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Productivity Commission
Airports Inquiry
LB2, Collins Street east
MELBOURNE VIC 8003

Attention: Ms Michelle Cross

Dear Ms Cross

Productivity Commission inquiry into the Price Regulation of Airport Services

The Department of Industry, Science and Resources would like to provide the following submission to assist with the Commission's inquiry into price regulation of airport services.

We have focussed our comments on the importance of airports to tourism industry growth and to those elements of the Commission's issues paper of relevance to the industry's continued development. The Australian Tourist Commission has also been consulted in the preparation of the submission.

We are happy for the Commission to make this submission publicly available. Thank you for the opportunity to provide comments on this matter.

Yours sincerely

Janet Murphy
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Market Access Group
Sport and Tourism Division

June 2001

SUBMISSION TO THE PRODUCTIVITY COMMISSION INQUIRY INTO THE PRICE REGULATION OF AIRPORT SERVICES

**Sport and Tourism Division
Department of Industry, Science and Resources,
June 2001**

Tourism, Air Services and Airports

Tourism is a key growth industry for Australia and the development of a competitive and sustainable tourism sector is one of the Government's priorities for industry development. According to figures provided by the Tourism Satellite Account, in 1997-98 tourism directly accounted for 4.5 per cent of expenditure on GDP and employment of around 513,000 people. While international tourism is the fastest growing segment of the industry, domestic travel is still the most significant, accounting for nearly 80 per cent of total tourism.

The tourism industry is heavily reliant on efficient airports and competitive air services. Over ninety nine per cent of the approximately 5 million¹ short term visitors to Australia during 2000 travelled by air and entered through the international airports. Domestic tourism is also heavily reliant on airports and according to the Bureau of Tourism Research², 17 per cent of Australian residents who undertook an overnight trip during 2000 used airlines as their main mode of transport.

Airports provide a necessary service for tourists and are increasingly meeting traveller demand for a range of complementary services such as shopping and entertainment. Airports and the services provided at them create first and last impressions of Australia and therefore have an influence on Australia's image as a tourism destination. Indeed they form an integral part of the holiday experience.

What type of tourists are using Australian Airports?

The majority of visitors utilising Australia's major airports are undertaking domestic travel. For the year ended June 1999, domestic and international passengers accounted for 67 per cent and 21 per cent respectively of all passenger movements at Australian airports, with regional passengers accounting for the balance. These ratios vary between airports. For example, at Sydney Airport, 54 per cent of passengers were domestic and 33 per cent international. This compares with Darwin with 75 per cent domestic and 17 per cent international.³

Forecasts for Tourism Growth

International visitor arrivals to Australia have grown at an average annual rate of some 8 per cent over the past decade. This strong growth is expected to continue with the Tourism Forecasting Council predicting an average annual increase in arrivals of 7.8 per cent⁴ over the ten years to 2010, when around double the current number of international tourists will be arriving at Australia's international airports. Infrastructure must be in place to cater for this growth.

¹ 4.946 million.

² Bureau of Tourism Research, *National Visitor Survey*, December 2000

³ AVSTATS, Airport Traffic Data, 1988/89-1998/99

⁴ Tourism Forecasting Council, *Forecast*, February 2001.

The number of Australians travelling by air is also expected to increase with overseas travel forecast to grow at an average annual rate of 4.6 per cent over this same period. There has also been a strong surge in domestic air travel following the entry into the domestic market of Impulse Airlines and Virgin Blue, putting further pressures on airport infrastructure to meet this demand. In January 2001, combined passenger activity on the three major domestic routes⁵ had increased by some 42 per cent in comparison to January 2000⁶. This growth continued in February and March 2001, with increases of 17 and 19 per cent respectively over the corresponding period of 2000.

The provision of adequate airport infrastructure will be a determining factor in whether Australia is able to fully realise expected tourism growth.

Main Issues for Consideration

Airport privatisation has increased the commercial focus and efficiency of airport operations and benefited the tourism industry generally. The price cap and price regulatory arrangements appear to have constrained airport prices below those that would have operated in the absence of prices regulation. This has been of benefit to both airlines and consumers.

Airport market power.

This Department is of the view that airports do have considerable market power, particularly the major city airports. However the degree to which market power exists varies for each individual airport.

Airports which serve large centres such as Sydney have relatively greater market power than airports that serve smaller centres such as Adelaide. Airports which primarily service seasonal tourist destinations such as Cairns and Maroochydore have the least amount of market power. Airlines can more easily reduce services at smaller regional airports but the commercial risks of sacrificing access at major city airports would be much higher. By the same token high airport charges have been raised as a cost impediment for air travel by the regional tourism industry.

