Melbourne Airport Response
to the Draft Report of
the Productivity Commission
on
Price Regulation of Airport Services

October 2001

Introduction

Melbourne Airport welcomes the opportunity to provide comment on the Commission's Draft Report on the Price Regulation of Airport Services. We are in broad agreement with the Commission's findings and strong agreement with the Commissions strongly preferred policy option.

It is an understatement to observe that much has changed since the Draft Report. These changes must of course be taken into account by the Commission and, on receipt of its final report, by Government. Nevertheless we believe there are important matters of principal and sound policy and commercial practice at stake which must also receive due weight.

Just as the Commission's preferred policy options take us further in the journey embarked upon with the breakup and privatisation of the old FAC, so too we must ensure that any responses to the short and medium term shocks the industry has experienced since September are consistent with that journey.

In the short term, the Ansett situation will present very real cash flow issues for privatised airports. As Melbourne was Ansett's headquarters, the impact on property income and traffic generally is likely to be more severe than at other major airports. Deteriorating global conditions, an impact that will be seen most starkly at Australian international airports, will compound this as will any further deterioration in airline, and in particular Air New Zealand's, trading position.

In the longer term, we will be operating in an industry radically different to the one we have known. The impacts of such issues as the future of Ansett's terminals, the loss of the Star Alliance's Australian member and the emerging market position of Qantas in both domestic and international markets are all issues that will profoundly affect Australian aviation and airports policy. Clearly it is now more important than ever to ensure that regulatory policy is both soundly based.

The irony is that the shock and the policy response so far have helped allow an increase in airport prices that we have always argued is appropriate. To this extent the ends go some way to justifying the means. The recent price increases allowed Phase 1 airports should be seen as a step in addressing the previously identified problem of inefficient and unsustainably low prices, not as a state sponsored underwriting of private commercial risk.

The Commission's preferred option not only provides a mechanism for dealing with inefficiently low prices, it also enables more flexible arrangements to be in place to meet the individual circumstances of airports and their airline customers. The private commercial need for airports to work co-operatively with airlines to grow traffic, and indeed the wider need of the economy as a whole, is greater now than it was some months ago. This can only be achieved if airports are able to flexibly deal with their current customers whilst at the same time have sufficient freedom to act commercially to encourage airline (re) entry and route development. Current interventions impede these necessary commercial developments.

Melbourne Airport is concerned at the prominence given in the Draft Report to issues that relate primarily to Sydney Airport (such as slots, congestion and land valuation). Whilst it might be stretching a point to argue that these matters are outside the terms of reference of the inquiry, it does not seem to us that they should be as central to the Commission's concerns as they are in the Draft Report. Firstly they are of short and medium term relevance almost exclusively to one airport about which policy considerations are unique from several perspectives.

- Sydney Airport is the only airport with the likelihood of serious congestion problems for the time horizon of five years from July 1 2001 envisaged by the Draft Report.
- Sydney Airport is the only airport that cannot expand runway capacity substantially and so meet all conceivable demand for the next several decades.
- Sydney Airport has not yet been privatised and so the issue of policy continuity and honouring implicit and explicit commitments to investors does not arise.

Secondly the issues have been dealt with at least in principle both by recent legislation and by executive agencies – the ACCC. On the other hand, the current Phase 1 regulatory system expires on 30 June 2002 so it is critical that the Commission's final report contain well developed options for Government to consider and act on in time to allow the necessary work (by policy agencies, regulators, airlines and airports) to ensure an orderly transition. If this not done, we fear that government may be tempted just to "roll over" the current arrangements. We are very hopeful that the Government can do better than this.

This submission is guided by the Draft Report and in particular those matters upon which the Commission has sought further information and the Draft Recommendations. It is divided into three sections. These sections address:

- Market power (including the countervailing power of airlines)
- Pricing issues including the structure of charges and likely pricing outcomes under less intrusive regulatory regimes;
- Specific issues relating to the Commissions draft recommendations and their implementation.

We also provide an Appendix on access issues.

Market Power

The Commission's Draft Report argues – convincingly in our view – that larger capital city airports enjoy market power in the provision of certain aeronautical services. Further it argues – again in our view correctly – that activities other than this, such as non aeronautical services and aeronautical services in smaller airports enjoy sufficiently little market power or are insufficiently important to be confident that the benefits of price regulation would exceed their potential costs.

What has been contentious in this inquiry is the extent to which there might be reasons for deregulation even in the event that major airports were found to exercise some market power. The Commission has identified the commercial reasons why airports are unlikely to price up to the full extent of their market power. Whilst not addressing the issue at any length, it does seem to us that the Commission also accepts the political constraints that are placed on airport conduct and which we outlined in earlier submissions to the Commission.

In addition to the forces at work to moderate airports' exercise of any market power they have, there is also the question of the degree of economic damage that any exercise of market power would have. Although much demand for air travel is price elastic, that price elasticity is hugely diluted by the very small share of the total costs of an airfare accounted for by aeronautical services. Thus for instance, if Melbourne airport were to increase its charges by 20%, the total cost of air-travel would rise by less than one tenth of the amount of the levy recently imposed on air travellers to vouchsafe Ansett employee entitlements. The Commission did not come to a very clear conclusion on this argument in the draft, and we would hope it could come to a more definitive view in its final report.

