DEPARTMENT OF TRANSPORT AND REGIONAL SERVICES

SUBMISSION TO THE PRODUCTIVITY COMMISSION REVIEW OF PRICE REGULATION OF AIRPORT SERVICES

JUNE 2001

Attachments:

Executive Summary

This submission: examines the context in which major airports in Australia were privatised; outlines the objectives underlying the design of the prices oversight framework to apply for the first five years post privatisation; makes observations on the experience to date on the success of that regime and regulatory supervision in this area; and suggests an approach to future regulatory supervision of airports in pricing and competition policy matters.

Under the pricing framework and associated quality of service (QoS) regulatory regime, the Australian Competition and Consumer Commission (ACCC) reports annually on airport operations in the complementary areas of: prices monitoring and price cap compliance; airport financials (from information supplied by airport operators); and QoS.

This reporting regime was intended to improve the transparency of airport operations and to assist users in assessing airport financial performance and economic efficiency. Making airport operations open to industry and user scrutiny also facilitates and encourages competitive benchmark assessments and weighs against an airport attempting to take advantage of any market power it may possess.

While Australian airports typically under recover on the costs of aeronautical assets, it was neither practicable nor feasible to attempt to unwind this pricing distortion prior to privatisation – which in itself was intended to accelerate the pace of micro economic reform in the aviation industry. Importantly, in choosing to privatise the operations of the major airports, the Government was seeking to improve the efficiency and flexibility in the way airports were being managed and operated.

To ensure that some of the efficiency gains available would be shared with airport users, the prices oversight framework to apply for the first five years provided for a CPI-X price cap on 'aeronautical services' at major airports. The framework also provided flexibility for airport operators to introduce new charges and restructure charges within the overall cap and scope to cover costs and earn a commercially sustainable rate of return on necessary new investment under aeronautical price increases outside of the cap. These were intended to be transitional arrangements as airport operators and airport users (particularly the airlines) established a more commercial working relationship in an environment where the parties would negotiate directly and resolve prices rather than rely on arbitration (by the ACCC) or regulatory control.

The experience with the administration of the prices oversight regime, however, suggests that the parties (and notably the airlines) have not been prepared to negotiate commercially – instead continuing to rely on arbitration under regulation. This is seen to be partly attributable to the existence of the price cap arrangements which have acted as a strong incentive for stakeholders to dispute and adopt regulatory gaming tactics on any new pricing proposals or price increases put forward by airport operators to obtain commercial advantage. Evidence to date suggests that this has been at the cost of economic and dynamic efficiency in airport operations.

It has also been partly attributable to the statutory and administrative arrangements underpinning the prices oversight framework which are not suitably structured for delivering on the intended

policy outcomes in a satisfactory way. It is our observation that the interaction of the requirements of the *Prices Surveillance Act 1983* and Instruments issued thereunder, has resulted in: an excessive regulatory burden for all parties concerned; a cost plus approach being taken toward the regulation of airports rather than economic efficiency; and disputation over the meaning and purpose of the regulatory instruments and whether they were delivering on the economic policy intent.

Examples used to support these observations include:

- the introduction of fuel throughput levies at Brisbane and Perth airports;
- levies on taxis for the use of infrastructure facilities (such as cab holding ranks); and
- circumstances surrounding the proposed development of the Multi User Integrated Terminal at Adelaide Airport and the Domestic Express Terminal at Melbourne Airport.

Taken together the experience with the administration of the prices oversight arrangements suggests that the regulatory approach adopted is not working as intended and an alternative approach is required to achieve efficient outcomes for air travel.

There is little evidence to support an argument that any of the major airport operators has actually abused any market power they may possess. There is also little evidence to suggest that this is because of the existence of the cap arrangements. 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 to reduce the significant economic distortions being created under the current regulatory regime. Moreover, even in the absence of countervailing power, it is not clear that airport operators have an incentive to abuse any power since it is in the interests of airports to grow airline services and maximise passenger numbers to generate business growth.

It is suggested, therefore, that a higher level view be taken in the regulation of prices for airport services. The preferred model is to encourage a market outcome with commercially negotiated agreements being formed under 'umbrella' regulatory arrangements which could take more the form of prices and services monitoring. Those agreements could include the pricing and coverage of airport services to be charged, the quality of those services and maintenance standards, the conditions of use by airlines of those services, and consultation and arbitration mechanisms.

Experience to date suggests that a regulatory structure that has the regulator continuing to arbitrate for the industry is unlikely to promote an efficient market outcome and is thus to be avoided if possible. In that context the access provisions under the *Trade Practices Act 1974* should not become a default arbitration mechanism to avoid negotiated outcomes. Our recommendation is that the shift in approach should be toward using 'umbrella' type provisions under competition law (eg an extension of the powers within the *Trade Practices Act 1974*) that can be activated when an abuse of power is judged to have occurred. Coupled with that could be strengthened requirements for information reporting to allow more detailed and transparent cost attributions to be made for 'aeronautical services' and meaningful productivity comparisons under benchmarking.

Introduction

1. This submission: examines the context in which major airports in Australia were privatised; outlines the objectives underlying the design of the prices oversight framework to apply for the first five years post privatisation; makes observations on the experience to date on the success of that regime and regulatory supervision in this area; and suggests an approach to future regulatory supervision of airports in pricing and competition policy matters.

2. Over the last two decades, successive Australian (Federal and State) Governments have actively been pursuing microeconomic reform across a number of areas to make the Australian economy more responsive and efficient.

3. In regard to the aviation industry, the micro reform initiatives have included:

(i) Commercialising, corporatising and privatising government businesses to improve the effectiveness and efficiency of service delivery and facilitate a move to service specific charging. For example, this process has been followed in regard to the operation and subsequent sale of the Australian Government (Federal) airports.
(ii) Reducing business regulation to essential elements and disentangling regulatory activities undertaken by Government from non-regulatory elements capable of being provided under contestable conditions with appropriate regulatory safeguards. For example, a new regulatory framework is being developed to facilitate competition in providing control tower and fire fighting and rescue services on airport.
(iii) The Government withdrawing from operating business enterprises where it has been judged that the particular services can equally be provided under private ownership. For example, the Federal Government merged its domestic carrier, Australian Airlines, with Qantas and subsequently privatised that carrier.
(iv) The Government introducing contestability and competition into Australia's domestic and international markets, and liberalising the economic regulation of air services to the greatest extent possible consistent with safety and international obligations and the national interest. For example, Australia now has multiple designation for Australian international carriers and has created a single aviation market with New Zealand (that permits competition on domestic routes).

4. Australia has no legislative restrictions on entry to its domestic market for air services subject to safety, insurance, aviation security etc. requirements being met. The State of New South Wales controls access to its intrastate routes under its own State legislation (*Air Transport Act 1964*), but no other State or Territory imposes such controls.

Airport Infrastructure in Australia – the Historical Context

5. A Government-owned statutory authority, the Federal Airports Corporation (FAC), was established in 1988. It started with 17 airports comprising all the major capital city airports, to which a further 6 were added in 1989 (one later being sold by the FAC).
The majority of other smaller airports in Australia are under local ownership.
Following a scoping study in 1995 into the possible sale of the 22 airports operated by the FAC, the then Government announced its intention to privatise those airports. The sale of the Sydney Basin airports (including Sydney Airport), however, was deferred pending the outcome of an environmental impact study into a second major airport for Sydney.

6. The decision to privatise reflected a number of factors, including:

- On going constraints on Government funding, and the large (sunk) capital investments that could be released for other higher priority expenditure requirements.
- The growing maturity of private financial markets, capable of funding major transport and infrastructure investments.
- The need to improve efficiency and flexibility in the way airports are managed and operated, by introducing new technology and working practices and fostering a commercial culture through privatisation.

7. During 1997 and 1998, long-term leases (50 years with an option to renew for a further 49 years) were sold over seventeen of the FAC operated airports in two phases. The first phase sold leases to Melbourne, Brisbane and Perth airports and the second phase sold leases to a further fourteen airports, comprising:

- 10 regular public transport airports – Adelaide, Alice Springs, Canberra, Coolangatta, Darwin, Hobart, Launceston, Townsville, Mt Isa and Tennant Creek; and
- 4 general aviation aerodromes – Archerfield, Jandakot, Moorabbin, and Parafield (Attachment A refers).

