

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

May 2001

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Introduction

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

The purpose of the following submission is to examine whether current regulatory arrangements, targeted at those charges for airport services and products where airport has been identified as having most potential to abuse market power, are needed to ensure that the exercise of any such power may be appropriately counteracted.

The approach to this submission is broadly along the lines of the Productivity Commission's Issues Paper¹. First, the markets for various airport services in Tasmania are defined and examined in relation to the degree of competition, substitution and market power, and the extent to which airports are likely to abuse market power in a way that is damaging to economic efficiency. Following, the effects of the current regulatory system on Tasmanian airports are examined. It is suggested in this submission that the case for ongoing airport regulation in Tasmania is currently weak and the negative consequences currently prevail over the positive.

Launceston Airport is managed by the Australia Pacific Airport Corporation (APAC). APAC has a 100% shareholding in Australia Pacific Airports (Launceston) Pty Ltd (APAL) but shares a 90% to 10% equity distribution with Launceston City Council. APAC acquired the lease over Launceston Airport on 29 May 1998 for \$17.1 million. APAC maintains an active interest in further airport acquisitions and service provision where it feels it is able to add value to the businesses concerned. A business overview of the airport is provided in Appendix 1.

Economic concepts of 'market' and 'competition' and 'market power' underlie the operation of the *Trade Practices Act 1974*. The Federal High Court has held that a market is the area of close competition between firms, and if there is no close competition, there is a monopolistic market². Within the bounds of a market there may be substitution between one source of supply and another, in response to changing prices or product specialisation. More specifically, a market can be defined as the field of actual and potential transactions between buyers and sellers amongst whom there can be strong substitution if given a sufficient price incentive³. In other words, if the firm were to 'give less and charge more' would there be, to put the matter colloquially, much of a reaction? As noted by the Commission, 'market power' requires barriers to entry and no close

¹ Productivity Commission (2001).

² Latimer (2001). Classic definition of "market" in trade practices from the QCMA (Queensland Co-operative Milling Association; Re Defiance Holdings Ltd) case. p.593.

³ Latimer (2001).

substitutes available to consumers. Characteristics of the market for airport services that have been identified to provide airports with market power include:

- Economies of scale combined with large lumpy investments that advantage incumbent airports; and
- Limited scope for substitution of destinations and/or travel modes by airline passengers⁴.

With consideration of the underlying concepts of 'market', 'competition' and 'market power', it will be demonstrated that the current regulatory system is not suitable for the Tasmanian airport industry due to the following reasons:

- The market for airline services should be considered as part of a larger market for transport services in Tasmania.
- Within the bounds of the Tasmanian airport market there is competition arising from the fact that there are four main airports in Tasmania all of with significant surplus capacity. No individual airport can effectively use market power arising from economies of scale because of this surplus capacity.
- There are currently inconsistencies regarding airport regulation in Tasmania as only half of the airports are regulated.
- Regulatory intervention through price controls is likely to reduce welfare in the long run due to issues concerning return on investment for airport developments, lengthy approvals for investment submissions, and funding and time for regulatory administration.
- Pricing oversight arrangements do not promote the operation of the airport as an *efficient* and *commercial* a manner as possible.

⁴ Productivity Commission (2001). p.10.

The Tasmanian Operating Environment

Tasmania is an isolated state of Australia with a total population of 473,000 people⁵. According to the Commonwealth Department of Transport and Regional Services, there were a total of 1,648,125 passenger movements in Tasmanian airports in 1998/1999 financial year⁶. The total number of passenger movements and the percentage of market shares by airport from 1990/1991 to 1998/1999 are illustrated in Figure 2 and Figure 3 respectively. As demonstrated by Figure 2, the market share of Launceston airport has decreased by 7% from 1995/1996 to 1998/1999 financial years. This may be explained by various factors, the most significant being the changes Ansett Australia's made to its flight schedule in 1997.

An estimated 542,000 adults visited Tasmania in 1999, of which were mainly domestic travellers (85.5%), and the remaining international travellers (14.5%)⁷. As portrayed by Figure 4, the mix between international and domestic visitors has remained relatively stable from 1995 to 1999. The main purpose of visiting Tasmania in 1999 was for holiday purposes (77.5%), and the remaining was for non-holiday purposes, such as business and conferences (22.5%). In 1999, visitor's expenditure in Tasmania was \$562.9 million, which represents approximately 5% of Tasmania's Gross Domestic Product⁸. Such statistics qualify the importance of the tourism industry to the welfare of the Tasmanian economy.