The Commission has been less convinced about the ability of customers to restrain airports from using market power – this is the issue of countervailing market power. Professor King's paper for the ACCC provides a useful framework for considering this issue, particularly in light of the current market and economic conditions:

> If airlines using the airport are involved in strong competition then it is unlikely that any individual airline could exert countervailing power. Conversely, if there are, say, two airlines that only compete for marginal customers, there is a high degree of customer lock-in with each airline, and the relevant airport is not significant in terms of either total airline profitability or airline network configuration, then it is likely that each airlines could have significant countervailing power. Each airline has a credible threat to stop using the airport. This power may be increased if the airport itself cannot credibly reduce its output: for example, if the airport is credit constrained and potentially faces cash-flow problems.[1]

Airline markets are likely to be less competitive in the short to medium term. Commentators suggest that Qantas' share of the domestic market is likely to be in the range of 70-90%[2]. In addition, market segmentation and the resulting customer lock in is likely with Qantas being the only full service vertically integrated network carrier with strong international links. At the same time Virgin Blue will focus its participation on the "discount" market segment, possibly with one other carrier being present. It looks like being a long time before competition of the sort seen during 2000/01 will emerge again. Indeed, in the short term, there is a chance that with the segmentation discussed above, competition may even be less intense than it was prior to the entry of Impulse and Virgin Blue.

The CEO of Qantas has indicated his view that there is likely to be some consolidation of international carriers[3]. Melbourne Airport has experienced lower load factors on both arriving and departing international services since 11 September and is aware of carriers considering abandoning not only route development plans but also existing routes. The loss of Ansett's domestic network significantly reduces the ability of Star Alliance carriers to compete against Oneworld carriers in offering airline packages to tourists visiting Australia and thus reducing the viability of Star Alliance members' services to Australia. The cloud over Air New Zealand's future also has consequences for competition across both the Tasman and the Pacific run to the United States. In short, competition will be diminished in the short to medium term whist airline concentration will continue to rise into and beyond the medium term.

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[1] King (2001, p13)

[2] CSFB (2001) presents arguments for the low end of the range. The ACCC believes a much higher figure is likely – see Ferguson (2001).

[3] Dixon (2001)

The last sentence of the quote from Professor King accurately describes the current position of most, if not all, Australian airports. There is no doubt that cash flow is a major concern for all airports since the events of September[4].

In our view, even before the events of September, Professor King's framework encapsulated in the words extracted above suggested that countervailing power was a potentially strong force in Australian airport pricing. Since September, it must surely be very much greater.

We willingly concede that if this issue is addressed without resort to the economists' stock in trade – comparisons at the margin – it is easy to argue that airlines have no market power. It is clear that, if Qantas wishes to service the Melbourne market it cannot do so without using Melbourne Airport. But we have been dismayed by the crudity with which the debate has been conducted. As we sought to emphasise in our supplementary submission, any contest between airlines and airports over prices and volumes occurs *at the margin*, a point acknowledged by Professor Snape during the Draft Report hearings. We are disappointed that having provided the Commission with evidence on this point at its request, the Commission has ignored the marginal nature of the analysis we provided and then on account of its interpretation simply dismissed our comments with a trivial observation.

The Commission argues that our evidence illustrates a 10% reduction in Qantas' services. In fact it illustrated the effect of a range of reductions of services, with the explicit intention of suggesting that *over that range* substitution into the medium term could be contained by Qantas' capacity to divert business to other destinations – with the customer lock in it has. The submission contained the following observation emphasising the importance of a marginal focus.

> Clearly the further we move away from the margin, the less true this is and the closer we get to the 'joke' threats to which Professor Forsyth alluded in his testimony. If a large airline pulled out 50% of its services, a substantial proportion of this demand would be replaced by competitors. But even this may take some time. More importantly, it may be able to sustain a reduction in services to an airport of 5% or 10% of its normal demand with relatively little 'leakage' to competitors for a substantial period of time[5].

We would concede that some substitution would occur into the medium term if Qantas reduced its services to Melbourne by over 10%, but there are levels of supply reduction which are certainly not trivial to us which would attract relatively

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[4] A number of major Australian airports are on negative credit watch, Moody's (2001).

[5] Melbourne Airport (2001b, p10)

little substitution. This provides credibility for such threats from a dominant carrier with substantial customer 'lock in'.

The Commission's observations about the incentives for airports to grow their business are presumably well known to airlines. Airlines' preparedness to respond to airport pricing decisions surely indicates that airlines do enjoy to some extent substitution at the margin, if not with some passengers between airports at one destination, then certainly in route and network decisions and the location decisions of some tourists.

This is born out in a recent comment by Virgin Blue when a spokesperson said "the company will have no option but to operate its new Boeing aircraft on routes where the relevant airports act as responsible members of the community instead of opportunistic monopolies"[6]. BARA has made similar comments; "Airports need to be aware that airlines are sufficiently sensitive enough to charge increases to take their services elsewhere"[7]. This is of course all evidence of the preparedness of airlines to substitute at the margin between airports. This point we have argued all along and is one critical to determining whether airlines possess sufficient countervailing market power, when considered with other factors, to render regulation unnecessary.

