



Price Regulation of Airport Services

Issues Paper
January 2001

THE ISSUES PAPER

This issues paper is intended to assist individuals and organisations to prepare submissions to the inquiry into price regulation of airport services. It outlines:

- the scope of the inquiry;
- the Commission's procedures; and
- matters about which the Commission is seeking comment and information.

The paper is not intended to limit comment. The Commission wishes to receive information and comment on issues which participants consider relevant to the inquiry's terms of reference.

KEY INQUIRY DATES

Receipt of terms of reference	21 December 2000
Due date for submissions	16 March 2001
First round hearings	March 2001
Draft report	August 2001
Second round hearings	September 2001
Final report	21 December 2001

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HOW TO MAKE A SUBMISSION

Anyone can make a submission. It can be as short as a letter outlining views on a few aspects of the inquiry or a more substantial document canvassing a wide range of issues. Where possible, submissions should contain relevant data and documentation to support the views expressed.

Submissions will become publicly available documents once placed on the Commission's website. This normally will occur shortly after receipt of the submission, unless it is marked confidential or accompanied by a request to delay release for a short period of time. Commercially sensitive information that is not to be made publicly available should be provided under a separate cover and clearly marked **COMMERCIAL IN CONFIDENCE**.

Where possible an **electronic copy** of submissions should be provided either on a 3.5 inch diskette or by email.

TERMS OF REFERENCE

Prices Regulation of Airports

PRODUCTIVITY COMMISSION ACT 1998

I, ROD KEMP, Assistant Treasurer, pursuant to Parts 2 and 3 of the *Productivity Commission Act 1998*, hereby refer Prices Regulation of Airports to the Commission for inquiry and report within 12 months of receipt of this reference. The Commission is to hold hearings for the purpose of the inquiry.

Background

2. During 1997 and 1998, long-term leases (50 years with an option to renew for a further 49 years) were sold over seventeen airports previously operated by the Federal Airports Corporation, to private sector operators. In July 1998 two wholly Australian Government-owned companies were formed to acquire leases over the four Sydney basin airports (Sydney, Bankstown, Camden, Hoxton Park) and Essendon airport.

3. All 22 of the leased airports are regulated under the *Airports Act 1996* and twelve of the airports (Adelaide, Alice Springs, Brisbane, Canberra, Coolangatta, Darwin, Hobart, Launceston, Melbourne, Perth, Sydney and Townsville) are currently subject to prices regulation under the *Prices Surveillance Act 1983*.

4. Except for Sydney Airport, the prices regulation of the airports comprises a CPI-X price cap on declared aeronautical services, prices monitoring of aeronautical related services, and special provisions for necessary new investment at airports. At Sydney Airport aeronautical services are subject to prices surveillance and aeronautical related services are subject to price monitoring. The arrangements are administered by the Australian Competition and Consumer Commission.

5. In establishing the current prices regulations in 1997, the Government announced that the arrangements would only apply for the first five years of operation of the lease. Subsequent regulation would be determined after a review of the arrangements before the end of the first five year period, with the review to be based on the premise that the price caps applied to aeronautical services will no longer operate.

6. The purpose of this inquiry is to examine whether new regulatory arrangements, targeted at those charges for airport services or products where the airport operator 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.

Scope of Inquiry

7. The Commission is to report on whether there is a need for prices regulation of airports, and the appropriate form of any prices regulation, taking into account the following principles:

- (a) the CPI-X price cap applied to aeronautical charges during the first five year period of private ownership will no longer operate;

- (b) future prices regulation should be applied to those aeronautical services and those airports where airport operators have most potential to abuse market power;
- (c) airport operators may propose to the inquiry alternative approaches to prices regulation which would provide equal or better protection to users;
- (d) prices regulation should minimise compliance costs on airport operators and the Government;
- (e) prices regulation should promote the efficient operation of airports;
- (f) prices regulation should facilitate benchmarking comparisons between airports, competition in the provision of services within airports (especially protecting against discrimination in relation to small users and new entrants), and commercially negotiated outcomes in airport operations; and
- (g) the Commission may recommend more effective forms of prices regulation than are currently in place, where this may be necessary.

8. In making its recommendations, the Commission is to:

- (a) review the operation of the existing prices regulation of airports;
- (b) identify the rationale for any future prices regulation at airports;
- (c) identify relevant alternatives to the current arrangements, including the prices oversight arrangements at relevant airports in other countries, and the extent to which these alternatives would achieve the rationale in (b);
- (d) analyse and, as far as practical, quantify the benefits, costs and economic and distributional impacts of the current arrangements and the alternatives identified in (c);
- (e) identify the different groups, including the travelling public, likely to be affected by the current prices oversight arrangements and the alternatives identified in (c); and
- (f) list the individuals and groups consulted during the review and outline their views.