Tasmania currently has four airports: Hobart, Launceston, Devonport and Burnie. The respective locations of the airports are illustrated in Figure 1. It is important to note that the Hobart and Launceston airports are located within two hours driving distance of one another, a short distance compared to that required to be travelled by passengers accessing other major interstate airports. The Devonport and Burnie Airports are similar distances from the Launceston Airport.

⁵ Australian Bureau of Statistics (2001).

⁶ Air Transport Statistics (1998-1999).

⁷ Tasmanian Visitor Survey Data Card (1999).

⁸ Australian Bureau of Statistics (2001).

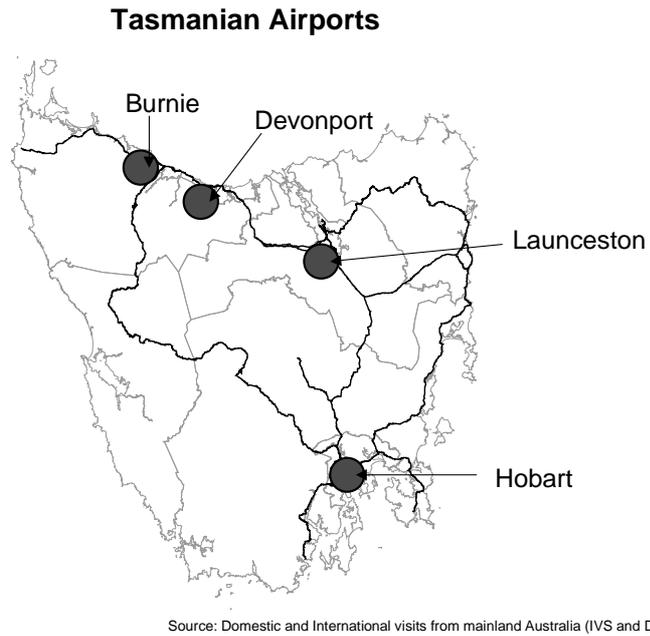


Figure 1: Map of Tasmania including the locations of airports.

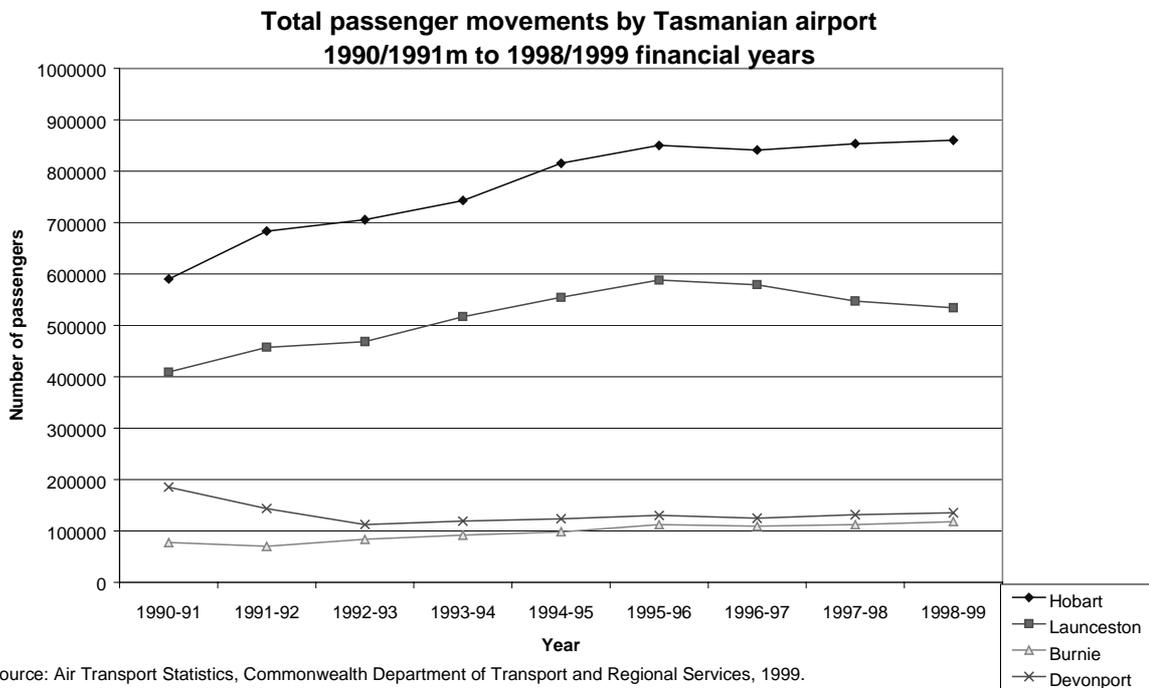
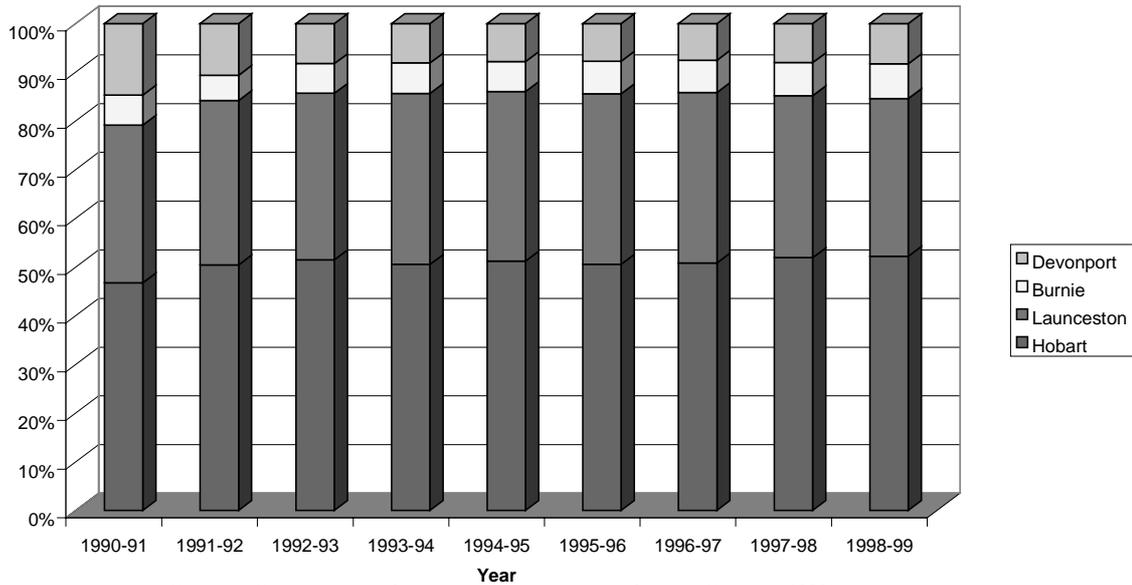