There has been a tendency in this debate to miss the point about countervailing power. Again, Professor King puts the debate in context when he writes, "countervailing power involves considering factors that might be relevant to market place negotiations and that reflect the relative bargaining power of buyers and sellers"[8]. Those commentators, such as Professor Forsyth, who dismiss this matter out of hand, clearly have little understanding of the bargaining that occurs in the industry. When airlines dismiss this matter, not only are they being disingenuous, they are really also denying the very "interdependencies" or "strategic relationships" that they assert are (or at least should be) at the heart of airport-airline interactions. The question that policy makers must answer is whether given these complexities, a regulator will not do more harm than good. In addressing what we concede is the possibility of the exercise of market power, regulation not only involves decision makers who know much less about the business but almost inevitably poisons the nature of commercial negotiation.[9]

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[6] Virgin Blue (2001)

[7] Sandilands (2001)

[8] King (2001, p12)

[9] The issue of 'gaming' seems to have generated unnecessary heat because those who allege it allege it of others. Our point is a more neutral one. Once an outsider is present to second guess a commercial negotiation, neither side can be expected to conduct the negotiation with as much commercial good faith as it would in the absence of the outsider.

Airport Pricing Outcomes

The Draft Report seeks further comments on two issues relating to airport prices: possible overall pricing outcomes in the absence of price regulation (Draft Finding 7.1) and impact of a general move to passenger based charges. Each of these issues is addressed below.

The Commission has sought to extend its analysis through to the final demand for passenger services. We consider this neither necessary nor appropriate. The decisions about the consumption of the services in question are reached through the interaction of airlines with airports – the passenger is not involved. Pricing conduct by airports, either to attract or retain services or send signals about capacity scarcity, is directed at airlines, not passengers. This is not to say that the impact of airport pricing and investment decisions do not matter to final consumers but rather they are not involved in transactions involving aeronautical services. The extension of the analysis, in our view, simply clouds the analysis in a way that contributes little to the design of the policy outcome.

Overall Price Levels

A central question that the Commission seeks to resolve is if price regulation were to be relaxed, would prices increase to levels that would constitute an economically damaging exercise of market power? Whilst we would expect aggregate price levels to rise over time until major capacity is added, as the Commission has suggested, there are good reasons to believe that airports will refrain from setting prices that would cause significant welfare losses.

The Commission has recognised that the current level of prices arrived at largely under the FAC single till, are inefficiently low in the sense that they are do not ensure that efficient investment will occur without further regulatory involvement. In the case of some airports, aeronautical revenue does not cover average aeronautical costs. If the current arrangement continues with the NNI processes as

they are, prices will certainly increase over time, particularly once an airport is faced with the decision to build a new runway or undertake major terminal extensions. So the debate is not about whether prices will increase, it is about how, to what extent and the respective economic consequences of the various actions open to us.

If price controls are removed, it is reasonable to assume airports would look to move prices towards more efficient levels. As the Commission notes in Draft Finding 7.5, whether the prices arrived at are substantially above efficient levels is a question that is not possible to answer although the Commission and others (including ourselves) have identified a number of reasons for believing that this will not occur to a damaging extent. This does suggest that some form of ongoing monitoring would be appropriate in a new regulatory environment. However, the extent of any over pricing, or indeed the pace at which prices rise to efficient levels, will depend critically on the strategy of the airport concerned and its relative bargaining strength with airlines in the market.

Recent developments may significantly reduce traffic volumes in the short and medium term. This will make airports even keener to attract new traffic and as such, efficient price discrimination is more likely to occur. We note that in its submission, the ACCC dismisses effective price discrimination by airports as "irrelevant given practical realities". It adds that it does not happen and suggests that airports would need much more information than they in fact have to succeed in such a strategy[10]. The facts, as the Commission correctly identifies, are quite to the contrary. Moreover, because such activity is occurring, one must assume that the bargaining parties do in fact have sufficient information to conclude such arrangements and it seems reasonable to conclude – as the Commission does - that such arrangements could generally be expected to improve the efficiency of pricing outcomes. This is an interesting illustration of how the information needs of commercial parties in a negotiating environment are much less than those required (or at least perceived to be required) by regulators to arrive at similar decisions.

We would, however, make two further observations. First, we make the behavioural observation that airport managements are more likely to be prepared to price discriminate to attract risky marginal traffic if they are earning normal returns on their aeronautical assets than if returns are sub-normal, or even negative. Second, there is emerging a concerning trend (identified in our original submission[11]) in airline negotiating conduct to demand airports to commit to not charging the airline's competitors, current or potential, prices lower than those charged to the airline in question. A case in point is the current authorisation application before the

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[10] ACCC (2001, p7)

[11] Melbourne Airport (2001a, p15)

ACCC in relation to the Adelaide MUIT. Whilst circumstances will alter case, it is possible to see how such arrangements may have the intent or effect of preventing airports from efficient price discrimination that would lead to entry.