8. The sale of Essendon Airport is now well advanced and the Government announced on 29 March 2001 that Sydney Airport would be sold by trade sale in the second half of this year. The remaining Sydney basin airports (Bankstown, Hoxton Park and Camden) are scheduled to be sold next year.

9. In respect to the privatised airports, only companies that meet strict ownership criteria can own / operate a Federal airport lease. These criteria are that:

- Australians hold a majority (at least 51%) of the paid-up capital, voting power, and rights to distributions of profits and capital of each company holding an airport; and
- an individual airline together with its associates does not hold more than 5% of any interest in an airport company (this maintains competition policy principles by separating ownership of an airport operator from ownership of airlines); and

- an airport company's head office is located in Australia and a majority of its directors are Australian citizens.

10. The sale of leases to the 17 major airports resulted in 11 different consortia, with a spectrum extending from major Australian (eg AMP, Commonwealth Bank) and international firms (eg BAA, Schipol, Manchester, Serco and AGI) operating the larger airports to smaller, locally owned businesses, for smaller regular public transport airports. Local government now operates the majority of general aviation and regional airports in Australia.

11. Permitting a level of foreign ownership and participation in the operation of Australia's major airports not only facilitated access to international capital and expertise but also permitted new and innovative management practices to be brought to bear in the Australian market place. This diversity of experience and managerial practices is today presenting itself in innovative approaches to attracting airline business and hence competition between airports desiring to grow their businesses and operations. That competition is no more evident than in 'benchmark' comparisons now being made on performance in both quality of service and pricing. This was also an important plank in the Government's reform agenda to facilitate a more commercial approach to airport operations.

12. At the leased Federal airports the primary focus of management has been on growing business activities not on service restriction and exploiting any market power. In terms of annual passenger movements, Brisbane expects that by 2005 it will be comparable to Melbourne Airport today and by 2012 it will be of comparable size to Sydney Airport today. Since privatisation airline services at Canberra Airport have grown by 60 per cent and at Perth Airport by 8.0 per cent.

Current Quality of Service Regulations

13. The Australian Airports Association (AAA) has indicated that the QoS performance indicators are what could be regarded as fundamental to understanding an airport's business and accords with what would customarily be expected as part of an operator's information base to run the business effectively. Monitoring of QoS does not, however, allow objective assessments to be made in the short term nor judgements as to the correct or appropriate level of service. An exception is where engineering or other uniform standards can be applied but these latter indicators are more often associated with safety regulations than QoS standards per se. Hence QoS indicators tend to be long run measures that require a uniform base for comparisons. They can and do reflect customer expectations but at present this has been complicated by a poor understanding that many services on airports are in fact provided by airlines (eg domestic terminal facilities of Qantas and Ansett) rather than airport operators themselves.

14. To facilitate the comparison of airport performance in a transparent manner, Part 8 of the *Airports Act 1996* established a broad legal framework for quality of service (QoS) monitoring of the leased Federal airports. Part 8 provides for:

- regulations to be made specifying performance indicators to be used in monitoring and evaluating QoS (section 153);
- the ACCC to have the monitoring function (section 155);
- regulations to be made requiring QoS information to be kept and provided to the ACCC (section 156); and
- the ACCC to publish reports about airport QoS (section157).

15. In December 1997 Regulations were made under Part 8 of the *Airports Act 1996* to put in place a quality of service (QoS) monitoring regime for Melbourne, Brisbane and Perth Airports. Subsequently those Regulations were amended to include Sydney Airport and the eight larger regular public transport airports sold in Phase 2 of the airports sales (Adelaide, Alice Springs, Canberra, Coolangatta, Darwin, Hobart, Launceston, and Townsville).

16. QoS monitoring was not applied to the smaller general aviation airports, principally because those airports were not to be subject to the prices oversight arrangements and the perceived benefits of monitoring were not seen to outweigh the associated regulatory burden. This reflected an important regulatory principle underpinning the administration of the leased Federal airports - that comparable airports be treated consistently and equitably as far as practicable.

17. The QoS monitoring regime is intended to:

- complement the airport prices oversight arrangements (which have been established by Ministerial direction under the *Prices Surveillance Act 1983*) by permitting an objective assessment of whether there has been any offsetting change in QoS as a result of imposing a price cap on aeronautical charges;
- enable an assessment by the Australian Competition and Consumer Commission (ACCC) of an airport operator's market conduct; and
- provide benchmark information on airport service performance.

18. The performance indicators that have been provided for under Part 8 of the *Airports Act 1996* are designed to measure the capacity and utilisation of airport facilities and the adequacy of, and customer satisfaction with, services provided at the airports. Under the pricing framework and associated QoS regulatory regime, the ACCC reports annually on airport operations in the complementary areas of:

- prices monitoring and price cap compliance;
- airport financials (from information supplied by airport operators); and
- QoS.

19. This reporting regime is designed to improve the transparency of airport operations and assists users in assessing airport financial performance and economic efficiency. Making airport operations open to industry and user scrutiny also facilitates and encourages competitive benchmark assessment and weighs against an airport attempting to take advantage of any market power it may possess.

20. A difficulty is that where the regulatory framework creates distortions or disincentives to invest we are likely to see over time a diminution in quality of service as assets are 'sweated' for efficiency improvements. Such 'sweating' may not be readily transparent in the short run. This has been referred to in the submission by Melbourne Airport in citing the example of Perth airport not being able to cost recover a runway overlay on its secondary runway (page 38 of the submission refers) as new investment. While the $2.7 million required by Perth Airport to undertake the overlay was acknowledged by the ACCC to have a 'new investment' component, the Commission was not prepared to accept it all as new investment. Hence the proposed investment was disqualified from being able to be passed through the price cap under the application of the 'necessary new investment' criteria in the pricing policy framework.[(1)] As a result, restrictions have been placed on the use of the runway thereby limiting the capacity of the Airport. The cost of the overlay, if recovered from airlines over the life of the investment (15 years) would have added 9 cents (excluding GST) to the MTOW landing charges (which currently are $4.95 and $2.02 per tonne for domestic airlines and international airlines, respectively). If passed through to passengers the estimated increase in fares would be around 9 cents for a ticket on a B737 service and 12 cents a ticket on a B747 service (assuming a 70 per cent load factor).

21. In the foregoing example, the impact of the regulatory framework has been immediate and tangible – in effect delivering an outcome that would normally be heralded as an abuse of monopoly power, namely a restriction of capacity and deterioration in quality of service. It underscores our basic concern for relying on regulation to achieve economic efficiency - that whatever regulatory system is designed, and no matter to what level of detail or from what basis, distortions of one kind or another inevitably surface and ultimately will impact on airport operations and users. It illustrates quite clearly that second best solutions imposed through economic regulation can and will have perverse and unintended results that cannot be anticipated.

Introducing Competition to Airport Operations

22. Through the sale and legislative processes, the Government's intention was to implement arrangements that would encourage competition between, and on, airports to the greatest extent possible. This reflected the widely accepted basic principle that economic efficiency (and hence social welfare) is maximised under a market situation that displays competitive characteristics (ie where the marginal cost of a service equals the marginal utility derived from that service and a market clearing price is set). Since perfect competition rarely exists in markets, and in the case of airport operations was historically not seen to exist in the provision of certain 'aeronautical

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[(1)] The ACCC interpretation is being disputed by Perth Airport. The November 1996 pricing policy paper states that 'operators need sufficient incentive to invest in new infrastructure, and the ability to meet the costs of 'necessary new investment'. Potentially a runway overlay qualifies as 'necessary new investment' where the view is taken that it is desirable to prolong or protect runway life or it is needed to improve capacity. In fact it could be considered 'new' in the sense that the operators have identified a need for an investment that may not have previously been recognised or where operating conditions are expected to (or have) changed in such a way as to recommend that course (eg the use of heavier aircraft by an airline(s) at an airport). The example illustrates how, notwithstanding best intentions, a disjoint may occur between the policy framework and its implementation.

services', the endeavour was to emulate market forces as best practicable under the regulatory environment and sales structure.