The competitive international aviation environment and the more recent increase in domestic competition could be impeded by the extent to which airports are able to extract monopoly rents, which will be passed on to tourists in the form of higher airfares. As infrastructure constraints become more pressing over time, particularly at Sydney, the market power of the airports could be expected to increase relative to airlines and other users.

The countervailing power of the larger airlines would seem to be quite limited at the larger airports which help the airlines service the most lucrative trunk routes. Withdrawal or scaling back, even by a number of airlines acting together, to 'punish' a major airport operator would not be viable given the opportunity this would grant airlines' rivals to increase market share at their expense.

Competition from other international tourist destinations implies that Australian airports are to some extent in competition with overseas airports for air services and international traffic.

It is also important to note that the privatised airports have become closely integrated into the tourist promotion effort of particular States/regions. This has provided a useful impetus including to the marketing efforts of the Australian Tourist Commission. Airports sometimes

⁵ Brisbane-Melbourne, Brisbane-Sydney and Sydney-Melbourne.

⁶ Department of Transport and Regional Services, Domestic Airlines Monthly Activity Report, 23 March 2001.

also offer prospective airlines special deals on landing charges and other incentives in order to attract their business. It is therefore arguable that they have an increased incentive to keep their charges to levels which will not deter airlines and tourists.

Regional Airports

Regional tourist destinations and the associated economies of regions such as Cairns, the Northern Territory and Broome are highly dependent on domestic and international air services. Regional destinations suffer disadvantages in attracting international airlines. They often have an insufficient population base or catchment area to support outbound traffic. Traffic therefore tends to be mainly one directional. They attract a predominance of low yield seasonal leisure traffic making it harder to support year round air services.

In part, the lack of demand for international services to most regional gateways reflects consumer preferences. Most international tourists spend the majority of their trip in the major cities of Australia. In turn, airlines provide services to meet this demand. While tourists do then travel to regions, often through codesharing on domestic airlines, this does not generate the tourism market volume of direct international services from some source countries.

A number of submissions to the PC have been supportive of reducing or removing explicit price regulation of some regional airports. This is largely on the basis that such airports cannot exploit their monopoly power, to the same extent, due the strong countervailing power of the airlines i.e. airlines can resist payment of higher charges or cut or reduce services to such airports. There is also some competition between the airports serving regional tourist destinations and in Tasmania's case inter-modal competition provided by Bass Strait ferries.

However, this may not be a uniform characteristic across airports; especially at the more remote locations. Nor would it be uniform across airlines. Major airlines are increasingly prepared and able to switch aircraft from low to higher yield routes. However, the low margins of budget airlines would imply that their market power in this regard would be more limited. Moreover, the capital intensive nature of airline operations would suggest some degree of 'lock-in' to existing routes.

Landing charges for domestic services at some regional centres are high compared to major gateways. These charges can significantly cut into airline revenue, particularly those of low cost carriers operating with tight profit margins, and act as a deterrent to servicing regional destinations.

Quality of services

Tourists are looking for airports which can deliver efficient passenger processing outcomes; pleasant surroundings, suitable retail shopping opportunities and high standards of safety and security.

The quality of service results recorded at the phase I airports and Sydney and have generally been good. This has benefited Australia's international tourism image. It indicates that under the existing regulatory regime, even in the face of price reductions, service standards do not seem to have been sacrificed by airport operators in order to cut costs.

However, it is notable that in general domestic tourists travelling on budget airfares neither pay for, nor expect, the creature comforts and quality infrastructure and services of international arrivals or those travelling on regular fares.

Domestic and International tourism

Tourists do not travel in order to visit an airport. Tourist utilisation of an airport is a derived demand based on the city, region or tourist attractions which the airport makes more accessible. Choice of airport for most tourists is made on the basis of travel price followed by the proximity of the airport to their ultimate destination and the efficiency of inter-modal transport links.

In tourism terms, Sydney Airport would have the highest level of market power given that it is the port of entry for 49 per cent of international passengers and 56 per cent of tourists include Sydney in their Australian itineraries⁷. It is expected to remain Australia's leading international tourism gateway for the foreseeable future. It is also Australia's most constrained airport in terms of available capacity due to heavy usage during peak periods, land availability, and environmental considerations.

However, decisions about how particular airports are serviced are ultimately made by airlines and include other commercial considerations such as maximising yields across networks; availability of maintenance facilities; fuel etc. Airline hub and spoke networks tend to concentrate international services into the major hubs such as Melbourne, Sydney and Brisbane. Many of Australia's international tourism markets are serviced by airlines through only one or two airports such as Sydney and Melbourne. In this sense, international tourists who wish to visit other Australian cities, have very little choice but to fly via Sydney, Melbourne or Brisbane on a connecting domestic service.