In our original submission, we set out a stylised path of efficient airport returns over the capacity cycle[12]. Increasing returns are due not only to increasing volumes reducing average cost but also prices increasing to reflect scarcity. Once new capacity is added, price growth would be moderated by the superior returns available through increased capacity utilisation and the non-aeronautical income that would be leveraged off increasing passenger numbers. It should also be noted that a dual till structure encourages airports to invest in aeronautical assets to access additional passenger-based revenue in their non-aeronautical business rather than pursue a strategy of keeping capacity inefficiently scarce in order to generate higher aeronautical prices. Any move to rate of return regulation, especially on a single till basis, would see prices fall as capacity utilisation increases thus preventing an efficient pricing signal being sent to users.

Structure of prices

As noted by the Commission, most airports charge for runway and taxiway services on an MTOW basis. Other services are charged for either on an MTOW basis or some other basis that reflects the nature of costs or congestion (eg. terminal on a passenger basis or parking on a time basis). Whilst the Commission has sought further comments on passenger based charges, it is probably better to comment on pricing structure more generally.

Airport pricing structure around the world strongly reflects the historical antecedence of public ownership, when the principal purpose of prices was to generate revenues to cover costs. Because airlines and airports were generally owned and operated by States, negotiations about pricing structure was limited and dominated by single till and the Chicago Convention issues (Article 15) relating to non-discrimination on nationality grounds. Suggestions by the ACCC[13] and IATA[14] that ICAO treaty obligations restrict economically efficient price discrimination are both false and misleading.

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[12] Melbourne Airport (2001a, p47)

[13] ACCC (2001b, p10).

[14] IATA (2001, p3)

As has been the case in other markets, particularly markets that have recently been privatised, there is much more diversity in the quality demanded by customers than used to be the case. Upon privatisation the structure of airport charges had, and still to a large extent has, little relationship with the commercial interest of airlines and airports. That privatised airports have not moved significantly from pre-sale pricing structures is probably a reflection of the commercial importance of the issue relative to other issues faced by new managements.

Overtime, there has been a move away from MTOW based charges for a variety of reasons. For instance:

- Attempts by airports to send price signals to airlines about the relative scarcity of capacity of some services. Examples of this are time-based charging for aircraft parking and minimum charges for weight-based landing charges.
- The legitimate desire of airlines to only pay for the services that they use in the volume that they use them has led to the number of pricing categories growing over time.
- As noted by the Commission in relation to passenger based terminal charges, attempts by both airlines and airports to have charging structures that better reflect the nature of costs.

MTOW based charging has the effect of levying the same charges on airlines for a given aircraft type irrespective of load factors. If airports wish to effectively price discriminate, one option might be to charge on a passenger basis so that new services which could be expected to have lower load factors during establishment (and therefore be more marginal) face charges that increase with their capacity to pay, that is, as their load factors increase. More generally, there appears to be a trend among airlines to prefer passenger-based charges as they effectively convert fixed to variable costs, at least at the aircraft level and are unaffected by aircraft allocation decisions between routes[15].

The structure of pricing also governs the way airports and their customers share volume risk. As a general proposition, passenger numbers are more volatile than tonnages (catastrophic events like Ansett's distress to one side). In addition airports, and especially international ones, have significant exposure to passenger numbers through their non-aeronautical businesses, so some degree of MTOW based pricing provides the airport with risk diversification. This reduced risk is

[15] It is interesting to note that Virgin Blue objected to the move to passenger based charges at Sydney Airport on the basis that because their load factors were higher than those of their competitors, prices would not represent Ramsey prices and that it would discriminate against new entrants.

traded against the fact that tonnages tend to grow less quickly over time as aircraft tend to become more efficient on a tonnes per passenger basis.

It seems likely therefore that efficient pricing structures may vary significantly from airport to airport. Any regulatory system that sought to impose the same pricing structure for all airports (and it should be noted that the current system in general doesn't do this) would almost certainly get it wrong. Negotiated outcomes, even under a price cap, would seem to be more likely to produce efficient solutions providing that:

- incumbent airlines did not act to prevent efficient price discrimination; and
- regulators were not empowered to intervene unless significant competitive detriment was involved (that is, to the extent that there was a significant lessening of competition as a result).

Future Regulatory Options

Option B

Melbourne Airport welcomes the Commission's strongly preferred option for a probationary five year period where the regulator would "step back" from pricing decisions and perform a monitoring function. We believe the preferred option is clearly superior to the continuation of the current regime for a number of reasons:

- By providing the maximum incentive for airports to meet the needs of their customers, it should ensure that the potential benefits of privatisation are fully realised.
- It avoids a "one size fits all approach" to airports where market power is an issue.
- It provides airports with maximum pricing flexibility, allowing them to pursue policies more likely to achieve efficient outcomes and in particular facilitate new entry.
- It enables airlines and airports to tailor arrangements to suit their own business needs, including their relative appetites for and capacity to control risk. It also facilitates a more economically efficient – price based – approach to capacity issues.
- It will minimise regulatory risk, delay and cost.
- It fulfils the original intention of Government policy and therefore eliminates any issues of sovereign risk for the Commonwealth in relation to representations made at the time of sale, which were clearly spelt out to bidders.
- It makes it clear to airport operators there this is no "free for all" on pricing but rather they must act reasonably and work with their customers – where once there was regulation there will remain the real and apparent danger of re-regulation.