23. To overcome some of these perceived shortcomings, the Government recognised that potential benefits were available from breaking up the network to allow a more focused development of airports under arrangements designed to elicit efficient airport operations. To that end, in the sale process, the Government (inter alia):

- encouraged local participation by the community in which the airport is located (particularly in the case of the airports located outside mainland capital cities);

- ensured the airports remained Australian owned and controlled and a diversity of ownership was achieved through cross ownership limitations between Sydney (Kingsford Smith) Airport and Melbourne, Brisbane and Perth Airports;

- limited vertical integration in airport businesses through limitations on airline ownership in airport operations;

- introduced new airport operators that had the appropriate financial strength and managerial capabilities to operate and develop the airports over the lease period, consistent with Australia's international obligations and safety and environmental laws; and

- provided for a prices oversight framework designed to facilitate corrections to some of the anomalies apparent under the former 'network based' pricing and investment regime.

24. Under the former network based pricing structure there was little, if any, relationship between the cost of providing aeronautical services and charges being imposed. In general, aeronautical services were strongly cross subsidised from non aeronautical revenues and general aviation airport operations were cross subsidised from major RPT airports. Moreover, the implicit operation of a single till on a network basis did not provide a strong incentive for the then management to focus on the efficiency of individual airport operations or on growing business opportunities by improving airline services (eg flight networks or hubbing arrangements of airlines).

25. The Prices Surveillance Authority had noted in 1993 that 'cross subsidisation of aeronautical services is generally undesirable on both efficiency and equity grounds'[(2)]. Consistent with international experience, however, Australian airports typically under recover on the costs of aeronautical assets and cross subsidise those investments from revenues from non-aeronautical assets.[(3)] It was, however, neither practicable nor feasible to attempt to unwind these distortions prior to privatisation – which was intended to accelerate the micro economic reform in the aviation industry. Hence an important feature in the sales process was a requirement that the efficiency gains potentially available at the major RPT airports be shared with airport users. In

[(2)] Page 70 PSA Inquiry into Aeronautical and Non-Aeronautical Charges of the Federal Airports Corporation, 1993.

[(3)] At Canberra, Melbourne and Sydney Airports, for example, returns on aeronautical assets are currently -0.4 per cent, 2.8 per cent and 0.7 per cent, respectively.

effect, the Commonwealth chose to forego value in the sale by requiring real price declines in aeronautical charges. The prices oversight framework, and in particular the application of a CPI-X cap, was the vehicle used to deliver these short term gains to aviation users.

26. Since little or no gains were immediately apparent from the operations of smaller general aviation airports, these airports were excluded from prices surveillance and monitoring arrangements.

Nature of Prices Oversight Operational Framework

27. Prices surveillance is currently applied to:

- aeronautical services of the larger leased airports - Adelaide, Alice Springs, Brisbane, Canberra, Coolangatta, Darwin, Hobart, Launceston, Melbourne, Perth, Sydney and Townsville airports; and

- charges made by Airservices Australia for terminal navigation, en-route navigation and rescue and firefighting services.

28. In addition the ACCC is currently required to undertake prices monitoring of all 'aeronautically-related' charges (eg for car parking and check-in counters) at the larger leased airports.

29. Findings from prices surveillance and monitoring of the larger leased airports are presented in regulatory reports also covering financial and quality of service reporting.

30. The pricing framework currently includes a price cap on 'aeronautical services' for larger leased airports. Under the price cap arrangements relevant airport operators must reduce prices for 5 years (following leasing) on charges for 'aeronautical services'. The price cap takes the form of 'CPI - X' where:

- CPI is the Australian consumer price index; and

- the X values were set by the Government (5.5% for Perth , 4.5% for Brisbane and Coolangatta, 4% for Melbourne and Adelaide; 3.0% for Darwin, Hobart and Alice Springs; 2.5% for Launceston; and 1.0% for Canberra and Townsville) based on expected productivity improvements.

31. In giving effect to the price cap arrangements it is less than clear how priority is to be accorded by the Commission between the matters set out in a Ministerial Direction and the functions set out under the *Prices Surveillance Act 1983*

32. Within the overall cap, the airport operator is able to introduce new charges and restructure charges and seek to achieve higher profit levels through productivity gains and cost reductions. Price cap compliance is calculated on a revenue weighted average price basis. Under this approach, increases in particular charges are weighted by that component's proportion of revenue

for the previous period. Charges for new or varied aeronautical services are also factored into the price cap arrangements and the weighting given to the particular component is derived by determining the share of the expected revenues to the total of all aeronautical revenues.

33. The price cap formed part of a broader prices oversight framework which was intended to improve the efficiency and flexibility in the way the airports were being managed and to provide:

- a period of assured price stability for the aviation industry in the transition period to the new airport operating environment;
- scope for airport operators to rebalance aeronautical charges within the price cap;
- airport operators with sufficient incentive to invest in new infrastructure;
- encouragement to airport operators and their customers to negotiate directly on infrastructure provision, service standards and requirements and charges; and
- a sharing of potential productivity gains with airport users and ultimately the consumers of aviation services.

34. Under the framework, the Government indicated that airport operators 'have scope to cover costs and earn a commercially sustainable rate of return on new investment'. It was intended that expenditure on capital investment would be negotiated between airports and airlines, and either be:

- accepted by both sides as essential and on-going and funded accordingly out of continuing revenue streams; or
- new and necessary and thus negotiable as to additional revenue that would be required.

35. Hence where new investment related to 'aeronautical services' and it gained the support of airport users with a significant interest in the investment, the logic of the pricing policy was that the ACCC would approve an appropriate aeronautical price increase outside of the cap. The support of airport users for an investment was not, however, seen to be a necessary or essential condition for obtaining ACCC approval to an aeronautical price increase - it being only one of a number of criteria to be taken into account in the assessment process. Importantly it was designed to facilitate airport infrastructure improvements that would overcome some of the anti competitive or inefficient features present under the existing airport operations – such as common use infrastructure developments.

36. The development of common use infrastructure on airports has been recognised for some time as efficient in that it not only facilitates competition and access by new airline entrants and supporting operators[4] but also enables better airport management of airline demand peaks and incremental growth. A recent report by the US Federal Aviation Administration has identified common use infrastructure as being important to mitigating the anti competitive effects of

[4] In facilitating greater competition at Australian airports in ground handling, for example, some airports will have to undertake infrastructure improvements in the future such as constructing common user by-pass facilities to allow cargo transfer between airside and land side by off-airport cargo operators.

dedicated terminal operations.[5] The failure of Compass Mk 1 and 2 had been widely attributed to their inability to secure adequate facilities at airports on a reasonable commercial basis.

37. The operation of the domestic terminal leases, and more recently the weighting given by the ACCC to the 'user support' criterion under the new investment assessment guidelines, appears to have empowered the commercial position of incumbent domestic carriers in a way that can potentially frustrate the entry of new airlines.

Approach of ACCC to Prices Surveillance

38. The Commission's task, in exercising its powers under section 22 of the *Prices Surveillance Act 1983*, is to determine whether prices proposed by an airport are appropriate, and if not whether specified lower prices would be appropriate.[6] In exercising that discretion the Commission takes into account the matters referred to in section 17(3) of the *Prices Surveillance Act 1983* as well as the Directions.

39. In respect of the recent draft aeronautical pricing proposal by Sydney Airport, the Commission considered that the following criteria were particularly relevant in evaluating SACL's proposal:

> 17(3)(a) the need to maintain investment and employment, including the influence of profitability on investment and employment;
>
> 17(3)(b) the need to discourage a person who is in a position substantially to influence a market for goods and services from taking advantage of that power in setting prices.

40. Moreover, the Unit Cost Direction. [7] to the Commission directs the Commission, in exercising its powers and performing its functions under the *Prices Surveillance Act 1983*, to give special consideration, in addition to the matters set out in section 17 (3), to:

> the Government's policy of generally not supporting price increases in excess of movements in unit costs.

41. The Commission concluded in its final decision on Sydney Airport's draft aeronautical pricing proposal that that it would not object to the use of a building block approach to assess the pricing proposal. It also noted that, in assessing price notifications, the criteria set out in section 17(3)(a) and (b) are best assessed by an examination of:

- the efficiency of the cost base that the declared company is working from to earn a return; and
- the reasonableness of the rate of return that the declared company is seeking.

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[5] In facilitating greater competition at Australian airports in ground handling, for example, some airports will have to undertake infrastructure improvements in the future such as constructing common user by-pass facilities to allow cargo transfer between airside and land side by off-airport cargo operators.
[6] Page 40 ACCC draft decision on Sydney Airport draft aeronautical pricing proposal, February 2001.
[7] Direction by the Treasurer to the Prices Surveillance Authority dated 15 October 1985.