However, airport charges as a proportion of total travel costs are relatively minor for international tourists and therefore airport price increases are unlikely to influence travel decisions except at the margin.

A different situation prevails in relation to domestic travel. Most domestic tourists are travelling in discount fare categories and are sensitive to price changes. Price increases would be expected to impact relatively more heavily on these sectors especially on the new market of 'holiday flyers' generated by the entry of Virgin and Impulse. While in general, most major domestic airports are far apart and not substitutable, in the tourism market travellers will substitute one destination for another (and one transport mode for another) based on package price and travel time. In this sense there is significant competition between holiday destinations such as Broome, Cairns, Coolangatta, Darwin and Hobart.

Market power would seem to be the greatest where demand is the highest and alternative transport modes or arrival points are limited. Airport prices which do not reflect required services/infrastructure provision will adversely effect budget airlines' sustainability.

Tourists are particularly price sensitive users of air transport. However, it is difficult to determine the impact of increases in airfares on tourism to Australia and various studies have estimated a wide range of demand elasticities. Traveller reaction to changes in airfares can vary according to traveller type and market.

A 1995 study by the Bureau of Transport and Communication Economics⁸ confirms that there is a negative relationship between airfares and leisure travel demand. The study also indicates that overall travel to Australia from many tourism markets tends to be inelastic, such that an increase in airfares will result in a less than proportionate decline in travel to Australia. The study found

⁷ Bureau of Tourism Research, *International Visitors in Australia 1999*, August 2000.

⁸ Bureau of Transport and Communications Economics, *Demand elasticities for air travel to and from Australia*, December 1995.

that airfare elasticities for foreign leisure visitors ranged between -0.5 and -1.86 and were lower on short distance routes such as those between Australia and the Asia-Pacific region.

The Price Cap

While the price cap has been effective in keeping down aeronautical costs, many airports have looked instead for alternative sources of revenue, such as through the introduction of fuel through-put levies and ground access fees. Ground access fees directly impact on taxi and hire car access to air port terminals and are generally passed directly on to travellers, including tourists. There is a strong argument that all aeronautical services, including fuel through-put levies and ground access charges, be treated the same under future prices regulations.

The CPI-X price cap formula has provided some degree of certainty and stability during the first few years of airport privatisation. It has provided some practical working guidelines that both airports and the users of airport services have been able to work within. It has also provided an indicator of whether more or less regulation is required in the future. Given its usefulness in this regard, a similar form of cap would be useful at Sydney Airport and on a continuing basis at the other major airports.

Investment

The regulatory framework provides for the pass through of charges to fund 'necessary new investment' outside the CPI-X price cap. Most major airports have added significantly to the stock of quality infrastructure in recent years, and/or have plans for further expansion.

Access to airport infrastructure is critical for new entrant airlines in order that they are placed on a competitive footing with the major incumbent airlines. In the case of Sydney and Melbourne new terminal infrastructure has been built to accommodate new entrants such as Virgin and Impulse. It is important that the regulatory framework facilitates infrastructure development to keep pace with market demand and facilitate the entry of new carriers. This will be particularly important, given the need for adequate transport infrastructure to be in place to facilitate the large forecast increases in inbound tourism.

However, we note that both Impulse and Virgin expressed strong reservations about the electiveness of the current airport regulatory framework in ensuring the development of appropriate common user terminals for new entrants.

Conclusions

It is important to achieve the appropriate balance between protecting the consumer from potential abuses of market power and allowing airports to make commercially driven decisions.

Higher airport charges are ultimately passed on to travellers and, at the margin, may influence the decision to travel. However, it is also important that airports receive a fair return on their capital and be on a sound financial footing to fund infrastructure developments to which the airlines and the travelling public are entitled and expect. Indeed, the regulatory framework must encourage infrastructure provision which can facilitate expected tourism growth over the next decade and beyond.

We believe that airports do have market power in relation to pricing, although the amount of power may vary from airport to airport. For these reasons we believe that some form of prices regulation should continue into the future; particularly for the major privatised city airports. Services included should include all services in which airports have significant market power.

Our preference would be to see a regulatory /pricing framework which:

- encourages airport operators to increase and improve infrastructure as required to meet forecasts for tourism growth and the growing demands and expectations of travellers, whilst maintaining incentives to find efficiency gains;
- is flexible enough to differentiate between each airport's degree of market power, particularly some regional gateways, and past performance in terms of setting prices in consultation with users;
- treats Sydney Airport in a similar fashion to the Phase 1 and Phase 2 airports, including a productivity incentives-based pricing formula;
- allows airports such as Sydney Airport some degree of flexibility in aeronautical pricing, within the overall regulatory framework, so as to achieve greater operational flexibility and efficiencies; and
- considers the special circumstances of new entrant airlines which require timely access to low cost new infrastructure.