Charge.

¹⁵ "Payouts may bankrupt air industries," The Courier Mail, 2 Oct.2001

These interim prices will again be reviewed early in 2002 to determine whether further adjustments are required. This process will focus on the actual level of services provided by RPT airlines into Darwin and Alice Springs and the ongoing patronage of those services.

We remain acutely aware that the current NTA pricing structure substantially under-recovers on the costs of providing and maintaining its aeronautical assets - indeed DoTARS recognised this in their submission to the Productivity Commission.¹⁶ The new charges still do not result in a reasonable return on aeronautical assets, confirming NTA's previous pricing was at an inappropriate level.

Accordingly, NTA confirms it will seek over time to negotiate commercial outcomes directly with the airlines (hopefully before the end of the 2001/2002 financial year) that provide a responsible and reasonable return on these aeronautical assets, which is both justifiable and consistent with the "dual till" principles envisaged by the Federal Government at the time of privatisation.

6. Inconsistent & Iniquitous regulatory Treatment of the Airports Sector

Up until October 8, 2001 when the Federal Government revised the prices oversight arrangements at airports, there was a clear inconsistency and inequity between the regulatory treatment of airports and other parties adversely affected by the terrorist attacks. Government regulation does not prevent insurers from reflecting the new commercial realities in their premiums. The same can be said for airlines, though in Australia's case Qantas' finds itself in the fortunate and indeed unique position amongst airlines globally of having picked up a huge windfall in market share and income at the time the rest of the industry must face a dramatic cost/demand squeeze.

¹⁷ "Qantas will undoubtedly emerge from the domestic shakeout in a stronger position, and it has unique opportunities to reinforce its financial position while many of its international peers are battling to stay afloat.....Ansett's collapse has prompted hefty earnings upgrades."

Unlike the airlines we have received no direct governmental financial assistance. Unlike both the airlines and the insurers, we are bound by government regulation that until October 8, 2001 explicitly prevented us from raising our major revenue source capable of addressing the new situation – airport charges. Unlike the tourism sector in the Northern Territory and other parts of regional Australia we are, as a consequence of the Ansett collapse, not in a position to respond to losses being incurred by the terrorist attacks with domestic substitution. With a high level of fixed costs, little flexibility in revenue raising, airports could well be more affected in the longer term than any other sector.

¹⁶ "Executive Summary p. 1 DOTARS Submission to the Productivity Commission Review of Price Regulation of Airport Services June 2001

¹⁷ "Qantas grabs chance with both hands" The Australian Financial Review, 8, October 2001

7. Countervailing Power

We believe that recent events have strengthened to a very great degree the arguments NTA has put forward previously concerning airlines' countervailing power. The ACCC in its submission argued strongly that airlines exercise negligible countervailing market power against airports and according to their consultant Professor Forsyth described countervailing power as a "mirage"¹⁸. Since that time Qantas has emerged from the current crisis with effectively 100% of the NT domestic market (apart from some regional airline scheduled services). Given the alarming proportion of airport landing fee revenue which we have now lost as a result of the Ansett collapse, (40% at Alice Springs, 27% at Darwin based on last financial year), NTA is now in a position in which the continuing use, at reasonable capacity levels, of both airports is critical to the future of the company. Without Qantas' continued patronage, Darwin and Alice Springs Airports as viable businesses would cease to exist in any recognisable form.

We placed the following quotation at the head of our second submission because though it appeared in the ACCC's submission we thought it summarised the reason for unburdening us from the ACCC's regulation in an almost uncanny way.

"If there are, say, two airlines that only compete for marginal customers, there is a high degree of customer lock-in with each airline, and the relevant airport is not significant in terms of either total airline profitability or airline network configuration, then it is likely that each airline could have significant countervailing power. Each airline has a credible threat to stop using the airport. This power may be increased if the airport itself cannot credibly reduce its output; for example, if the airport is credit constrained and potentially faces cash-flow problems" (1st ACCC Submission to the PC, Appendix C, p. 13).

Of course a rereading of it in the light of recent events just serves to highlight that we are now in a situation, which has gone well beyond the point, which the ACCC's consultant thought delineated a situation where countervailing power was clearly demonstrated. Indeed DoTARS recognised back in June in their submission that "on the other hand, there is growing evidence that airlines have a degree of countervailing power that, together with various market forces, may be sufficient to warrant a shift in approach to any future regulation".¹⁹ There is now effectively one domestic carrier to Darwin, it has a domestic monopoly of cabotage. If it does not have a credible threat to stop using the airport altogether, it certainly has a threat to curtail some services and/or to use its 'customer lock in' to divert international passengers away from Darwin. Further it must know that our credit constraints and cash-flow problems have greatly intensified since the events of September.