42. In effect that required a detailed assessment of SACL's cost base, including asset values and depreciation. But this also implies rate of return regulation that, in itself, can be a very intrusive, time consuming and burdensome process for all involved.[8] It is also likely to suffer from a tendency to form views as to what may be 'fair' with reference to an appropriate return rather than on what actually reflects an efficient outcome. This has been compounded by the Commission being bound to operate in accordance with its legislative regime - under which it has not proved possible, for administrative and other reasons, to issue instruments that effectively allow implementation of the policy intentions of the prices oversight framework.[9]

Experience from Operating Under the Prices Oversight Framework

43. As noted above, and amongst other things, the pricing policy framework was intended to encourage a more commercial culture in the way in which airports and their customers operate – and in particular to negotiate directly and resolve prices rather than rely on arbitration (by the ACCC) or regulatory control.

44. The experience with the administration of the prices oversight regime, however, suggests that the parties have not always been prepared to adapt to the new arrangements and negotiate commercially – instead relying on arbitration by regulation. This may be partly attributable to the existence of the price cap arrangements which have acted as a strong incentive for stakeholders to adopt regulatory gaming tactics on any new pricing proposals or price increases put forward by airport operators. That gaming has resulted in disputation over whether investments can be characterised as 'necessary' and 'new' and what expenditures fall within the cap arrangements as well as lengthy debate on the facts and merits of underlying financial analysis. Inevitably that has delayed investment and created significant regulatory burdens with an asymmetry in the incentives on the parties to negotiate an outcome that is particularly in favour of the airlines to delay any aeronautical price changes.[10]

45. Regrettably the tendency to adopt gaming tactics with the ACCC in the pursuit of commercial advantage has been at the cost of economic and dynamic efficiency. It has also reinforced the 'cost plus' approach to regulation of the airports and a very intrusive and heavy regulatory burden for all involved. The airport operators have been very concerned at this development and have expressed concern for the way the framework has been administered.

46. In summary their concerns have centred on:

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[8] It took 14 months for the ACCC to process the SACL draft aeronautical pricing proposal (submitted in December 1999) and SACL spent around 15 months preparing it (from September 1998). In its entirety, the direct cost of this process is understood to have been in excess of $3m. For every twelve month delay SACL has potentially foregone over $70m in additional revenues (on a fee structure as outlined in the ACCC's draft report).

[9] ACCC letter to the Department of Transport and Regional Services 22 April 1999.

[10] This is not to suggest that these matters cannot be resolved through commercial negotiation. Brisbane Airport has, for example, formed a Project Control Group to consult with stakeholders and oversee proposed new developments. This has led to new investment proposals and related aeronautical price adjustments receiving endorsement from major airport users.

- the complexity and contentious nature of the assessment process (particularly for how the ACCC determines what constitutes 'new investment' and therefore qualifies to be passed through the price cap) and the level of regulatory burden this is imposing on industry;
- the unintended capture of some services within the CPI-X cap (namely, ground facility fees and airport charges for taxis using special facilities); and
- the Commission implying abuses of power by airports when the outcome has been commercially negotiated and arbitrated under contract entitlements.

47. The experience to date suggests that, notwithstanding the best policy intentions, the statutory and administrative arrangements for the prices oversight framework have not been able to deliver on intended outcomes in a satisfactory way. It is our observation that, unfortunately, the interaction of the requirements of the *Prices Surveillance Act 1983* and Instruments issued thereunder, has resulted in:

(a) an excessive regulatory burden for all parties concerned and effectively led to a cost plus approach being taken toward the regulation of airports rather than economic efficiency (notwithstanding a recognised inefficient pricing base inherited by airport operators);
(b) disputation over the meaning of the regulatory instruments and whether they were delivering the underlying economic policy intention;
(c) commercial gaming by the parties under the regulatory framework which can potentially, or does, frustrate the efficient provision of airport infrastructure and create perverse results;
(d) shadow management of Airport businesses by the regulator without appropriate regard to achieving higher order efficiency gains in the aviation market from facilitating structural adjustment and competition in the airline industry.

48. Each of these claims is briefly illustrated below with examples. Taken together, they indicate why price controls should only be used as a 'remedy of last resort'[(11)] and only when an actual abuse of market power occurs (as distinct from having market power). As the Productivity Commission has noted, 'the long run costs of regulatory failure are likely to outweigh the cost of market failure which regulation attempts to correct'.[(12)]

Fuel Throughput Levy

49. The approach to this issue taken by the ACCC illustrates the cost plus approach to administering the prices oversight framework rather than economic efficiency of operations. It also led to disputation over the intent of the regulatory instruments.

50. The Government chose, for the airport lease sale process, to exclude airport refuelling services from the price cap arrangements. That policy approach was confirmed in May 1998 when the Treasurer replaced the original declaration with a new instrument that maintained price monitoring of those services. At the time of providing the relevant Direction to the ACCC, it had

[(11)] Finding 2.2 in draft report of the Productivity Commission on its 'review of the Prices Surveillance Act 1983 (page 31).
[(12)] Finding 3.1 in draft report of the Productivity Commission on its 'review of the Prices Surveillance Act 1983 (page 43).

been indicated that the ACCC could recommend stronger forms of prices oversight if airport operators 'have a consistent track record of abusing their market power'[13]. Following concerns expressed by airlines and oil companies in relation to fuel throughput levies (then) proposed by Brisbane and Perth Airports, the ACCC (under its monitoring role) reported on the proposed fees against the section 17(3) criteria in the *Prices Surveillance Act 1983*.

51. In particular, the ACCC advised that it interpreted the reference to 'abuse of market power' in the 'context of section 17 (3) (b) of the PS Act'[14]. That section requires the Commission to have particular regard to 'the need to discourage a person who is in a position substantially to influence a market for goods or services from taking advantage of that power in setting prices'. In fulfilling this obligation the Commission chose to consider four issues in assessing the proposed fees:

- the extent of the increase in the price of refuelling services and consequent airport profits;
- whether the fees could be justified through increases in costs and/or offsetting reductions in other charges;
- whether the imposition of a levy is an abuse of market power; and
- whether the charges should trigger consideration of stricter forms of prices oversight.

52. The ACCC released its report in December 1998 and concluded that:

- there is a strong case that airport operators 'have market power' in the provision of refuelling services; and
- the price increases by Brisbane and Perth Airports are not justified in terms of increases in costs or through offsetting reductions in other charges; and
- suggested that a stricter form of prices oversight should be considered in relation to aircraft refuelling services – the recommendation being that refuelling services be included in a CPI-X price cap.

53. This report was particularly contentious in that it:

- did not adequately reflect economic efficiency considerations and the depth of analysis and robustness of conclusions drawn and recommendations made were open to being challenged;
- was recommending a result that would potentially have seen commercially negotiated (and arbitrated) outcomes overridden by Government decree (in effect seeking to set aside contract law entitlements); and
- utilised an interpretation of the meaning of section 17 (b) of the *Prices Surveillance Act 1983*, to infer that a revenue cap on airport operators was intended when clearly that was not the case under the (airport specific) prices oversight framework.

Taken together this delivered an outcome to Government that would not only be administratively difficult to reconcile with the policy objectives in privatising the airports but brought into question for the first time whether the airport specific pricing regulatory arrangements would prove to be workable from an economic efficiency perspective. Consideration of this matter has now been subsumed into the broader review of the price regulation of airport services being undertaken by the Productivity Commission.

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[13] Direction No 14 of 22 May 1998 issued by the Treasurer under section 27A of the Prices Surveillance Act 1983.
[14] Page 4, Report by the ACCC on Fuel Throughput Levies, December 1998.

Ground Access Fees

54. This issue has been particularly contentious with airport operators and reflects a disjoint between the policy intentions and delivery of that policy under the regulatory framework.

55. As noted above, the prices oversight regime applying to the major leased Federal airports incorporates a CPI-X price cap on declared 'aeronautical services', prices monitoring of 'aeronautical related services' and quality of service monitoring. The price cap arrangements apply to the provision of aeronautical services, defined as 'aeronautical services, limited to:

(a) aircraft movement facilities and activities; and
(b) passenger processing facilities and activities.

The latter is defined to include 'landside roads and landside lighting'.