Figure 2: Number of passenger movements segmented by Tasmanian Airport

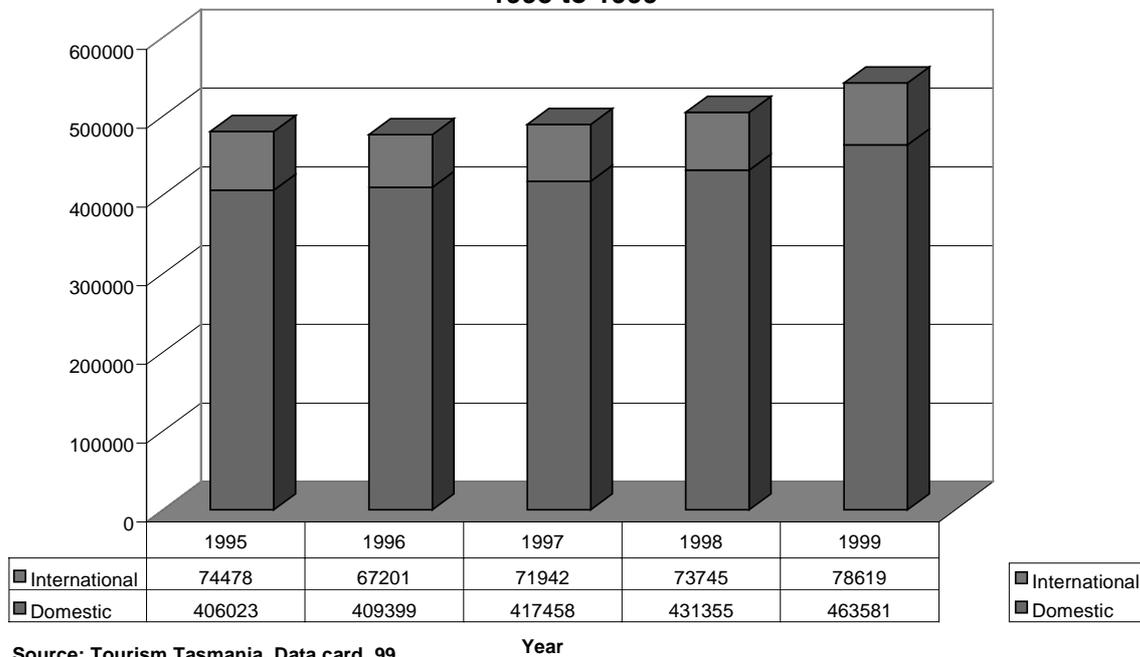
**% of total passenger movements segmented by of Tasmanian airport
1990/1991 to 1998/1999 financial years**



Source: Air Transport Statistics, Commonwealth Department of Transport and Regional Services, 1999.