¹⁸ Peter Forsyth, Airport Price Regulation: Rationales, Issues and Directions for Reform, Submission to the Productivity Commission Inquiry into Price Regulation of Airport Services, March 2001, page 4

¹⁹ Executive Summary p. 2 DOTARS Submission to the Productivity Commission Review of Price Regulation of Airport Services June 2001

In short, any market power that Darwin and Alice Springs possessed before the terrorist attacks and the collapse of Ansett has now been largely swept away by the increased market power of Qantas. NTA is now in a position where it is so urgently in need of new capacity that it would even have to contemplate unprofitable new airline business, from an aeronautical income perspective, based on a regulated but insufficient charging regime, as this activity would deliver incremental revenue from associated (non-regulated) airport activities.

The collapse of Ansett, the current problems being experienced by its parent company, Air New Zealand and problems facing the airline industry internationally (eg. Sabena, Swissair, etc) also appears to be further strengthening the political power of Qantas. There is currently very substantial pressure on national governments to ensure the viability of national carriers and in such an environment we are pessimistic about the willingness of government to take on Qantas on key issues of great strategic significance to Australia's most Northern airports such as domestic cabotage (as has been the case in the past).

8. Cabotage, Hubs, Spokes, and Kangaroos

Recent events have also created a situation that highlights the costs of the current near monopoly over domestic cabotage enjoyed by Qantas. Currently, foreign carriers are prevented from flying domestic passengers in Australia, except in rare circumstances where the Commonwealth Government grants dispensations.

Since the collapse of Ansett and the terrorist attacks in the US, the Commonwealth has granted a small number of cabotage dispensations to allow a number of international carriers coming through Darwin International Airport temporary access to domestic passengers. Both Royal Brunei and Malaysian Airlines have (after lengthy delays) been given temporary access in Darwin to fly domestic passengers to Brisbane and Cairns respectively until December 31, 2001 (however Royal Brunei will cease their transit Darwin to Brisbane service on October 25, 2001). The benefits from this temporary arrangement are negligible for NTA given that it does not increase aeronautical charges that to date are weight-based and have already been levied on the arriving international flight. The only gains at NTA are via retail activity flowing from increased passengers, however this is also minimised because passengers are boarding via the international terminal at which there are few retail services beyond customs.

Of much greater significance is the way in which Qantas' near monopoly of domestic cabotage is underpinning Qantas' domestic fare equalisation with respect to Asian destinations, particularly those on the 'Kangaroo Route'. Qantas intend to further exploit their ongoing domestic cabotage advantage with the commencement of "Australian Airlines" operations early next year. This will allow Qantas to carry domestic passengers under Qantas code share arrangements from Darwin to the East Coast with structural cost advantages that domestic competitors (should they eventually emerge) will be unable to match. This is a subject discussed at length in our second submission. However, this matter

was not dealt with in the draft report at any length. The Commission may have considered direct recommendations on the matter outside its terms of reference. We also appreciate that the Commission may have required more time to consider the matter than it had between receiving our second submission and completing the drafting of the draft report.

In any event we consider that with circumstances so changed since its draft report, and with further time to consider the matter, relief in this area could make a substantial contribution to NTA, other existing and prospective international carriers and the Northern Territory community.

We have cited a number of withdrawals of international services from Darwin in our second submission. On top of these, Malaysian Airlines have recently announced that it would discontinue all services to Darwin early in 2002, citing the impact of the US terrorist attacks.²⁰ While we cannot speak for the airlines making these decisions it seems to us quite likely that these decisions would have been different if foreign carriers had permanent access to domestic on-carriage passengers out of cities like Darwin. The current dispensation may partly offset lost domestic capacity but it provides no long-term incentives for Royal Brunei and Malaysian Airlines to maintain existing services, let alone expand them. In the meantime the temporary arrangements are a disincentive for an early start by potential domestic carriers such as Virgin Blue. It also seems incongruous that domestic airlines retain these exclusive rights when they are either partly foreign owned (Qantas & BA) or wholly foreign owned (Ansett and ANZ/SQ). The cost of operating “dead sectors” to the East Coast for International Airlines may be as high as AUD\$10M per annum and the securing of these “domestic” rights would have been a critical factor for the airlines that have ceased transit services and any prospective entrant that is contemplating commencing services to Darwin. It is unreasonable to assume that Darwin with a population base of 100,000 people can support many terminating services in the future. The collapse of Ansett demonstrated that there was real demand for capacity and competition in the Northern Territory and that many of the International carriers that operate to Darwin could have provided immediate and ongoing relief at competitive costs with large availability of seats. However they were frustrated initially and these services need to be secured for the long term in order for international carriers to seriously entertain permanent changes to their airline schedules.