9. In undertaking the review, the Commission is to advertise nationally, consult with key interest groups and affected parties, and produce a report.

10. The Government will consider the Commission's recommendations, and the Government's response will be announced as soon as possible after the receipt of the Commission's report.

ROD KEMP

21 December 2000

1 About this inquiry

The Assistant Treasurer has asked the Productivity Commission to undertake a review of price regulation of airport services and to report within twelve months, that is, by 21 December 2001.

The Commission is asked to report on whether there is a need for price regulation of airport services and, if so, its appropriate form. The Commission is to take into account several principles, including that the CPI-X price cap applied to aeronautical charges during the first five-year period of private operation will no longer operate. Other principles include that prices regulation should:

- be applied to those aeronautical services and to those airports where airport operators have most potential to abuse market power;
- minimise compliance costs on airport operators and the Government;
- promote the efficient operation of airports; and
- facilitate benchmarking comparisons between airports, competition in the provision of services within airports, and commercially negotiated outcomes in airport operations.

As well as considering the need for future regulation of airport charges, the Commission is asked to review the operation of existing price regulation of airport services. The terms of reference are reprinted in full at the beginning of this paper.

1.1 Background to the inquiry

In 1997, the Commonwealth Government commenced the sale of leases to airports previously operated by the Federal Airports Corporation (FAC). Under the privatisation program, long-term leases (50 years with an option to renew for a further 49 years) for 17 of the 22 airports operated by the FAC were sold to private operators.

Allocation of leases was based on a number of criteria and objectives in addition to price. Evaluation criteria included diversity of ownership, airport management capacity, airport development plans, environmental issues and consideration of interests of all stakeholders of the airports.

Leases were granted to private sector operators at Brisbane, Melbourne and Perth Airports in 1997 (Phase I), and for a further 14 airports in 1998 (Phase II). The remaining five federal airports (the four Sydney Basin Airports — Sydney (Kingsford Smith), Bankstown, Camden, Hoxton Park — and Essendon Airport) were not privatised, but their ownership was transferred to two wholly Government-owned companies in 1998: the Sydney Airports Corporation Limited (SACL) and Essendon Airport Limited (a subsidiary of SACL). The FAC subsequently ceased operation.

All leased airports are subject to regulation under the *Airports Act 1996* (Airports Act), which addresses issues such as airport safety, ownership structures and airport access. In addition, a number of airports, known as ‘core regulated’ airports, are currently subject to prices regulation under the *Prices Surveillance Act 1983* (PS Act). Core regulated airports comprise 11 privatised airports and Sydney. Privatised core regulated airports are those airports with significant ‘regular passenger traffic’ and include the three Phase I airports (Brisbane, Melbourne and Perth) and eight of the Phase II airports (Adelaide, Alice Springs, Canberra, Coolangatta, Darwin, Hobart, Launceston and Townsville).

Prices regulation for these airports under the PS Act comprises a CPI-X price cap on ‘declared aeronautical services’, prices monitoring of ‘aeronautical related services’ (box 1), and special provisions for necessary new investment at airports. Though Sydney Airport is regulated under the PS Act, it is not subject to the price cap on declared services. The Australian Competition and Consumer Commission (ACCC) was appointed to administer the prices regulations outlined in the PS Act.

The then Department of Transport and Regional Development described the pricing oversight arrangements as transitional measures, designed to allow all stakeholders to adjust to the operating environment for airports (DTRD 1996). It was envisaged that pricing arrangements would change after experience was gained in the new operating environment. As such, a review of the pricing arrangements was a key feature of the privatisation program developed by the Commonwealth Government.

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. In its place, the review will aim to develop arrangements targeted at those charges where the airport operator has the 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. (DTRD 1996, p. 7)

The review was to be completed before the end of the first five-year period of the leases.

Box 1 Regulation of facilities and activities provided by airport operators

Under the privatisation program airport operators are responsible for providing a wide range of services, not all of which are subject to prices oversight (that is, either 'declared' for price notification or subject to 'monitoring' under the *Prices Surveillance Act 1983* (PS Act)).

According to the second reading speech of the PS Act, 'the selection of goods and services subjected to surveillance will focus on areas where effective competitive disciplines are not present and where price or wage decisions have pervasive effects throughout the economy' (House of Representatives 1983, *Debates*, p. 3072). Declared services (under s. 21 of the PS Act, Declarations 87, 88 and 89) — which are included in the price cap for the privatised core regulated airports — are grouped in two main categories: 'aircraft movement facilities and activities' and 'passenger processing facilities and activities'.

'Aircraft movement facilities and activities' comprises: airside grounds, runways, taxiways and aprons; airfield lighting, airside roads and airside lighting; airside safety; nose-in guidance; aircraft parking areas; and visual navigation aids.