Figure 3: % of total passenger movement s segmented by Tasmanian airport

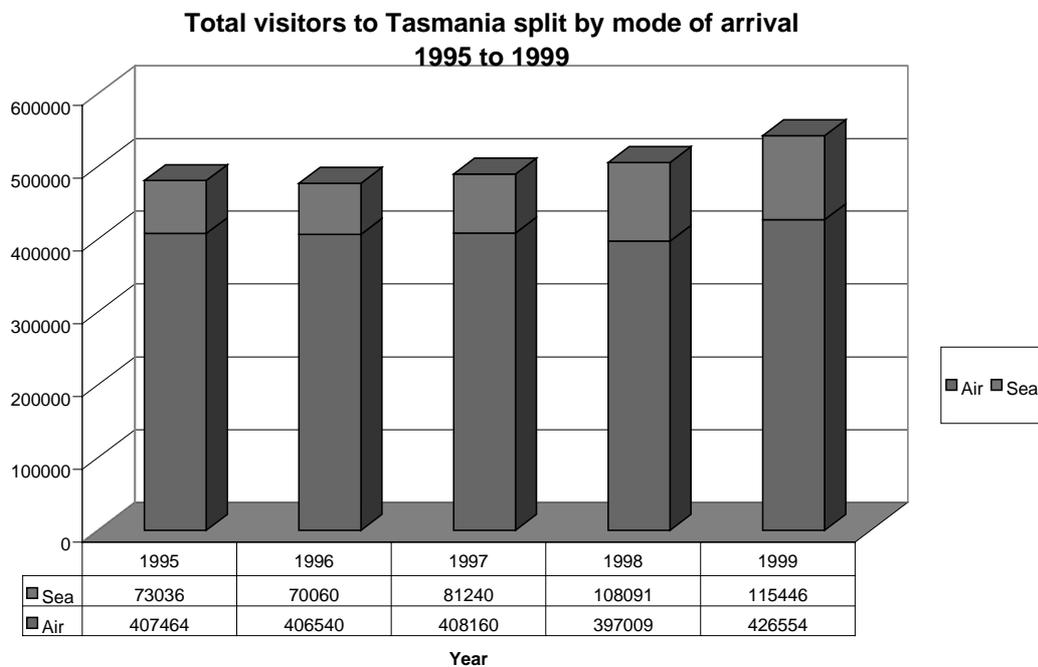
**Number of domestic and international visitors to Tasmania
1995 to 1999**



Source: Tourism Tasmania, Data card, 99

Figure 4: Number of domestic and international visitors arriving to Tasmanian airports

In addition to aviation services, Tasmania is serviced internally by the National Highway network and rail, and externally by sea. The Sea Cat (George Town) and Spirit of Tasmania (Devonport) passenger and vehicle services are augmented by substantial sea freight terminals at Hobart, Bell Bay (Launceston), and at Burnie on the North West Coast. A comparison of the market shares air and sea services have of the visitor market, and their relative growths from 1995 to 1999 are illustrated by Figure 5. In August 1996, the Commonwealth Minister for Transport and Regional Development announced the introduction of the Bass Strait Passenger Vehicle Equalisation Scheme, effective from 1 September 1996. The Scheme provides a rebate against the fare charged by a ferry operator to transport a driver plus passenger vehicle by sea across Bass Strait, and gives effect to the Government’s election commitment to provide a rebate of up to \$300 for a return trip⁹. The reduction in the cost to travel across Bass Strait by sea may have resulted in some consumers switching from air to sea travel.



Source: Tourism Tasmania, Data card, 99

Figure 5: Number of visitors to Tasmania split by mode of arrival.

As demonstrated, Tasmania includes a substantial level of transport services for external and internal markets. As such the market for ‘airport services’ should be defined as part of a greater market, the market for ‘transport services’, when the relative market power, substitution and competition of Tasmanian airports are being considered.

⁹ Tasmania Online (2001).

The nature of competition of transport services in Tasmania.