The Commission's preferred option has come under attack from a number of sources including the ACCC, BARA and IATA. Central to this attack is an appeal to the conduct of airports in New Zealand. We also note that the ACCC makes claims about European and American arrangements. These examples are of limited relevance as regulation is effectively achieved in these jurisdictions through a mixture of fiscal control and ownership.

A more comprehensive appreciation of the lessons from further afield indicates that the source of the problems in New Zealand is not the fact of deregulation but the institutional arrangements underpinning it. It seems to us almost bizarre that one would encourage litigation through traditional courts as the primary means of solving disputes about alleged commercial misbehaviour with regard to pricing and other access issues.

There is a wide range of examples where airlines and deregulated airports get on perfectly well – or at least as well as commercial partners in other industries get on. For instance, the BAA Scottish airports that have been presented as an alternative conduct outcome for deregulated airports (which we might add do not even have formal monitoring) seem to escape the notice of the ACCC and BARA.

Indeed, where airports in Europe are privately owned, there is a trend towards deregulation. The European Commission has put on ice its long held plan to introduce a directive regulating airport charges at airports. The Danish government has recently announced the current controls on prices at Copenhagen will be suspended for a trial period of two years to encourage negotiated outcomes. The UK government has refused to impose price control on London Luton airport. The UK regulator, the CAA, has signaled its wish to work towards regulatory disengagement where possible. The German and Dutch governments have rejected the single till as a basis for pricing. All this appears to demonstrate the lack of a policy need to regulate airport prices, not the need to as asserted by the ACCC[16].

There is clearly a myriad of differences between the New Zealand and Scottish cases. More recently in Australia, we have seen some small airports move to significantly increase prices whilst others, such as Launceston have taken no such action. Little can be concluded from this evidence one way or another as to how Melbourne, Brisbane and Perth would behave in the absence of formal price controls. There is little in the conduct of these three firms over the past four years in both their regulated and unregulated activities that has been put to the Commission publicly that would suggest significant abuse would occur.

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[16] ACCC (2001b, p3)

While ever the *Prices Surveillance Act 1983* remains on the statute book, the Commonwealth retains easy access to re-regulation if conduct is unacceptable and clearly this is contemplated by the Commission's proposed 5 year review. We are strongly of the view that better outcomes would be achieved under such a threat where actual substantial abuse of market power is dealt with rather than with a regulatory framework based upon an unsubstantiated suspicion that significant, economically damaging abuse may occur.

Monitoring

We would support monitoring arrangements that cover data beyond that currently collected under the *Prices Surveillance Act 1983* and the *Airports Act 1996* and see no reason why such arrangements could not be put in place by way of regulations made under existing provisions of Parts 7 and 8 of the *Airports Act 1996*. We would however stress that the monitoring arrangements need to be fit for the task, focussed and not overly burdensome.

We have previously indicated that we see quality reporting as desirable although we would encourage the Commonwealth to review current arrangements with a view to facilitating comparisons between airports and focusing on the areas most important to airlines and passengers. We intend to make quality standards and information transparency an integral part of the offer we make to airlines.

Other areas for which monitoring could be considered include prices (including annual changes), capital expenditure, capacity utilisation and traffic growth.

Contractual and Legislative Issues

Option B is not particularly different in content to the Price and Quality Undertaking proposed by Sydney Airport and endorsed and developed by us except that it would rely on contracts between airports and airlines.

What concerns us is what happens if agreement cannot be reached. It is not feasible for airports to cease to provide airlines with services. Whilst "good behaviour" guidelines will help, without compulsion, or significant and symmetric downside risks for both parties, our experience is that it will be difficult to reach conclusive agreements on an individual or industry wide basis. Again, the issues of 'the right to charge' will need to be addressed, especially in relation to itinerant users.

In our supplementary submission[17], we set out a legislative form that encourages negotiation and agreement but doesn't leave the parties stranded in the event that negotiation is not conclusive. It also addresses the 'right to charge' issue and the relationship of this industry specific regime with the more general National Access Regime. Having reviewed the relevant legislation, we are not clear on how the Commission's proposed "Ministerial reluctance to declare" would sit with rights of appeal to the Australian Competition Tribunal without specific legislative provisions.

We are also concerned as to the timetable for implementing these changes, given that the current regime expires on 30 June 2002. In the first instance, it would be worth exploring with the ACCC what form of undertaking they might be prepared to accept under Part IIIA in relation to the services in question. If such an undertaking could be put in place by 1 July 2002, Government would not need to put in place measures under the *Prices Surveillance Act 1983* or legislate for a specific regime. Alternatively, Government could put in place a reformed price cap along the lines of Option A (discussed below) but remove such controls if an access undertaking was accepted by the ACCC at a later point or an alternative industry based regime put in place. If this option were pursued, we feel the *Airports Act 1996* would be the appropriate primary piece of legislation to contain the industry regime with any regulatory powers held by the minister responsible for that Act.