'Passenger processing facilities and activities' includes: forward airline support area services; aerobridges and airside buses; departure lounges; immigration and customs services areas; public address systems, closed circuit surveillance systems; baggage make-up, handling and reclaim; public areas in terminals; flight information display systems; landside road and lighting; and covered walkways.

Some 'aeronautical related services' provided by airport operators are not declared but are subject to prices monitoring under s. 27A of the PS Act (Direction no. 14). These are: aircraft refuelling; maintenance and buildings; freight equipment and storage sites; ground support equipment sites; check-in counters and related facilities; and public and staff car parks.

There is no prices oversight of airport operators' revenues from rents or leases for retail shops and cafes, administration and office space, catering facilities, valet parking services and VIP lounges.

Airport operators do not have responsibility for all aeronautical services provided at airports. Aeronautical services outside airport operators' areas of responsibility include: en-route navigation and terminal navigation (air traffic control and airspace management within 50 kilometres of airports); aeronautical information; communications; and firefighting and rescue services.

Sources: Prices Surveillance Act 1983; ACCC (2000b).

1.2 Participation in this inquiry

The Commission encourages interested parties to express their views and contribute to this inquiry. The inquiry will be of particular interest to:

- airport owners and operators;
- airlines;
- other direct and indirect buyers and users of airport services, including passengers and users of air freight services;
- businesses operating concessions at airports;
- businesses competing with airports in the provision of non-aeronautical services, such as car parking;
- businesses associated with tourism and conventions;
- regulators of airports and government agencies with relevant responsibilities.

This list is not intended to be exhaustive. Other individuals and organisations with an interest in this inquiry are encouraged to participate.

1.3 Inquiry procedures and timetable

The Commission wishes to receive information and comments on issues which participants consider relevant to the inquiry's terms of reference. Wherever possible, please provide material in support of views expressed (eg copies of relevant reports, facts and figures, case studies). Information about how to make a submission is provided at the beginning of this issues paper. **Initial submissions should be lodged by 16 March 2001.**

During the inquiry, Commissioners and staff will have informal discussions with individuals, companies and other organisations to identify issues and relevant sources of information. A first round of public hearings will be held in March to allow participants to elaborate on the views in their submissions. Whilst the formality of these hearings will be kept to a minimum, a transcript will be made publicly available to maintain the transparency of the Commission's processes.

In August 2001, the Commission will release a draft report for public discussion. Participants will have the opportunity to make further submissions and to comment on the draft report at a second round of public hearings to be held in September. The Commission will then prepare its final report and present it to the Commonwealth Government by 21 December 2001.

2 Issues

Whilst in this paper the Commission has endeavoured to cover the major issues relevant to this inquiry, participants are invited to comment on any other matters they consider relevant.

Moreover, participants are not expected to address all issues or answer all questions raised here. Participants are encouraged to provide comments and evidence on any issue they consider relevant.

Data, examples, or other evidence should be provided wherever possible (on a commercial-in-confidence basis if necessary) in order to support arguments presented.

2.1 Why regulate prices of services provided by airports?

The terms of reference state that:

The purpose of this inquiry is to examine whether new regulatory arrangements, targeted at those charges for airport services or products where the airport operator 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.

Hence the Commission is asked to report on the need for price regulation of airport services, taking into account a number of principles set out in paragraphs 7(a)–(g). Paragraph 8(b) also asks the Commission to identify the rationale for any future prices regulation at airports.

Airports primarily provide intermediate services to airlines (box 1). They also provide and/or facilitate a range of other services — such as restaurants, shopping and parking — to passengers and others. As already outlined, since being privatised, several airports under review have been subject to prices regulation (including a price cap), apparently reflecting a view that they possess significant market power in certain aeronautical and aeronautical related activities.

*Is the potential for abuse of market power an appropriate rationale for **airport-specific** regulation of airport services? Are there other appropriate rationales?*

(The question of whether the general provisions of the *Trade Practices Act 1974* (TP Act) and PS Act are adequate for airports is raised below.)

Market power may allow airports to charge prices that yield excess profits and/or to have inefficient production or poor quality. These excess profits or inefficient production would be paid for by airlines and probably their customers (depending on the nature of the market for airline services). To the extent that higher airport charges or lower quality resulted in reduced consumption and production of those services, national economic welfare would decline.

However, market power may not necessarily result in efficiency losses and sometimes it can be countered effectively without regulation. And even if an airport exercises market power, whether airport-specific regulation is justified will require an assessment of both the impact of market power and the extent of potential problems created by the proposed regulation.

Therefore, in order to assess the need for price regulation of airport services, key tasks for the Commission will be to:

- identify which (if any) airports under review possess market power (and the potential to abuse it);
- identify those areas/services in which they may possess market power;
- assess the extent and potential impacts of abuse of market power by airports including distributional and efficiency effects; and
- assess whether any market power in relation to its source or consequence is sufficiently different from that in other industries to warrant special provisions for airports.