As previously stated, the Tasmanian airport market has close competition between aviation and other forms of transport services. In addition there is close substitution between airports. This argument may be further supported by the following facts:

1. As a result of the close proximity of the Tasmanian airports (as illustrated by Figure 1), a domestic passenger may land at any of the airports and leave at another. For example, a passenger may arrive in Hobart and hire a vehicle, and depart from Launceston, and leave the hire car at the airport. Fly-drive packages are designed to facilitate this.
2. As noted by the Launceston Chamber of Commerce, airlines are offering deals that make it more attractive in terms of price to fly into Hobart than into Launceston. A Melbourne/Hobart return ticket is \$33.00 cheaper than Melbourne/Launceston. Sydney/Hobart fares is \$44.00 cheaper than Sydney/Launceston¹⁰. Through the Tasmanian Government intervention in bringing Impulse Airlines into Hobart only, the market was redistributed, meaning business that would have come into Launceston was redirected to Hobart. In addition, airlines offer different choices of destinations, operate different size aircraft's and run different numbers of flights to and from Hobart and Launceston. If the gap continues to expand between the two destinations there will be a migration of passengers and services like car rentals away from Launceston. In fact, total revenue into Launceston during April 2000 for the five major car rental hire companies (Avis Budget, Thrifty, Hertz and National) was \$919,000 against \$1.25 million in April the previous year. Revenue through Hobart increased by almost exactly \$315,000 lost out of Launceston¹¹.
3. Air services can be substituted by sea services. The breakdown of the Spirit of Tasmania from July 1999 to September 1999 had a significant impact on the domestic passenger throughput. To be more specific, passenger throughput at Launceston Airport increased by approximately 12% over this period compared to the same time in the previous year¹².
4. Airline passenger traffic moves between airports depending on the marketing and pricing structures and packaging of the destinations and behaviour of the airports themselves. According to the Tasmanian Department of Transport, increased resources for marketing activities and the success of the integrated 'Imagine' campaign have further strengthened Tasmania as the nation's premier touring destination. According to the Tourism Forecasting Council, interstate holiday nights increased by 3.9 per cent nationally over the three years to

¹⁰ Archer (2001).

¹¹ Archer (2001).

¹² Launceston Airport Internal Data Source (2001).

June 1999. In the same time, holiday nights by interstate visitors to Tasmania increased by almost 40 per cent and sales of Tasmania's Temptation Holidays packages to the travel trade reached record levels in 2000¹³.

5. Due to the close proximity of Launceston to Hobart, interstate and domestic producers and manufacturers, and exporters, road freight their goods to Launceston Airport for transshipment by air, due to the cost impact of a 20-minute flight between Hobart and Launceston, compared to road freight costs.
6. Tasmanian airports face strong competition from the subsidised sea passenger and freight transport. For example, as noted by Hobart International Airport, Tasmanian salmon producers use both sea and air transport and it costs approximately \$2 per case less to transport salmon by road sea freight from Hobart to Melbourne, than by air. A further advantage of road-sea freight is that there is a seamless service from the salmon factory at Dover in the South of Tasmania, across Bass Strait, to the markets of South Australia¹⁴.
7. Tasmanian airports are in competition with other Australian travel destinations for business from airlines. Airlines have a certain amount of capacity available and segment this capacity in the most profitable way possible. For example, Launceston Airport recently provided Impulse airlines with a business case of why they should target extra capacity to Launceston instead of the Northern Territory. Working with the State Government, Launceston Airport showed Impulse why they should come to Tasmania including the fact that Tasmania has significant tourism potential and the current airlines are running at full capacity with and Sydney-Tasmania and the Melbourne-Tasmania routes. Reasons why they should come to Launceston Airport rather than Hobart included the fact that approximately 65% of the tourist destinations are in the upper half of Tasmania (Refer to Figure 6).

¹³ Tasmania Online (2001).

¹⁴ Hobart International Airport (2001).