56. BACL introduced a $1 ground access fee (ie. a fee for the use of facilities by licensed taxis, limousines, courtesy vehicles and buses to pick up passengers) at Brisbane Airport on 31 August 1998. The fee does not attach to the use of the public roads but rather for the use of taxi ranks when collecting passengers. Westralia Airports Corporation (WAC) introduced a similar fee on 1 January 1999. Canberra and Hobart airports also levy taxis $2 and $1, respectively, on taxis that utilise a parking area prior to accessing the taxi rank. At these latter airports, when the taxi rank is not full, taxis may enter the rank directly without attracting a fee.

57. The ACCC received a number of complaints from taxi owners, bus companies and other commercial vehicle operators to these fees and the Commission has advised airport lessees that they consider they are covered by the price cap as the list of 'aeronautical services' includes 'landside roads'. As such this means that any new service specific fees need to be offset by reductions in 'aeronautical fees' to remain within the price cap and no net gain is achieved by an airport operator to recover the costs of any new investment.

58. The ACCC wrote to the Department in April 1999 expressing a concern that the breadth of services covered by the price cap seemed to be considerably broader than that envisaged in Pricing Policy Paper released in 1996. It was never intended that the group of 'aeronautical services' that would be subject to the cap arrangements would extend to include non aeronautical activities such as car parks and taxi cab holding ranks. These were seen as essentially infrastructure investments that were not considered to directly relate to providing access for passengers to the terminal buildings. Accordingly it was envisaged that cost recovery for these operations could be partly, if not wholly, sourced from 'non aeronautical' sources outside of the application of the price cap.

59. The Department concluded that the Declarations and Directions need to be amended to remove this anomaly to more closely align the Instruments with the original policy intent and to alleviate the practical difficulties that were arising in the administration of the prices oversight framework.

60. In an endeavour to address these matters, the Department (with the assistance of the Australian Government Solicitor) reviewed the Instruments in 1999 to ascertain, and draft, the minimum changes that could be made to correct the shortcomings. The matter has been raised with the Government to consider making interim changes to the Instruments pending the outcome of the Productivity Commission's inquiry.

61. The taxi car park at Melbourne Airport needed to be relocated for a range of reasons, including: airport wide traffic management; operational safety; and relieving congestion as a result of the development of the new domestic express terminal. Melbourne Airport had proposed a fee of $1.40 fee be introduced on taxis that utilise a parking area prior to accessing the taxi rank. The fee was intended to fund a new, larger taxi car park (to be constructed at a more remote site) and to fund improved infrastructure to facilitate traffic flow and relieve vehicle congestion at the Airport.

62. Since recovery of the associated costs of the facilities would effectively be neutralised through the (unintended) application of the CPI-X price cap on aeronautical charges, Melbourne Airport was required to seek approval to the charges under the 'necessary new investment criteria' of the pricing policy framework. The ACCC's decision found that only $0.66 (GST inclusive) of the proposed fee was justified as 'necessary new investment' attributed to the taxi facilities. The decision does not prevent Melbourne Airport from introducing a higher fee but effectively that requires other 'aeronautical' charges to be reduced (under the price cap arrangements) to offset any additional revenues received by the Airport beyond the permitted charge.

63. This illustrates an unintended consequence of the regulatory framework which adds considerable delays and expense to undertaking investment at the airports that is directed to improving operational efficiency. Notwithstanding best intentions, the legal mechanism has proved to be inadequate in delivering the economic policy intentions. The distortion to airport operations and resource allocation continues and, even if it had been remedied through adopting revised instruments, would only provide a partial, short term solution. The conclusion to be drawn is that the existing statutory apparatus is not conducive to promoting the correct incentives for achieving economic efficiency in the longer term.

<u>Regulatory Gaming for Commercial Advantage</u>

64. The current regulatory approach in dealing with applications for price increases to fund new investment is proving burdensome and time consuming, with evidence suggesting that the benefits available are not commensurate with the associated economic and other costs. There is also some evidence to suggest that the regulatory process itself, relying on the use of Declarations and Directions under the *Prices Surveillance Act 1983* to interpret the policy framework, may be giving rise to strategic behaviour by stakeholders in the aviation industry seeking to obtain commercial benefit.

65. Adelaide Airport considers that the existing domestic and international terminals at the Airport have insufficient capacity and amenity to meet customer expectations and standards. To overcome these constraints and provide flow on benefits to the regional economy through

improved infrastructure designed to facilitate tourism, freight and high value adding industrial activity, the Airport designed a Multi User Integrated Terminal (MUIT) facility designed to:

- alleviate prospective congestion by creating apron access and additional terminal capacity;
- remove operating inefficiencies inherent to having split terminal facilities, while continuing to utilise existing infrastructure to the maximum extent possible;
- providing the shortest direct access for aircraft from apron to runway, thus maximising aircraft operational efficiencies; and
- allowing room for expansion and efficient land access to freight handlers.

66. In October 1998, the Airport lodged its initial proposal with the ACCC to pass through the price cap relevant portions of the cost of the MUIT. Under that proposal the Airport sought approval for cost recovery on the basis of a passenger facilitation charge amounting to a one way charge of $6.00 for international passengers, $4.45 for domestic passengers and $1.00 for regional passengers. One year later (October 1999) the Commission released its Decision approving these charges except for domestic passengers – where an amount of $4.09 was stipulated (a $0.36 cent or 9% price reduction).

67. The lynchpin to the MUIT proposal succeeding was the need to obtain the agreement of the two major airlines to surrender their existing Domestic Terminal Leases and to relocate to the MUIT when it was completed. It is understood the two incumbent airlines agreed commercial terms with Adelaide Airport, with the parties signing an MoU in August 1999 that committed them to the new MUIT and to continue negotiations in a timely manner and in good faith, subject to finalising acceptable detailed documentation.

68. With the entry of Virgin Blue at Adelaide Airport towards the second half of 2000, some two or more years after the start of negotiations, Qantas decided to make it a condition of their continuing participation that Virgin also be required to pay the same passenger facilitation charge – no matter where they access the Airport. Virgin were asked to sign a binding agreement to this effect to avoid any possibility that they might seek sometime in the future an access undertaking whereby the ACCC would 'declare' the existing terminal and thus allow Virgin Blue to challenge paying the full passenger facilitation charge.

69. Adelaide Airport had planned for, and originally required, that Virgin occupy the new MUIT but Virgin, when it found itself central to a deal being concluded between the Airport and Qantas, was able to commercially capitalise on this opportunity. In early 2001 Virgin expressed a preference to occupy part of the existing domestic terminal currently occupied by Qantas.

70. In effect the result is that an incumbent stakeholder is seeking to minimise its costs (ie the passenger facilitation charge) and hence strives to ensure that a new entrant does not obtain a potential cost advantage from utilising the regulatory structure (ie access provisions under the *Trade Practices Act 1974* to obtain a discounted passenger facilitation charge). The regulatory structure itself is being used in commercial negotiations to drive commercial outcomes that may result in (possibly unintended) distortions to an efficient outcome. A penalty is that product differentiation and service specific pricing is more difficult to achieve between the airline stakeholders which, in itself, could be seen as an anti competitive outcome.

71. Ultimately the investment initiative has been further delayed and negotiations continue which may require a further submission to the ACCC seeking approval to revised arrangements.

Impeding Efficiency Gains

72. In examining proposals, the way in which criteria are weighted by the Commission potentially can lead to perverse outcomes that have wider efficiency gains available from new infrastructure proposals being compromised from undue weighting given to immediate cost concerns.

73. Under the pricing oversight guidelines issued prior to the sale of leases, the Government clearly stated that airport operators 'have scope to cover costs and earn a commercially sustainable rate of return on new investment'. The provisions were designed to provide, within the context of a price cap applying on aeronautical services, airport operators with sufficient incentive to invest in new infrastructure to facilitate competition and growth in the aviation market. The criteria provided to guide the ACCC in making assessments on new investment proposals make it clear that the weight given to any of the criteria to be used in making a judgement may vary on a case by case basis (Attachment B refers).

74. The Government actively encouraged Melbourne Airport to develop the Domestic Express Terminal (DET) to facilitate the entry of Impulse and Virgin Blue Airlines and greater diversity of services. The Terminal was designed to provide space for five jet aircraft to B737 – 800 size plus two B1900 aircraft.