Identifying airports with market power

Market power — if it is to persist — requires barriers to entry and no close substitutes available to consumers. Characteristics of the market for airport services that may give airports market power include:

- economies of scale combined with large lumpy investments that advantage incumbent airports (airports frequently are described as natural monopolies); and
- limited scope for substitution of destinations and/or travel modes by airline passengers. (In other words, demand for a particular airport's services is said to be highly price inelastic.)

Nonetheless, there appears to be a range of views about the significance of economies of scale and the magnitude of demand elasticities. For example, barriers

to entry may be more a function of regulation and non-economic constraints than any natural monopoly characteristics of airports.

Do any airports in Australia have market power? What are the sources of their market power?

Do some airports with market power have more market power than others? Why?

In which services/activities are these airports likely to have most market power? Why?

How significant are economies of scale in airports and to what extent are economies of scale a barrier to entry? Which services/activities provided by airports exhibit significant economies of scale?

How sensitive is demand for a particular airport's services to any change in the prices charged, or the services offered, by that airport? What alternatives do consumers have (eg other airports or transport/communication modes)? How does this price elasticity of demand vary between the short to medium term and the long term?

How important is the port of entry/exit to international tourists? How important is hubbing through a particular airport en route to another destination?

How sensitive is demand for airport services to changes in the quality of those services?

Currently, what is the extent of competition between Australian airports? Do airports compete on quality and/or price?

What is likely to happen to competition in future? What factors, other than regulation, are likely to be most influential in curtailing/promoting competition?

Assessing the extent of market power of airports — what is an efficient pricing benchmark?

As noted above, market power may allow airports to charge prices (at least for some services) that yield persistent excess profits (that is, profits in excess of costs where costs include a 'normal' return on assets), or that allow the airport to operate inefficiently.

The difficulty in assessing whether particular prices are excessive is to establish what set of prices would prevail in the absence of market power. This set of prices is not that which would prevail under conditions of competitive supply. The very

circumstances that can give rise to market power — large lumpy investments combined with substantial economies of scale, for example — mean that a ‘standard’ competitive outcome is not feasible.

The appropriate benchmark is a set of prices that allocates demand efficiently and promotes efficient investment, and which, over time, gives (efficient) airport operators a ‘normal’ rate of return. Thus, as airport investment is lumpy, efficient prices may generate high profits when facilities are congested, rationing limited capacity and signalling the need for new investment. When facilities are not congested, lower prices may be appropriate.

What is an appropriate price benchmark (for example, in relation to costs, particularly opportunity costs of the use of facilities) against which to assess potential abuse of market power by airports?

What is an efficient level and structure of prices in airports? Would a two-part pricing system combining the sale of take-off and landing slots with charges for use of facilities be a feasible and efficient pricing policy?

What is likely to happen to the level and structure of prices in airports under review if prices regulation were removed? Are there any constraints on efficient pricing of airport services? Would removal of prices regulation result in airports earning excess profits?

What expected rate of return is required to attract new investment in existing airports? In new airports?

Pricing of complementary services and allocation of common costs also may complicate any efficient pricing structure and therefore any assessment of the degree of excessive pricing of certain goods and services.

How significant are common costs in the provision of airport services? What are the major common costs of providing airport services?

How pervasive are demand complementarities in the provision of airport services? How do they affect pricing of these services?

Current price regulation of airport services has constrained pricing decisions of airports, but some major airports have not been regulated and not all services have been regulated.

Is there any evidence of abuse of market power (and excess profits) by airports that are not subject to price regulation (Cairns Airport, for example) or by regulated

airports in their unregulated activities? Is there evidence of attempts to abuse market power by unregulated airports in Australia and/or overseas?

Countervailing power of users of airport services

If airports possess some market power, this could be counteracted fully or partially by any buying power of airlines and other users of airport services (eg freight operators).

Do airlines and/or other users have any countervailing buying power when negotiating with airports? Is there any relevant Australian or overseas experience?

Are there any constraints on, or disincentives to, airlines and other users exercising such power?

How vigorously do airports compete for airlines and other users?

Potential effects on efficiency and income distribution of airport market power

Abuse of market power typically results in a reduction in the quantity provided and an increase in price(s) and/or lowering of quality.

To help gauge the order of magnitude of potential efficiency losses and income redistribution effects arising from abuse of any market power of airports, what are the quantities sold per year of major airport services and their prices?

Is the demand for air travel (and airport services) of foreign travellers to Australia more or less price elastic than that of domestic travellers?

Are airports with market power in a position to discriminate between buyers of their services? Is such price discrimination precluded by regulation? Is there evidence of price discrimination by airports in Australia or overseas?