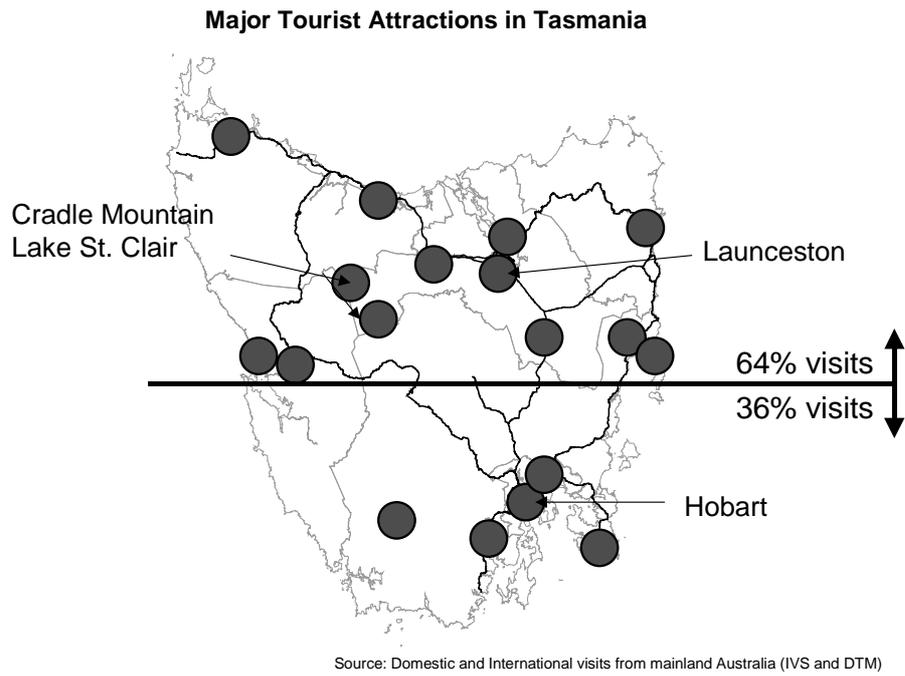


Figure 6: Major tourist attractions in Tasmania

The effects of price regulation.

As noted in the Commission's Issues Paper, the Department of Transport and Regional Development stated in its Pricing Policy Paper:

"Pricing oversight arrangements are intended to promote operation of the airport as an **efficient** and **commercial** a manner as possible...The arrangements should also aim to protect airport users from any potential abuse of market power by airport operators. Market power stems from the fact that airports have natural monopoly characteristics (DTRD 1996, p.1)"¹⁵.

Although many of the benefits envisaged by the reform of Australia's airports have been delivered, the current pricing oversight arrangements do not promote as efficient and commercial Tasmanian airport businesses as possible. The implications for the current arrangements involve the following key factors:

1. The current arrangements have led to some perverse outcomes, and airports have been involved in a process of almost continuous activity and contest with regulators and airlines about the regulatory system should work. Consequently, this has generated uncertainty among those involved, leading to adverse effects on investment and other business decisions. It has hindered rather than facilitated commercial negotiations. In particular, it has made Tasmanian airports 'risk averse' when assessing investment opportunities. Such risk aversion may stifle innovation and progress within Tasmanian airports rather than encourage it.
2. The operating costs of Airport Operator Companies (AOC) are generally fixed. However, they have no or little ability to guarantee existing aeronautical revenues. The major domestic passenger and freight companies unilaterally determine the degree to which they utilise airport facilities. Schedules are frequently cancelled or aircraft type changed, which can have a significant impact on airport revenues.
3. Price regulation has impeded rather than facilitated competition. To elaborate, where airports would have normally invested in new facilities in order to attract new airlines or new services from incumbent airlines, they are not prepared to do so prior to necessary new investment decisions from the ACCC, due to the high level of regulatory uncertainty surrounding these processes.

¹⁵ Productivity Commission (2001). p.16.

4. Launceston airport's return on assets for the aeronautical business was 2.4% for the 1998/1999 financial year and 3.9% for the 1999/2000 financial year, which are very low for a commercial business¹⁶. It is important to mention that an adequate return on assets in a business is assessed with consideration of the relative risk of a business. Therefore the higher the risk, the more return is expected to justify the risk. Airport businesses are extremely dependent on airlines, passenger volume, the tourism industry and the domestic economy for returns so they are to a certain degree a risky investment. The low returns obtained from the aeronautical business are inappropriate for the level of risk Launceston airport endures in the operation of the business.
5. As quoted from the Productivity Commissions Issues Paper, "price caps can provide an incentive for the regulated airports to decrease costs and improve productivity"¹⁷. While this statement may be true in some aspects, it is important to mention that bestowing sufficient returns to shareholders provides a more than adequate incentive to decrease costs and improve productivity, and therefore such an argument in support of a price cap is relatively weak. Mobile investment capital and active shareholders are a far greater force for cost efficiency.
6. There are inconsistencies with the regulation of Tasmanian airports as Devonport and Burnie airports are unregulated and do not have the same Air Services Australia fees. The fact that Devonport and Burnie airports are effectively run while being un-regulated provides further evidence that successful non-regulated airports can be achieved in the Tasmanian environment.
7. If regulation of airport services were removed, it would be reasonable to suggest that the threat of re-regulation would be a form of regulation. In addition, the threat of breaching the *Trade Practices Act 1974*, would be a sufficient form of regulation for Tasmanian airport services. Rather than adopting a 'guilty until proven innocent' approach to airport services, a more efficient approach of 'innocent until proven guilty' is required, which is more consistent with the general principles of Australian Trade Practices Law.
8. The current regulatory system provides a barrier to commercial relationships with airlines. Airlines lack incentive to negotiate with airports on commercial decision making as they feel a better result is achievable from the regulator, or by using the ACCC's processes they can delay and frustrate processes beneficial to their competitors and airports. Airlines have been using the procedural aspects of the necessary new investment provisions as their primary means by which to undertake regulatory gaming and therefore stifle new investment activity at

¹⁶ Return on assets is defined as EBITA/Total fixed Assets.