But the greater impact of deregulation of domestic cabotage would be the emergence of Darwin as a staging post – however small initially – on the ‘Kangaroo Route’ between Australia and Asia and Europe. For as long as Qantas uses its privileged position to maximise its own profits – by preventing international visitors to the Northern Territory from capturing the cost benefits of their transit through the Territory – Darwin International Airport cannot prosper and make the strategic contribution it could to the Territory’s and the country’s economy.

²⁰ “Malaysia Airlines Unveils Network Restructuring Program,” Media Release, 4 Oct. 2001

We believe that for Darwin Airport the issue of domestic cabotage is directly within the terms of reference of the Commission's inquiry on account of its significance for the operation of at least one Australian airport if not others in the North and West of Australia. However if the Commission considers the issue of domestic cabotage to be outside its terms of reference in this inquiry, we would respectfully urge Commission to draw public attention to potential costs of the current policy in impeding development in the Northern Territory. Failing this we hope the Commission will recommend, or at the very least canvas the prospect of an independent inquiry into domestic aviation cabotage.

9. CPI-X Price Regulation

NTA has already argued that while it may be appropriate for larger airports and/or those with strong growth prospects, the CPI-X regime is completely inappropriate for a small airport with low growth prospects such as Darwin and Alice Springs Airports. The current situation emphasises just how much risk the CPI-X regime imposed upon smaller airports. We need the flexibility to respond to major shifts and shocks just like any other commercial enterprise.

The current circumstances clearly justified a departure from strict application of the CPI-X formula and demonstrated how ineffective these artificial pricing arrangements can be in a dynamic global business environment.

We would strongly suggest by analogy that, the prior pricing regime is inappropriate for contemplated future market conditions, that accordingly the Commission should maintain its recommendation to remove NTA from price regulation and monitoring in its draft report, and that the Government should implement those recommendations immediately.

10. Necessary New Investment

While the principals behind the NNI arrangements are laudable, we have documented in hearings and in our earlier submissions the dismal failure of the arrangements in practice for a small airport such as Darwin. As already documented, NTA applied for such a dispensation under the NNI once in the past two and a half years and found the process so time consuming, cumbersome, and ultimately fruitless that we no longer view it as a viable part of a solution to any current or future problem. We welcome the Commission's finding that the NNI provisions "largely have not achieved the commercially-negotiated outcomes that were envisaged by the architects."

11. Concluding Remarks

In our August 2001 submission to the Commission's Inquiry, we closed with the following statement: "CPI-X regulation is best suited to an environment in which there is a reasonable

expectation of steady growth. It is clearly operating in Darwin not just to depress returns inexorably over time, but to dramatically ratchet up the risk which investors must face... the airport is struggling to survive. It is in no position to exercise monopoly power.” Our words were unintendedly prophetic.

The struggle to survive suddenly became almost unimaginably difficult. Our revenues have been massively squeezed – by around a third while our aeronautical costs have escalated almost as dramatically. We anticipate a (further) major drop in demand for international tourism into Australia, and hence a further blow to services into the Northern Territory. The prospect of global recession is now very real, and timed to hit at what would normally be the peak season for inbound tourism. In addition to losing Ansett and Flight West, we are about to lose three very important international services at Darwin. It is inconceivable to us that other carriers will come close to fully offsetting the losses caused by Ansett’s demise even into the medium term, and other entrants who might partially offset losses like Virgin Blue are not likely to arrive before the end of 2001 at the very earliest.

In these circumstances, the Productivity Commission’s recommendations for the medium term future of airports have suddenly become critical to our short-term survival. We strongly support the implementation of the Commission’s Option B – removal of price caps with a price-monitoring period of 5 years followed by a further review. We restate our view that Darwin Airport be reviewed to determine whether it should be considered in the same category as those considered to have moderate to significant market power. We believe that Darwin’s market power is no greater than the other airports like Townsville, etc. However we believe that the new arrangements should be introduced immediately rather than in June 2003 as contemplated in the original Government timetable. While we are comfortable with the Commission’s decision to exclude Alice Springs from the fall back option of continued regulation we remain wary of our property being swept back into this scenario at some later stage.

Therefore, in our view, the work of this Commission and the acceptance of its recommendations are critically important. In ways that could not have been appreciated until the month of September, the need to implement the Commission’s proposals is now immediate and critical to future airport operations and development.