There may be other efficiency losses associated with market power: higher costs (including 'gold plating') or losses associated with activities to preserve a privileged position (rent-seeking activities). It is also possible that a firm with market power will under- or over-invest in new facilities and technologies.

Is there any evidence that airports tend to be inefficient in production? Do they have a tendency to under- or over-invest in new capacity and quality?

Is there any difference in performance between regulated and unregulated airports?

Are airports different from other industries?

Even if airports were considered to possess some market power, airport-specific regulation may not be warranted.

Are airports different from, or likely to have more market power than, other industries with some natural monopoly characteristics? In what respect, if any, do airports differ?

Are any such differences so significant as to warrant specific provisions? If so, are these specific provisions best incorporated under the TP Act and/or PS Act or under separate legislation?

2.2 Current prices regulation

The terms of reference require the Commission to evaluate the operation of the existing prices regulation of airports (paragraph 8(a)), as well as to analyse and quantify the benefits, costs, and economic and distributional impacts of the current arrangements (paragraph 8(d)).

In addition, the terms of reference require the Commission to have regard to a number of principles when determining the need for, and appropriate form of, prices regulation. These include consideration of compliance costs (7(d)), efficient operation of airports (7(e)), and the facilitation of benchmarking comparisons between airports and commercially negotiated outcomes in airport operations (7(f)). The questions raised here in relation to assessing current prices regulation also have regard to these issues.

Prices regulation is only one component of the economic regulation of airports that was established by the Commonwealth Government as part of its leasing program (box 2). It is administered under the PS Act, complemented by some provisions of the Airports Act.

Under the PS Act, ‘aeronautical services’ — relating to aircraft movement and passenger movement facilities and activities — of the core regulated airports are ‘declared’ for price notification, while a number of other ‘aeronautical related services’ are ‘monitored’ (box 1). A CPI-X price cap applies to the declared services of the privatised core regulated airports.

The prices regulation of airports is complemented by quality of service monitoring under Part 8 of the Airports Act. Phase I airports are subject to more rigorous quality monitoring than some of the Phase II airports.

Box 2 **Economic regulation of airports**

Three main pieces of legislation govern the economic regulation of airports: the *Airports Act 1996*, the *Prices Surveillance Act 1983* (PS Act) and the *Trade Practices Act 1974* (TP Act). Together, these regulate a number of aspects of the provision of airport services, including planning, development and pricing.

Airports Act 1996

This is the main legislative instrument governing all the leased airports in Australia. Only some parts of the Act deal with economic regulation. For instance: Part 3 (airport ownership restrictions), Part 7 (lodgement of accounts with the Australian Competition and Consumer Commission (ACCC)), Part 8 (quality of service monitoring by the ACCC) and Part 13 (access and demand management provisions).

Part 13 includes s. 192, under which some airport services at core regulated airports were automatically declared for the purposes of Part IIIA of the TP Act, effective one year after the granting of the leases (a one-year extension could be granted in certain circumstances). This deferral of declaration for access was designed to enable airports to submit an undertaking before the declaration took effect. There are two other main ways that the access provisions can be applied to airports: airport operators can submit an undertaking to the ACCC, or airport services can be subject to declaration under Part IIIA of the TP Act.

Prices Surveillance Act 1983

As already noted, 'aeronautical services' of the core regulated airports are declared for price notification, while a number of other 'aeronautical related services' are monitored under the PS Act (box 1). A price cap applies to the declared services of the privatised core regulated airports.

Although the ACCC administers the Act, the designated Minister (currently the Minister for Financial Services and Regulation) determines which services are to be declared (under s. 21(1)) and monitored (under s. 27A). The Minister issues 'Declarations' to specify the declared services and 'Directions' to specify the monitored services. Under s. 20, the Minister also can issue 'Directions' to direct the ACCC to give special consideration to particular matters in exercising its functions.

Under s. 22 of the PS Act, airports must notify the ACCC of plans to increase prices of declared services. The ACCC has 21 days to make a determination on the proposal (this can be extended with the consent of the notifying party (s. 22(6))). The ACCC does not have the discretion to object to proposed price increases that fall within the price cap. Airports are not compelled to abide by the determination but the ACCC can ask the Minister for permission to conduct an inquiry if a determination is not complied with. Where services are subject to monitoring, the ACCC monitors and reports publicly on prices, costs and profits of companies in relation to the specified services.

Trade Practices Act 1974

As corporations, all privatised airports are subject to the restrictive trade practices and consumer protection provisions contained in Parts IV and V of the TP Act.

2.3 Effects of current prices regulation

There appear to have been two main objectives of the prices regulation of airports: to promote the efficiency of airport operations and to protect users of airport services from abuses of market power. In its Pricing Policy Paper, the Department of Transport and Regional Development stated:

Pricing oversight arrangements are intended to promote operation of the airport in as efficient and commercial a manner as possible. Pricing is fundamental to the efficient use of airport infrastructure ...