We do share the ACCC's concerns about the pure negotiate-arbitrate model presented by pure use of Part IIIA. However, we feel that an approach along the lines set out above would address many of their concerns and we would be keen to explore with them how such and outcome could be achieved in an administrative sense.

Good Conduct

The Commission has sought comments on what might represent "good conduct" for the industry. This is a difficult issue and care needs to be taken to ensure that the development/imposition of such a code does not become a form of intrusive regulation. Moreover, if the industry develops in the way that the we and Commission hope, the industry is likely to move increasingly onto a more bilateral rather than multilateral footing where successful conduct outcomes will be a reflection of the styles and commercial interests of the two parties.

That said, there will be some basic features of any such arrangement

[17] Melbourne Airport (2001b, p13-14)

- *Transparency and information exchange*. Both parties are entitled to have information about how the other's business plans will impact their own. Airports need to understand how traffic volumes and route structures are evolving to ensure that adequate infrastructure is put in place in a timely, and from their point of view, profitable way. The situation of Virgin Blue refusing to provide Melbourne Airport with its traffic forecasts is a classic case in point. The parties also are entitled to have such information kept confidential.
- *Consultation*. Airlines are entitled to be consulted regularly about the development of the airport, especially in relation to the airfield and terminal precinct. Both sides are entitled to the other being genuine about meaningful consultation including each committing the necessary resources to resolve issues promptly. Neither side should have to chase the other for responses to requests for dialogue or discover the others view when the matter is with the regulator.
- *Pricing conduct*. Airports should have in place basic pricing policies that are known and sustainable over time and these should, wherever possible, be agreed with the majority of their airline customers. These policies should be part of a "standing offer" around which individual agreements can be structured.
- *Clear description of services*. It is in the interests of both sides for there to be a clear understanding about what services are being provided, including the quality of the provision of those services. Airlines need to make a real effort to properly express to airports what exactly it is that they want.

One can no more legislate for good conduct in business dealings than one can legislate for honesty in political life. As these issues are ultimately about arrangements between airports and their customers, the best option is for them to be addressed by the contractual arrangements for the provision of aeronautical services. They should also be part of any access undertaking or similar device that may be used.

Option A

Whilst we agree with the Commission that Option A is an inferior outcome for the regulation of Phase 1 airports, it does have the potential to provide improved outcomes if a number of issues are addressed with sufficient clarity.

Scope of regulatory domain

The range of services covered by the cap should be no broader than is currently the case with the possible exception of fuel throughput levies. However we would urge the Government to issue an exposure draft of the relevant instruments along with a discussion paper so that as much clarity about definitions can be built into the instruments. As this is largely an issue about policy development rather than regulation, we would suggest this be most appropriately done by the Department of Transport and Regional Services.

We agree with the Commission that the cap should be restricted to services provided to airlines and as such, car parking, taxi and other ground access services should be excluded. That said, some clear guidance is needed about the treatment of multiple use assets (such as road infrastructure) largely for the purposes of allocation in regulatory accounting and any on-going investment procedures.

Efficient Prices

In our original submission, we cited Professor Kahn's view that prices based around long run incremental costs would be efficient and have a number of other desirable qualities[18]. Moreover, if prices were set at long run incremental cost, then airports would not need to seek price increases to fund investment in capacity and maintenance. This will limit any necessary new investment arrangements (which are the singularly most costly, uncertain and contentious part of the current regime) to new services, quality improvements and regulatory-change related (safety, security, environment) expenditure.

Arriving at long run incremental costs would be a highly complicated and intrusive process for regulators to undertake on a service by service basis – the task of identifying services and increments in an airport system would be fraught with problems. As we have also indicated, the return path of such a pricing regime would see airports earning returns that are below WACC when surplus capacity is plentiful that rise over time as capacity is utilised – and it should not be assumed that this path is linear. Thus, using returns as a proxy for efficient prices also presents some difficulty.

The approach to this issue used by Sydney Airport seems to have been to argue that as the airport is at or near capacity (essentially because of site constraints), the

[18] Melbourne Airport (2001a, p44)

reasonable increment for analysis is the airport as whole and therefore average costs approximate incremental costs.

This approach does not work for Phase 1 airports. Firstly, the sites in question, perhaps with some minor augmentation, are large enough to accommodate airport development for the foreseeable future. Secondly, varying elements are at differing levels of utilisation, some near capacity. For example, in the near future Melbourne Airport's international terminal will require additional aerobridge serviced gates and parking positions but new runway developments probably won't be required for a decade.

As we have previously indicated, it would be appropriate for airports to be earning around their cost of capital by the end of the next five-year period. We have previously indicated that we did not see an overwhelming argument for a step increase in price but rather this could be achieved by a price path that saw prices increase at a modest rate in real terms, after taking into account capital programs and expected movements in operating costs. Recent events have caused us to reconsider our position on this question. In the light of those events, current prices are so low that if they became the benchmark upon which a new price control regime was build that regime might well collapse under the weight of under-investment and congestion. Further, a step increase would provide some more scope for airports to price discriminate. However, we would not consider a step increase of the magnitude achieved by Sydney Airport appropriate.