75. At the time of notifying the Commission of the proposal (May 2000), Melbourne Airport had negotiated a commercial agreement with Impulse for a passenger charge of $1.50 (pre GST). On 27 June 2000, the ACCC released its draft decision with a price of $1.28 (GST inclusive) for the use of the DET. Little weight seems to have been given in the Commission's draft report to this commercial agreement but rather considerable emphasis was given to determining whether the charges were reasonable assuming certain passenger forecast numbers.

76. It was expected that the new services would deliver airfare reductions in the order of around 50 per cent (around $130) to aviation consumers flying Melbourne to Sydney one way. To potentially delay (or at worst frustrate) this important investment initiative on the basis of seeking a passenger charge reduction of $0.37 (from the $1.65 agreed by the parties – GST inclusive) seemed to be ignoring a major consumer welfare gain and efficient outcome being facilitated by the Airport.

77. Moreover, since the ACCC's draft findings were based on contentious assumptions, the making of such a categorical finding was questionable. The assumptions underpinning the Commission's finding included:

- optimistic forecast passenger numbers (for both Impulse and Virgin) despite a very high and real risk that the forecasts would not be achieved over time when there is no certainty that new entrant airline operations will be successful; and

- a lower level of risk being assigned to the project than that judged appropriate by the Board of Melbourne Airport and used to determine the minimum return required to permit the investment to proceed.

78. In effect the ACCC was standing in the place of the Board at Melbourne Airport in making these judgements but was not subject to the same market accountability mechanisms for subsequent performance.[(15)] This appeared to be a potentially serious Type II error in the making[(16)] and, for Melbourne Airport and the Government alike, it was suggesting an undesirable level of regulatory risk was arising in the administration of the prices oversight arrangements. As it transpired, Melbourne Airport successfully negotiated with Virgin Blue a similar arrangement to that concluded with Impulse. In light of this, the Commission found in its final report that 'the commercially negotiated price of $1.65 (GST inclusive)…to be acceptable'.

Conclusions on Experience with the Prices Oversight Framework

79. Taken together, the experience with the administration of the prices oversight arrangements suggests that the regulatory approach it is not working as intended. An alternative approach is required to achieve a better balance between regulatory intervention and achieving efficient and competitive outcomes for air travel through market forces. At present the level of regulatory intervention is excessive and may in fact be counterproductive in that it is providing an incentive for regulatory gaming by stakeholders for commercial advantage rather than allowing market forces to operate and encourage commercial negotiation. There is also considerable evidence growing that the regime is creating disincentives to invest in aeronautical infrastructure and economic efficiency is being adversely affected.

General Regulation or Service Specific Regulation

80. There is little evidence to support an argument that any of the major airport operators has actually abused any market power they may possess. On the other hand, there is growing evidence that the airlines have sufficient countervailing power to warrant a shift in approach to any future regulation. Our recommendation is that the shift should be toward using umbrella type provisions (eg an extension of the powers within the *Trade Practices Act 1974*) that can be activated when an abuse of power is judged to have occurred. To assess that, the regulator could rely on either an active or passive monitoring role for airport operations plus residual powers for the Government to call for an inquiry where evidence suggests that intervention is required.

81. The following fundamental principles are seen to be appropriate in determining the form of any future economic regulation whether it be generic (universal in application such as with the

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[(15)] As it transpired the subsequent withdrawal of Impulse meant that over 60% of the passenger volume intended for the MUDT will now be lost.

[(16)] This is where a price control is applied when it is not beneficial. For more detail on this matter see page 43 of the Draft Report of the Productivity Commission on the Review of the Prices Surveillance Act 1983. The concerns centred on what appeared to be an overly intrusive and legalistic approach by the ACCC which was attracting gaming behaviour by stakeholders that potentially could frustrate a market based outcome.

provisions under Part IV of the *Trade Practices Act 1974*) or industry specific. Income distribution between stakeholders should not be a focus of the regulatory apparatus but this does not deny using the regulatory mechanism in a transparent manner to deliver any Government initiatives directed to influencing the distribution between stakeholders.

Preferably any regulation should be:

- *a remedy of last resort for service specific pricing controls;*
- *focussed, when imposed, on correcting an abuse of monopoly power (rather than potential for abuse) which is likely to result in reducing economic efficiency (cf being concerned with the existence, or distribution, of any rents);*
- *of a nature that encourages commercial solutions generated by industry participants;*
- *credible and sustainable over time;*
- *transparent and predictable - in order to provide a stable basis for industry to plan; and*
- *time specific or independently reviewable following a defined period of application .*

Where is Market Power?

82. The concept of having regulatory arrangements specifically targeting those elements of the airport business where potential for market power was seen to be at its greatest was embedded in the November 1996 policy statement for the review of these arrangements:

> *'The review will be based on the premise that the price cap applied to aeronautical charges during the first five years will no longer operate …(it) will aim to develop arrangements targeted at those charges where the airport operator has most potential to abuse market power. The existing set of aeronautical charges will be examined, on an airport by airport basis, with the review assessing whether services should be added or removed from surveillance'.*[(17)]

83. Since prices oversight, as part of competition policy, should focus primarily on improving economic efficiency it can no longer be assumed, with hindsight, that this is the best approach for achieving an efficient outcome. The Government has acknowledged that prices surveillance should only apply in those markets where competitive pressures are not sufficient to achieve efficient prices[(18)]. But in achieving efficient prices it is not a necessary condition that competitive pressures exist since other factors may come to bear in influencing the market behaviour of a firm - such as countervailing power of buyers, market mechanisms utilised for providing a service, political pressures, threat of regulatory intervention and transactions costs. Rather, prices surveillance (or other regulatory control) should only apply when there is evidence of an abuse of market power.

[(17)] Page 7, Transport and Regional Development – Pricing Policy Paper, November 1996. These terms of reference have been overtaken by the terms of reference for current Productivity Commission Inquiry.

[(18)] Page1, Press release by Treasurer of 19 September 1996 (Treasurer Announces Decisions on Future Prices Surveillance Report Activities.

84. Determining whether there is market power requires, in the first instance, a determination of what the market is for the product or service. On one view, such a determination may not be necessary if the product or service is broadly considered to be, say, 'aeronautical services', and the consumers of those services or the circumstances in which they are provided suggest that commercially negotiated outcomes are possible by virtue of countervailing power.

85. In that context, it is suggested that the majority of RPT - if not all RPT airports – face a measure of countervailing power from the airlines in the market for 'aeronautical services'. The two major airlines and the two alliances possess considerable power by virtue of their dominance of industry. For example, less than 16 % of Melbourne Airport's aeronautical income comes from airlines that are not members of the Star or oneworld alliances and approximately 80 % of its aeronautical revenue comes from four customers[(19)]. At Perth Airport, Qantas and Ansett account for approximately 46 % of aeronautical revenues and the two alliances around 84 % of those revenues**.** Sydney Airport's top 10 aeronautical customers provide 80 % of total aeronautical income and 8 of those 10 customers are in one of two alliances. At smaller airports such as Launceston aeronautical revenue is sourced almost entirely from the two incumbent airline groups.

86. The importance of airline customers to the airports' revenue base and the resourcing differential between the respective companies and bargaining conduct of the airlines would seem to largely balance any monopoly power of the airports. Sydney Airport highlighted this in their submission at the public hearings to the inquiry when it was noted that:[(20)]

> *'One of the courses of conduct open to airlines and which has been used by the airlines to date is to exert commercial pressure on airports to give airlines a particular commercial outcome using litigation.'*

The starkest example of this behaviour is the actions brought against Sydney Airport in the Federal Court by the airlines over SACL's proposed charges.

87. Moreover, the property rights of an airport operator are not clearly defined and this significantly weakens the position of airport operators in negotiations. Since there is no statutory underpinning for charging arrangements, the airports are implicitly relying on contractual arrangements in circumstances where normal commercial remedies are not available. That is, in general an airport operator effectively cannot deny access by RPT operators to the suite of airport services making up 'aeronautical services' and this tends to favour the airline businesses in their negotiations[(21)]. At some RPT airports, market power clearly lies with the airlines since the airport operations would collapse without their custom and airport lessees readily acknowledge this.

[(19)] Melbourne Airport submission to the Productivity Commission Review of Prices Regulation of Airport Services, March 2001, pp 17 and 18.

[(20)]) Productivity Commission 2001 Inquiry into Price Regulation of Airport Services, Transcript of Proceedings, 2 April 2001, p 87.