¹⁷ Productivity Commission (2001). p.16.

airports. Removal of regulation would help prevent such complications and force airlines and airports to negotiate on commercial matters.

9. Launceston Airport successfully negotiated a \$2 million non-aeronautical investment decision with Southern Airlines in 2000. This provides evidence that it is possible to accomplish commercial and mutually beneficial decision making between airports and its customers without regulation.
10. Airlines have significant market power when dealing with airports, and especially small airports due to the higher degree of dependence on domestic airlines. An example of how airlines have used their countervailing power to influence commercial decision making in their favour involves the fact that one of the major airlines threatened to withdraw services to Tasmania if the airports encouraged Impulse to enter Tasmania.
11. The Productivity Commission, in its issues paper proposed the following question:
“Has current price regulation protected against discrimination in relation to small users and new entrants?”¹⁸

The response to this question is no. Small users are currently not protected with the current pricing regulation. Launceston Airport is a privately owned organisation and small users and new entrants, like the larger users, require a sufficient business case for the airport to agree to invest in new infrastructure. In addition, airports can currently structure pricing within the price cap that can discriminate against the small airlines, however, have not done so in the past, as there is little commercial incentive to do so. Furthermore, if airports were to conduct such discrimination, they would be most likely be in breach of the section 51AA of the *Trade Practices Act 1974*, ‘Unconscionable Conduct’¹⁹.

¹⁸ Productivity Commission (2001). p.20.

¹⁹ Latimer (2001). p. 357.

Conclusion

As demonstrated by this submission, current regulatory arrangements, targeted at those charges for airport services and products where airport has been identified as having most potential to abuse market power, are not needed to ensure that the exercise of any such power may be appropriately counteracted in Tasmania.

Tasmanian airports are in a unique situation in comparison with other airports, which should be considered when assessing the current regulatory system. To elaborate, not only are Tasmanian airports small and sparse of resources to administer such an arduous regulatory framework, they face significant competitive pressures from other airports and other forms of transport services. It would not be in Tasmanian Airport's interests to increase prices by substantial margins, as they risk losing customers to competitors.

Government arrangements with respect to protecting the abuse of market power should not be based on theoretical potential, as is currently the case, but should be based on evidence of actual abuse. We believe that the threat of re-regulation and the *Trade Practices Act 1974*, are more than sufficient to restrain any abuse of market power. The current regulation is intrusive, excessive, encourages gaming and stifles innovation and progress in the Tasmanian airport and tourism industries.

The current regulatory system results in the returns to the airport of productivity enhancing investments and other improvements in operations to be confiscated so that in the long run, incentives to improve efficiency are undermined. The longer-term efficient use of Tasmanian airports is critically dependent on allowing them the flexibility to structure aeronautical pricing arrangements to drive potential efficiency gains. Removal of regulation would allow airports to get on with dealing with customers, encourage innovation and improve services across the airport market. Government should be working with airports, airlines and tourism to facilitate growth and competition in the Tasmanian economy.

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Appendix 1: Business Overview of Launceston Airport

Ownership

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

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

Launceston Airport is managed by the Australia Pacific Airport Corporation (APAC). APAC has a 100% shareholding in Australia Pacific Airports (Launceston) Pty Ltd (APAL) but shares a 90% to 10% equity distribution with Launceston City Council. APAC acquired the lease over Launceston Airport on 29 May 1998 for \$17.1 million. APAC maintains an active interest in further airport acquisitions and service provision where it feels it is able to add value to the businesses concerned.

Launceston Airport enjoys the benefits of having sound infrastructure, loyal market base and a low staff to operating costs ratio. The 1999/2000 financial year saw a positive passenger growth. Following three years of the passenger base being eroded slightly by the subsidised Bass Strait ferry services, Launceston Airport has reversed this trend. New scheduling and aircraft introduced by Kendell Airlines (Ansett) and Southern Australia Airlines (Qantas) increased flight frequencies and total available seats. And customers responded with a 4% increase in passenger numbers. Launceston Airport continues to work closely with 'Tasmanian Government Tourism' and 'Gateway Tasmania' to develop marketing strategies and initiatives to grow the business.