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)

Are these objectives appropriate? Has the current regulation met these objectives?

Prices, profitability and efficiency

The value of X in the price cap for each airport was set by the Commonwealth Government on the advice of the ACCC. In determining X, the ACCC considered projected demand and costs and economic performance, as well as expected productivity gains (ACCC 2000b). A positive X ensures that real prices are reduced each year. Where X exceeds the rate of inflation, nominal prices also will fall.

As noted above, under current arrangements, only the aeronautical services of the core regulated airports are declared for price notification. Aeronautical related services are monitored; other non-aeronautical services are not subject to price regulation.

What have been the implications of the current arrangements for prices of declared, monitored and other airport services?

Has the delineation of services under the current pricing system been appropriate? Has there been pressure to shift costs and prices across services?

What has been the effect of current arrangements on airline prices to final consumers?

Price caps can provide an incentive for the regulated airports to decrease costs and improve productivity. This incentive arises because the regulated airports bear the costs of not reducing costs/increasing productivity in line with the cap, but can keep the gains (increased profitability) of additional increases in productivity over and above those allowed for in the cap, at least during the period for which X is specified and remains unaltered.

What has happened to each airport's costs, productivity and operational efficiency under the price cap arrangements? What has been the impact on airport profitability?

What are appropriate ways to compare airport performance? Have the prices regulation arrangements facilitated benchmarking comparisons across airports?

Congestion and demand management

Airports can be subject to significant congestion. This may be related to peaks and troughs in demand that can occur during the course of a day, or it could be spread throughout the day.

Sections 194–209 of the Airports Act outline the demand management provisions for the core regulated airports. One hundred per cent pass-through is permitted for congestion charges levied as part of a Government-mandated demand management scheme.¹

Which airports have congestion problems? What is the nature of these problems (for example, do they only occur at certain times of the day or year)? What is the cause of congestion (for example, airspace, terminal space or runway congestion)?

What has been the effect of the demand management and congestion charge provisions in practice? What have been the efficiency and distributional effects of the current arrangements?

Does the current regulatory and price regime encourage efficient pricing of available capacity? What constraints are there on airports adopting pricing policies such as congestion charges and peak load pricing?

Quality

Given the incentives for cost reduction under the price cap, airport operators could choose to lower their costs through reducing the quality of service, as well as (or instead of) improving the efficiency of providing a given level of service.

It is for this reason that quality monitoring under Part 8 of the Airports Act is seen as an important complement to prices regulation. Quality of service provision is one factor the ACCC can consider both when it assesses compliance with the price cap

¹ A demand management scheme is defined in s. 201 of the Airports Act as 'a scheme for the handling of aircraft movements at the airport'.

and when considering notifications to increase prices (PS Act, Directions nos 17 and 18).

Is quality monitoring necessary? Why or why not? What has been the impact of quality monitoring?

Are the indicators used to measure quality adequate and sufficiently defined?

Has quality of airport services been rising or falling? In what ways? Why?

Investment

The current pricing arrangements allow for price increases exceeding the cap (but not 100 per cent pass-through) for ‘necessary new investment’. ‘Necessary new investment’ must improve the capacity or quality of service above ‘pre-existing levels’ (ACCC 2000a, p. 5). Thus, it does not include maintenance costs or replacement investment. Nor does it include ‘cost saving innovations’ that have no impact on quality or capacity, since price caps are expected to provide adequate incentives for investment of this sort (ACCC 2000a, p. 6).

The ACCC considers a number of factors in determining the allowable price increase resulting from necessary new investment. These include whether an increase in prices is required to fund the new investment, the contribution of the investment to productivity improvements, and support from airport users with a ‘significant interest in the investment’ for the proposals (including in relation to the changes in charges) (DTRD 1996 and Directions nos 17 and 18). Thus, airlines have a right to comment on proposals.

How have the investment provisions operated in practice? Have they facilitated appropriate investment at airports? What have been the major issues involved in applying the investment provisions in practice (eg price determination, rates of return, asset valuation)?

Are the processes involved, including consultation and time allowed for a determination to be made, appropriate?

Scope of prices regulation

As noted above, not all the former FAC airports are subject to the same regulation. Only the eleven privatised core regulated airports are subject to the price cap, the aeronautical services of Sydney Airport are declared for price notification under the PS Act but not subject to the price cap, and some Phase II airports are subject to less

stringent quality monitoring than the Phase I airports. For non-FAC airports (for example, Cairns Airport) the regime is different again.

What is the rationale for these different approaches to airport regulation? Is it appropriate?

What has been the experience of regulation for the different airports? Do the different regulatory approaches create a competitive advantage or disadvantage for any airports?