[(21)] See submissions made by CIA, for example in the public hearings of 4 April 2001 (pp 299 and 300 of Transcript of Proceedings).

88. Even in the absence of countervailing power, it is not clear that airport operators would have an incentive to abuse any power. It is in the interests of airports to grow airline services and maximise passenger numbers through airports as this represents a major source of revenues. Hence in determining charges airport lessees will be cognisant of the prospective impact on demand for air services at the airport and the effect charge increases may have on that.

89. **[Paragraph is confidential]**

90. Another approach is to examine aeronautical charges and services on an airport by airport basis and assess whether services should be added or removed from surveillance. This alternative approach has the disadvantage of requiring 'aeronautical' and other services to be disentangled and for the examination to consider each element for market power.

91. Where a service (or product) is considered to have monopolistic elements, it would be desirable to also examine the context of its provision to establish whether an efficient pricing outcome is being threatened. For example, where services are provided under contract through tender and those services are passed through at cost there may be no need to consider further their inclusion under any arrangements. Attachment C illustrates, by broad sectors, those elements of an airport business that could be seen to have market power.

92. As can be seen from Attachment C, the variety of airport operations and the diversity in delivery mechanisms for those operations recommends against following this route. Potentially it could result in a very intensive regulatory framework and increased probability of regulatory failure in delivering an efficient outcome. A framework that has competitive tendering for airport services, for example, excluded from surveillance may itself result in creating distortions (eg where an airport operator contracts out to avoid regulation rather than provide from in house regardless of cost advantages). Moreover, there is little benefit in imposing such a heavy handed regulatory solution if there is no evidence to suggest that an operator is actually 'abusing' market power.

93. For those reasons it is suggested that a higher level view be taken in the regulation of prices for airport services. The preferred model is to encourage a market outcome with commercially negotiated agreements and any 'umbrella' regulatory arrangement taking more the form of monitoring. Those agreements could include the pricing and coverage of airport services to be charged, the quality of those services and maintenance standards, the conditions of use by airlines of those services, and consultation and arbitration mechanisms.

Form of Regulation and Future Monitoring

94. An important component to any future 'umbrella' regulatory arrangements would be the availability of relevant and comparable indicators across airport operators, including a range of productivity and QoS measures. If benchmark comparisons can more easily be made between airports this will facilitate performance comparisons and highlight those airports that may require closer regulatory scrutiny. Also important is that specific industry information is disclosed on a uniform basis to: facilitate intra and inter airport comparisons of productivity and cost structures; and transparency in financial returns. The intention would be to allow the market to judge efficiency of airport performance through transparency in operations and reporting.

95. Under industry specific regulations airports could be required to provide more detailed and transparent cost attribution to be made for 'aeronautical services' as well as other performance indicators such as return on assets by class of asset. The reporting of this information could be underpinned by the *Airports Act 1996* and supported by improved reporting of QoS indicators. In effect this would be more akin to a monitoring role underpinned by new statutory provisions in the *Trade Practices Act 1974* and industry specific guiding principles as to the interpretation of the term 'abuse of market power'.

96. Overlaid to this monitoring role could be either *passive* or *active* regulatory requirements (also given effect to) through amendments to the *Trade Practices Act 1974*. Experience to date suggests that a regulatory structure that has the regulator continuing to arbitrate for the industry is unlikely to promote an efficient market outcome and is thus to be avoided if possible. In that context the access provisions under the *Trade Practices Act 1974* should not become a default arbitration mechanism to avoid negotiated outcomes.

97. Under an *active* approach, relevant legislation could provide under, say, airport specific regulations, that airport companies were permitted to raise aeronautical prices (for defined services) in accordance with a certain formulae. That formulae may be described in general terms such as price rises no greater than CPI for a basket of services. New investments (described broadly to include additions to the aeronautical capital stock) could be permitted to be funded from a passenger service or facilitation charge collected on tickets under a capped limit which could be modelled on the US passenger facilitation charge arrangements (Attachment D refers). Other proposed charges could be notified for examination on a case by case basis – to be approved by the regulator unless demonstrably an 'abuse' of pricing power (subject to court appeal). This approach would require some strengthening of the section 46 provisions in the *Trade Practices Act 1974* and places the onus on the regulator to prove an 'abuse of power' has taken place.

98. A *passive* approach would not provide for any intervention except when a price change was demonstrably an 'abuse' of pricing market power with the onus of proof placed on the regulator to demonstrate this against a set of (gazetted or statutory) principles that need not necessarily be airport specific. The shift of onus of proof from the airport to the regulator reflects a view that the efficiency costs of failing to invest in airport infrastructure are likely to be larger than the costs of monopoly pricing of the services provided.[(22)] Statutory remedies for an 'abuse'

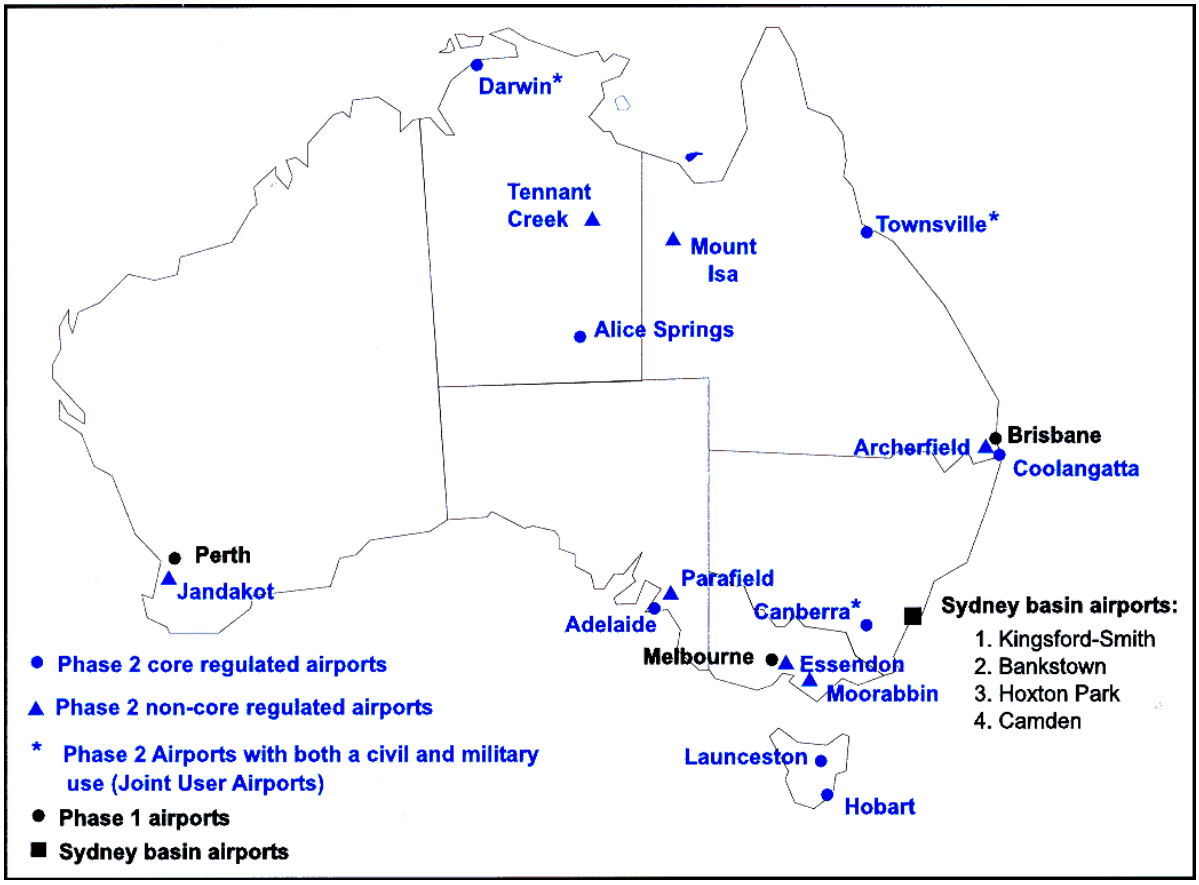
[(22)] Page XII, Productivity Commission Position Paper on 'Review of the National Access Regime', March 2001.

of power would be desirable and consideration could be given to penalties similar in nature to those already provided for under the *Trade Practices Act 1974.* This is the preferred approach for future airport regulation.