The importance of airports to the people of the Island State cannot be underestimated. Launceston Airport is more than a facility for aircraft; it alone provides a fast and vital link to the Australian mainland and the world. Launceston is the base for the Flying Doctor service and is the hub for King Island and Flinders Island flights. Hence it has a larger place in the heart of the local community.

Operating profit

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

Revenue

Launceston Airport's revenue in 1999/00 was \$4.44 million, up 6.7% from the previous year.

Aeronautical income in 1999/2000 was \$1.53m, an increase of 5.9% on the previous year.

Non-aeronautical income in 1999/2000 was \$2.91m, an increase of 4.4% on the previous year.

**Launceston Airport Financial Performance
\$ Million**

	1998/99	1999/2000
Revenue	\$1.44	\$1.53
Operating expenses	(\$1.15)	(\$1.08)
Earnings before interest, tax, depreciation and amortisation	\$0.29	\$0.45
Depreciation	(\$0.53)	(\$0.53)
Earnings before interest and tax	(\$0.24)	\$(0.08)
Fixed Assets	\$11.90	\$11.40
Return on Assets	2.42%	3.90%

Aeronautical Business

	1998/99	1999/2000
Revenue	\$2.72	\$2.91
Operating expenses	(\$1.23)	(\$1.30)
Earnings before interest, tax, depreciation and amortisation	\$1.48	\$1.61
Depreciation	(\$0.25)	(\$0.36)
Earnings before interest and tax	(\$1.24)	\$(1.25)
Fixed Assets	\$6.76	\$6.49
Return on Assets	22.00%	24.80%

Non-aeronautical Business

	1998/99	1999/2000
Revenue	\$4.16	\$4.44
Operating expenses	(\$3.38)	(\$2.29)
Earnings before interest, tax, depreciation and amortisation	\$1.78	\$2.05
Depreciation	(\$0.89)	(\$0.90)
Earnings before interest and tax	\$0.89	\$1.15
Fixed Assets	\$18.66	\$17.90
Return on Assets	9.56%	11.45%

Total Business

Operating Costs

In 1999/2000 Launceston Airport incurred operating expenses of \$3.3 million. Roughly 40% of these were direct wages and salaries for staff and another 20% were accounted for by services and utility costs and property maintenance costs. Depreciation and amortisation charges amounted to \$0.90 million.

The aeronautical business accounts for half these costs although it should be noted that it accounts for only about one-third of the revenue. As would be expected capital charges feature heavily in the cost breakdown of both businesses.

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

	Aeronautical	Non -aeronautical	Total
Salary	33%	41%	37%
Depreciation	33%	15%	24%
Amortisation	0%	7%	3%
Services & Utilities	6%	12%	9%
Maintenance	10%	10%	10%
Other	18%	15%	17%

Cost Structure of Launceston Airport's Business

Assets

Asset Structure

Launceston Airport's assets are valued at \$17.9 million. The following table provides a broad indicative breakdown of asset values by their use.

	Aeronautical (\$m)	Non Aeronautical (\$m)	Total (\$m)
Land	0.8	0.1	0.9
Accum depreciation	(0.6)	(0.8)	(1.4)
Buildings	0.3	3.2	3.5
Land improvement	9.6	0.7	10.3
Intangible assets	0.0	1.7	1.7
Plant and machinery	1.8	1.4	3.2
Other	1.1	0.0	1.1
<i>Total</i>	<i>11.4</i>	<i>6.5</i>	<i>17.9</i>

Indicative Asset Valuation by function as at 30 June 2000

Capital Expenditure

Launceston Airport has spent around \$248,000 on capital projects in 1998/1999 financial year and \$223,590 in the 1999/2000 financial year. Details of the 1999/2000 projects are shown below.

<u>Launceston Airport (\$000)</u>	
Concrete lining for drains	90
Upgrade of terminal entrance	26
Extension of taxiway	25
Spray paint unit	29
<u>Airport Infrastructure Investment: 1999/2000 financial year</u>	

Capacity

The current weekly capacity of flights to Launceston Airport is illustrated in the following table:

	<u>Ansett</u>	<u>Qantas</u>
Sydney-Launceston	350 seats	988 seats
Melbourne- Launceston	2700 seats	2812 seats
Total	3050	3800
% of total	45%	55%
<u>Capacity of seat per week; Launceston Airport</u>		