Compliance costs and procedural issues

One rationale for using CPI-X over other types of prices regulation is that it can be simple and relatively light-handed (Forsyth 1999). This seems to have been a consideration of Government in the design of the price cap system:

The price cap is designed to be as simple and straightforward as possible, in the interests of minimising costs of regulatory oversight for both the ACCC and the airport operators, while ensuring appropriate outcomes. (DTRD 1996, p. 2)

What have been the compliance costs of prices regulation of airports? Are they changing over time?

Current price regulation of airport services is administered under the provisions of the PS Act. The PS Act currently is the subject of another inquiry by the Productivity Commission and participants in this inquiry may already have made submissions regarding the PS Act. These submissions will be taken into account in this inquiry (except for any material submitted to that inquiry on a commercial-in-confidence basis).

Some issues relating to the operation of the PS Act of particular relevance to this inquiry include:

Are the timeframes in the current PS Act notification process appropriate?

Does the current approval process allow for sufficient flexibility in pricing and investment decisions?

Are appeals mechanisms adequate?

Does the PS Act provide for adequate enforcement of price regulation of airport services?

Other issues

There are several other issues relevant to assessing the operation of current price regulation. Some of these are addressed in the questions below but there also may be others that participants may wish to raise.

For instance, one of the principles to which the Commission is to have regard in assessing appropriate prices regulation is that ‘prices regulation should facilitate ... competition in the provision of services within airports (especially protecting against discrimination in relation to small users and new entrants)’ (paragraph 7(f)).

Has prices regulation facilitated competition in the provision of services within airports? Has it impeded competition?

Has current price regulation protected against discrimination in relation to small users and new entrants?

In addition, a goal of the Commonwealth Government has been to move toward a more commercially oriented approach to pricing and investment decisions.

The prices oversight regime is designed to strike a balance between protecting airport users from monopoly pricing and creating the conditions for commercially-driven decisions on the part of the airport operators. Over time the Government wants to see airport operators and their customers negotiating directly on pricing and investment decisions, but with the Australian Competition and Consumer Commission (ACCC) remaining empowered to prevent monopoly pricing. (P. Costello (Treasurer), *Press release*, no. 055, 25 May 1998)

To what extent has the current price regulation provided a basis for the development of a more commercial approach to pricing and investment decisions? Has it facilitated or hindered commercial negotiations?

There are also a number of potential externalities resulting from the use of airport services, such as noise, pollution and congestion.

What are the types of externalities involved in airport operations? Should incentives for the reduction of negative externalities be included within the price cap? Have they been adequately addressed in the present price cap?

2.4 Future prices regulation

The terms of reference require the Commission to report on whether there is a need for price regulation of airport services, and the appropriate form of any price regulation. Section 2.1 above canvassed possible reasons for regulating airport service prices. These factors, and the extent to which they apply to the various airports under reference, will be critical in influencing the type of regulation (if any) that might be recommended.

In addition, the terms of reference (paragraphs 7(a)–(g)) provide a list of principles that the Commission should take into account when considering future price regulation, within the constraint of effectively meeting the underlying objective of preventing abuse of market power. In particular, the CPI-X price cap applied to aeronautical charges during the first five-year period of private operation will no longer operate. Airport operators also may propose to the inquiry alternative approaches to price regulation that would provide equal or better protection to users. In addition, the legislative policy guidelines in the *Productivity Commission Act 1998* require regard to be taken of the need to reduce regulation of industry where this is consistent with the social and economic goals of the Commonwealth Government.

In proposing various approaches to prices regulation, participants should be mindful that the terms of reference (paragraph 8(d)) ask the Commission to analyse and, as far as practical, quantify the benefits, costs and economic and distributional impacts of alternative arrangements. It also should be noted that the PS Act and Part IIIA of the TP Act are currently the subject of National Competition Policy reviews by the Productivity Commission, with draft reports likely to be released in the first quarter of 2001. Participants may wish to consider the possible impact of these reviews on the options for regulation of airports.

Options for future airport prices regulation

If it were considered that the market power of airport operators was not substantial, or no greater than and no different in principle from other industries in which there is some degree of natural monopoly, it might be decided to have no special price regulation of airport services and to rely on the general provisions of the TP Act (including Part IIIA access provisions).

Should regulation be specifically tailored to the airports sector or should more general regulation be relied upon?

If airports are deemed to require special regulation or if they are declared under Part IIIA of the TP Act, a number of options might be adopted (either as stand-alone or in combination) to regulate airport services pricing. These include:

- a broad price cap set for some or all airport services prices (under a different formula than the current CPI-X) and no other prices surveillance or monitoring;
- a broad price cap but including scope for pricing reviews for new investment or other special circumstances (for example, congestion pricing);
- prices surveillance, with proposed price increases for some or all airport services subject to approval;
- rate of return regulation;
- prices monitoring, with more detailed reviews only by exception or complaint.