99. Whatever regulatory approach is adopted it would be important that it not bias airports toward adopting either a single or dual till approach to airport pricing but rather to adopt efficient pricing principles.

Attachment A

Former Federal Airports Corporation Airports



Attachment B

Assessment of Proposals for Charging Increases Related to Necessary New Investment – Guidelines for the ACCC

These criteria will, where relevant for its purposes, guide the ACCC in its assessment of proposals related to necessary new investment to increase aeronautical charges at a rate in excess of the CPI-X cap:

(a) the operator's plans for new investment or service innovation and the associated costs;

(b) the relationship between the proposed increases in aeronautical charges and the costs (including the level of rate of return) of the new investment or service;

(c) support from airport users with a significant interest in the investment for the operator's proposals, including in relation to charging changes;

(d) contribution of the new investment / service to productivity improvements at the airport;

(e) overall efficiency of the airport's operation;

(f) the particular demand management characteristics of individual airports, including any demand management schemes in place, capacity constraints and any underutilisation of airport infrastructure;

(g) airport performance against quality of service measures, including services under the control of the airport operator;

(h) airport performance *vis a vis* other Australian airports and any comparable international airports; and

(i) the extent to which the proposed investment will facilitate the operations of new entrants to domestic or international aviation.

While the ACCC must take the above into account in deciding whether to approve a proposal to increase charges outside the cap, each proposal will be considered on its merits having regard to the information available to the ACCC. The weight provided by the ACCC to each of the criteria (a) to (i) may vary on a case by case basis.

Consistent with the provisions of the *Prices Surveillance Act 1983*, where the ACCC does not approve a proposal to increase charges outside the price cap, it will provide a statement of reasons for its determination.

Attachment C

Services Provided at Airports

Service Class	Service	Provider	Basis of Provision	Airport Market Power
Airfield				
	Runways	Airport	Charge for use	High
	Taxiways	Airport	Charge for use	High
	Aprons (int'l)	Airport	Charge for use	High
	Aprons (domestic)	Terminal Operator	Charge for use/ lease	Significant
	Aprons (Freight)	Terminal Operator	Charge for use/ lease	Significant
	Aprons (Common use)	Airport	Charge for use	High
	Aprons (GA)	Terminal Operator	Charge for use/ lease	Significant
Terminal				
	Aerobridges	Terminal Operator	Charge for use, may be included in overall terminal charges	Significant
	Concourses	Terminal Operator	Charge for use, may be included in overall terminal charges	Significant
	Baggage systems	Terminal Operator	Charge for use, may be included in overall terminal charges	Significant
	Mandated security	Terminal Operator	Charge for use, may be included in overall terminal charges	Significant
	Amenities	Terminal Operator	Charge for use, may be included in overall terminal charges	Significant
	Seating areas	Terminal Operator	Charge for use, may be included in overall terminal charges	Significant
	Gate lounges	Terminal Operator	Charge for use, may be included in overall terminal charges	Significant
	VIP rooms	Terminal Operator	Free/small charge for use	Low
	Chapel/ Pray Room	Terminal Operator	Free	Low
	Medical centre	Third party	Lease	Low
	CIQ	CIQ Agencies	Departure Tax	Low

Service Class	Service	Provider	Basis of Provision	Airport Market Power
Ground Handling				
	Catering	Airlines/ third parties	Contract/fee for service	Low
	Refuelling	Airlines/ third parties	Contract/fee for service	Low
	Baggage	Airlines/ third parties	Contract/fee for service	Low
	Freight handling	Airlines/ third parties	Contract/fee for service	Low
	Line maintenance	Airlines/ third parties	Contract/fee for service	Low
	Heavy maintenance	Airlines/ third parties	Contract/fee for service	Low
	Towing	Airlines/ third parties	Contract/fee for service	Low
	Cleaning	Airlines/ third parties	Contract/fee for service	Low
Property				
	VIP lounges **CHECK**	Terminal Operator	Lease	Moderate
	Airline and other offices (necessary on-airport)	Terminal Operator	Lease	High
	Fuel sites	Airport	Lease, fuel levy	High
	Airline and other offices (not necessary on-airport)	Terminal Operator / off airport sites	Lease	Low
	Maintenance sites and buildings	Airport/ off airport sites/ other airports	Lease	Low
	Cargo facilities	Airport/ off airport sites/ other airports	Lease	Low
	Hotel sites	Airport/ off airport sites/ other airports	Lease	Low
	Industrial/Commercial Parks	Airport/ off airport sites/ other airports	Lease	Low
	Retail Premises	Terminal Operators	Lease, Concession fee	Low

Service Class	Service	Provider	Basis of Provision	Airport Market Power
Ground transport				
	Public car parks (short and long term)	Airport/third parties	Charge for use	Moderate
	Staff car parking	Airport/third parties/airlines	Annual fee/ self provision	Moderate
	Valet car parking	Airlines/ third parties	Charge for use	Low
	Car rental desks/offices	Airport/other terminal operators	Lease/concession fee	Moderate
	Car rental spaces	Airport	Concession fee	Moderate
	Car rental wash-down/prep etc	Airport/ third parties	Lease/Concession fee	Moderate
	Taxi and hire car services	Third parties	Charge for use	Low
	Taxi and hire car Infrastructure (holding areas/amenities etc)	Airport	Free/charge for use	Moderate
	Public buses	Government and Private operators	Airport access fee in some cases	Moderate
	Private coaches/mini-buses (including courtesy buses)	Multitude of operators	Airport access/parking fee	Moderate
	Train	Third Party	Possible airport easement fee	Moderate
	Public set-down areas	Airport	Free	High

Notes:

Terminal operators include airports and other parties, such as airlines and independent freight terminal operators. An airport does possess market power in providing sites to other terminal operators but once a site is provided, competition between operators is provided.

The principal suppliers of ground handling services in Australia are the two major Australian carriers, Ansett Australia and Qantas Airways. Many airlines make their choice of 'ground handler' for a particular requirement based not so much on price but other factors, such as reciprocity of handling at other locations and/or based on commercial alliances. There is, however, a range of companies at Australian airports that supply the various ground handling services to meet airline requirements should an airline not wish to perform the tasks. The choice is a commercial matter and its impact on airport services depends on the particular arrangements adopted at an airport.

Aircraft refuelling is usually performed by a fuel supplier contracted to the particular airline but utilising a common hydrant facility.

Freight (or cargo) terminal operations may be performed by the same company selected for other ramp handling activities; someone with whom the airline has a commercial alliance; or a separate party entirely who specialises in cargo handling.

Attachment D

Passenger Facilitation Charges - the US Experience

In 1990, the United States Congress removed the statutory prohibition on airports charging a per passenger facilitation fee (PFC). In its place the United States Passenger Facilitation Charges statute and implementing regulations (14 CFR Part 158) were introduced. They require that PFC revenues are used to finance eligible airport-related projects that accomplish one or more of the following objectives[(1)]:

(a) preserve or enhance safety, capacity or security of the national air transportation system;
(b) reduce noise or mitigating noise impacts resulting from an airport that is part of such a system; or
(c) furnish opportunities for enhanced competition between or among air carriers.

In granting airports this authority to impose PFCs (up to $3 per passenger), the legislation required airports to consult with airlines and other airport tenants, but overall 'control' over the imposition and use of PFCs lies primarily with the airport, subject to Federal Aviation Administration (FAA) approval of the application.

The FAA may only deny an airport the authority to impose and use a PFC for a project if one or more of the following conditions applies. The project :

- is not eligible for PFC funding as set forth in statutory and regulatory eligibility criteria;
- does not meet at least one of the above mentioned PFC objectives;
- has not been justified adequately;
- does not conform to other applicable regulatory requirements as references in Part 158 (eg environmental requirements, specified implementation schedules).

Unless the FAA can demonstrate that one of the above conditions for denial exists, it is compelled by statute to approve the particular project for PFC funding within 120 days of receipt of the PFC application.

At the time the legislation was passed, airport 'control' over PFCs was viewed as in the public interest in order to foster competition and ensure longer term investments in airport infrastructure less likely to be supported by airlines (which tend to be driven by shorter term financial considerations).[(2)]

[(1)] FAA/OST Task Force October 1999, Airport business Practices and their impact on airline competition, pp53-54.
[(2)] National Civil Aviation Review Commission, 1997, Airport Development Needs and Financing Options White paper.