Careful consideration will be needed in the event that Ansett's terminals by some means or another are operated in future by airports as common user facilities. This may also involve consideration of the treatment of some surplus or stranded assets. Again, we would urge that Government consult on these issues prior to instruments being set in place.

If Option A were preferred, we would suggest that each of the three Phase 1 airport operators should be able to put to Government a price path consistent with their business plans after having discussed it with their airline customers. Given only three airports would be involved, individual directions could be given to the ACCC for each airport. The ACCC could provide advice to government as to whether based on existing information collected and published by the ACCC, and relevant capital expenditure and traffic forecasts, the price path constituted an economically damaging abuse of market power. We believe that this could be done relatively quickly and should not involve a drawn out process similar to that undertaken for Sydney Airport's recent pricing proposal. Melbourne Airport has already commenced discussions on capital expenditure with its airline customers.

Further given the Commission's views on the balance of risks with price regulation, it would be prudent to ensure that the regulator was not instructed to aim for the optimal price, but rather a little above it, to ensure that if error was involved, the prices fixed were unlikely to be too low.

Investment

Unlike the Commission, we see clear merit in building capital expenditure into the price control formula, as the NNI provisions have been one of the most intrusive and costly parts of the regime. It is conceded that if prices were set around efficient levels, the need for NNI proposals would be lessened, as would the scope of any allowance for capital expenditure in the price control formula.

Our general preference is for a mechanism that includes a capital program in the price control formula largely for the reasons outlined by the ACCC[19]. We would see annual reporting of investment expenditure, especially to airlines, as an entirely appropriate first step to dealing with the under-investment problem. In any event, given a dual till, the likelihood of under-investment in both quality and capacity are low for the reasons identified by the Commission providing the rate of return implied by the pricing path is not too low.

If such an approach were adopted, some mechanism would need to be put in place to deal with projects unexpected at the time of setting the cap (especially those related to safety, security or environmental compliance) or those projects whilst expected at the time of the cap involved significant uncertainty about costs (such as works related to new large aircraft). We agree with the ACCC that such arrangements should only apply to large projects although we would caution against relying precisely on the triggers contained in section 89 of the *Airports Act 1996* for major development plans. We would see the current NNI arrangements as providing a useful place to start but would suggest that the relevant cost of capital parameters (in particular the asset beta) and cost allocation rules should be specified in detail at the time the instruments are put in place.

Quality

Airlines have rightly observed that they have no undertakings from airports about service quality and that this does seem to be an unusual commercial situation. That said, Melbourne Airport has on a number of occasions asked airlines to specify

[19] ACCC (2001a, p103-105)

what services they feel they need quality undertakings in regard to and what levels they would like these services provided at. To date, we have not received a response.

In a confidential consultation paper circulated to airlines, we have indicated a preference for adopting the "Q factor" approach, proposed by BAA to the CAA's review of UK airport regulation, as a way of incorporating explicit quality related price incentives. We would urge the Commission to look at this as a possible way of dealing with quality issues if Option A is preferred. However, incorporation should only be required if there was a strong view that the risk of quality deterioration below an acceptable level could be expected.

Contractual and Legislative issues

We would have thought that Option A could be implemented under the *Prices Surveillance Act 1983* albeit with all the inherent problems of that statute. Alternatively, the *Airports Act 1996* could be amended enable the Minister to make regulations in relation to price regulation of airports subject to the Act. This would have the advantage of retaining some "reserve powers" if Government felt it needed to deal with sustained unacceptable conduct by airports that had experienced price control removal or if the *Prices Surveillance Act 1983* was repealed or amended.

As part of this arrangement, airports and airlines should be asked to re-negotiate conditions of use documents which in many cases have been the subject of uncertainty and dispute. If after reasonable consultation, agreement is not reached, the airport should be able to put this document, along with evidence of the consultation to the Minister for consideration in much the same way that Master Plan and Major Development Plans are dealt with. The final approved version would be considered to be an enforceable document and should have a term of five years. Obviously, an agreement would have the force of contract and could be used as a default offer that was also enforceable for any new entrants. No constraints should be placed on agreement to variations other than the general statute and common law. It would be highly undesirable if the current lack of a clear contractual or statutory basis for charging for aeronautical services to continue.

Further, it would be highly desirable for these agreements, plus compliance with the price control device, to be treated as a effective access regime for the purposes of Part IIIA of the *Trade Practices Act 1974* in respect of the regulated airport services. In the event that access disputes arose with respect to any other services provided by price-regulated airports, or for any other airports, there should be no diminution of the rights of access seekers under the general provisions of Part IIIA.

Access Appendix

Aeronautical services access issues

The key issue in relation to access at non-congested airports is price. The commercial reasons the Commission has identified as to why airports would restrain from excessive pricing, coupled with the presence of large fixed costs and low marginal costs, would indicate denial of access to be simply an unprofitable strategy for airports. This seems to also be the view of the ACCC[20]. Arrangements with incumbents to exclude entry are for similar reasons unlikely although if they were to occur, it does seem clear that they would breach Section 45 of the *Trade Practices Act 1974*. Nonetheless, this seems to be an issue that many participants in this inquiry feel regulators should remain involved in.