Participants are invited to comment on the above or any other options for price regulation, including the following issues, providing a rationale for their preferred alternatives.

Which of the above approaches is most appropriate for any airport-specific pricing regulation? Are there other options that participants consider superior?

Which (if any) airports under review should be subject to Part IIIA declaration or airport-specific prices regulation? Should the type of any prices regulation differ between airports?

What services provided at airports should be covered by price regulation? In particular, should charges such as rent for retail premises, where there are significant off-airport alternatives, be treated differently from charges for aeronautical activities? Should they be regulated?

What have been the main lessons to be drawn from current regulation that may inform possible future regulation?

Do overseas regulatory experiences provide useful models of price regulation for Australian airports? What lessons do these experiences provide in applying airport price regulation?

Do international agreements place any constraints on approaches that might be adopted for regulating prices at Australian airports?

The legislative framework for airport-specific regulation could be the PS Act or specific airports provisions (either within the TP Act or in separate legislation). The regulator could continue to be the ACCC or, alternatively, an airports-specific regulator could be established.

What is the most appropriate legislative framework for implementing the preferred approach to prices regulation?

What are desirable procedural features of such legislation (for example, appeals mechanisms, transparency, procedural certainty)?

Regulation should be predictable and transparent in its application and keep compliance costs, regulatory delays and regulatory creep to a minimum.

Which regulatory option is likely best to promote these objectives?

In outlining the proposed approach to regulation of leased airports, the Department of Transport and Regional Development stated:

It is the Government's intention to step back from setting prices at individual, privately-leased airports and to provide a framework in which — over time — airport operators and their customers are encouraged to negotiate directly, and resolve prices rather than involve the Government of the day. (DTRD 1996, p. 1)

The terms of reference also state that prices regulation should facilitate commercially negotiated outcomes in airport operations.

How can regulation best promote commercially negotiated outcomes in airport operations? What form of prices regulation would best achieve this objective?

Another principle to be taken into account is that prices regulation should promote the efficient operation of airports.

How can regulation best promote the efficient operation of airports? Which regulatory option is likely to promote this objective? Why?

In this regard, the terms of reference refer to the need for any prices regulation to facilitate benchmarking comparisons between airports.

Can benchmarking of airports be used to assist in promoting efficient operation of airports and establishing appropriate prices for airport services? How does the performance (price and quality) of Australian airports compare with those overseas?

If a prices surveillance approach is applied in future, a method of assessing the appropriateness of price levels and/or proposed increases will be needed. Consideration of price increases based on cost changes or assessment of price levels based on a rate of return approach (on all assets or new investment) are two methods that have been used commonly by prices regulators in Australia and

overseas. These various approaches to assessing prices will have different impacts on incentives for airport operators and their customers.

What should be the objective(s) in setting prices for airport services? How are these best achieved?

How should appropriate price levels or price increases be assessed in the post CPI-X era?

Are the prices that have resulted from the current regulatory regime an appropriate starting point for any future prices regulation?

How should prices regulation be applied to encourage efficient operation and levels of investment in airport facilities?

What role should pricing play in allocating scarce capacity amongst the competing users of airports? How should the distributional aspects of any such pricing increases be handled?

The terms of reference indicate that prices regulation should protect against discrimination in relation to small users and new entrants.

How should discrimination against small users or new entrants be identified and protected against?

Because the effective price of airport services can be affected by changes in service quality, the Airports Act currently provides for monitoring of service quality.

Should quality monitoring be part of any prices regulation regime? If so, how should regulation of service quality be carried out?

Current prices regulation arrangements were put in place for five years.

If airport-specific prices regulation in some form were continued, what sunset/review arrangements, if any, should be put in place?

3 References, relevant reports and legislation

ACCC (Australian Competition and Consumer Commission) 2000a, *New Investment Costs Pass-through: the Distinction between ‘Necessary New Investment’ and other Forms of Expenditure, as it Relates to the Price Cap*, Position Paper, April.

—— 2000b, *Infrastructure Industries: Aviation*, March.

—— 1998, *Economic Regulation of Airports — an Overview*, July.

—— 1997, *Administration of Airport Price Cap Arrangements*, January.

Airports Act 1996.

DTRD (Department of Transport and Regional Development) 1996, *Pricing Policy Paper*, November.

Forsyth, P. 1999, ‘Monopoly price regulation in Australia: assessing regulation so far’ in Productivity Commission 1999, *1999 Industry Economics Conference: Regulation, Competition and Industry Structure*, Conference Proceedings, 12–13 July 1999, AusInfo, Melbourne, pp. 31–41.

Prices Surveillance Act 1983.

—— Declarations, nos 87, 88 and 89.

—— Directions, nos 17, 18 and 19.

Productivity Commission Act 1998.

Trade Practices Act 1974.