With respect to Phase 1 and 2 airports, access is available via Section 192 of the *Airports Act 1996* under criteria generally less onerous that those contained in Part IIIA of the *Trade Practices Act 1974*. We find it curious therefore that Qantas has indicated that it has experienced significant difficulty in accessing a range of services even though it has access provisions available to it and which it has not used. We can only assume therefore that the services they have had difficulty in gaining access to either are not subject to the regime or do not pass the declaration tests. In any event, this difficulty does not appear to have prevented Qantas pursuing its corporate objectives and therefore one must question whether the services in question are essential services.

It is important to keep in mind two things when assessing what might appear to be an access dispute. First, one must not confuse robust commercial bargaining as abuse of market power. Secondly, especially in relation to access conditions, facility location and similar issues, airports have a range of short and long-term planning and operational issues that must be managed for the benefit of all users and the travelling public and that are affected by existing rights and agreements. These may not always be convenient for individual access seekers but are in no

[20] ACCC (2001a, pp94-97)

sense an abuse of market power. We note that when these sorts of issues have emerged the ACCC rightly has not sought to involve itself.

We note further that Qantas has provided some ideas about the access provisions contained in the *Airports Act 1996*. Its proposals would entrench arrangements that were clearly intended to be transitional. To implement their proposals clearly raises issues of sovereign risk. Moreover, it would further widen the gap between the declaration criteria in the *Airports Act 1996* and Part IIIA of the *Trade Practices Act 1974*. Yet Qantas has provided no arguments as to why airports should be subject to less stringent declaration provisions than other providers of infrastructure services in the economy generally. We are strongly of the view that there is no justification either in theory or as a result of actual conduct to place airport operators under an access regime any more onerous than that faced by providers of other infrastructure services.

Non-competing ground access issues

When airports were publicly owned within the FAC public access to certain facilities was provided on what would now be regarded as a community service basis. An example of this the free access that was provided to a range of users (including limousines, politicians, the Diplomatic Corps) car parking at Melbourne Airport. When users have been asked to pay for these services, the obvious protests have emerged.

The services in question often involve parking facilities and in the case of services to the taxi industry and others, labour and systems to manage dispatch and traffic movement. Whilst associated costs were incurred previously and to some limited extent were recovered, there were no margins on operating costs and capital employed – not to mention the land used – earned zero returns. As demand for air travel and freight has grown, so has vehicular access of all sorts at airports leading to both additional costs and congestion. Safety, especially where traffic interacts with pedestrians is also an area of critical concern.

Congestion is an important concern. Where access is free, users will simply seek to use the most convenient parts of the roads and parking system. They share this system with the general public, airline staff and operational vehicles and others accessing the wide range of businesses at the airport. Part of our approach to managing the ever increasing demand on this finite capacity system is to use price to encourage various users to make use of less utilised facilities or revise their

intensity of use. The point of all this is the same as with access for airlines – in many cases, issues about access are actually a reflection of operational conditions or site constraints.

This is one of the reasons Melbourne Airport introduced taxi charges in order to discourage taxi drivers from seeing Melbourne Airport as a free, premium location to wait to collect larger than average fares, and to cover the significant cost that continues to be absorbed by both ourselves and the airlines. We find it interesting that the ACCC[21] and the Australian Taxi Industry Association[22] both recognise that airport ground access fees are essentially charges for parking vehicles in holding areas – a point we have made all along. What is not explained is why these parking facilities should be treated differently to those used by airline staff, car rental companies or the general public.

Competing service ground access issues

At a theoretical level we accept that incentives exist for airports to restrict access to competitors in markets where the airport is either directly vertically integrated (such as car parks) or indirectly integrated (such as car rental). That said, it is our view that these are not of major practical concern and certainly, would not constitute services that could be considered to be of "national significance" for the purposes of declaration under Part IIIA of the *Trade Practices Act 1974*. Further, only one dispute of this type has emerged. This was with Delta. To some extent Delta's application reflected its lack of understanding of the benefits it would derive from declaration. Clearly the sorts of practices of theoretical concern are not rife in practice.

The issues discussed above in relation to other ground access issues are also relevant in this case. A significant part of the debate in relation to the Delta Declaration was the issue of where Delta was able to drop off and pick up its customers. At the time, Melbourne Airport had become increasingly concerned about the conduct of off-airport car park and car rental vehicles at the front of the terminal – especially with regard to queuing across pedestrian crossings. The plan was to provide an area for car rental operators to collect and drop off passengers that would alleviate some of the congestion in an area used by a host of other operators and the public accessing the terminal complex.

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21 ACCC (2001b, p12)

22 ATIA (2001, p2)

In a similar vein, charging competitors for the use of these facilities which are highly congested does not of itself constitute an abuse of market power that should involve the intervention of regulators, particularly as competition regulators are in no sense accountable for operational or safety outcomes.

Again we accept that the granting of licences to car park and car rental operators by airports has the effect of integrating the airport down the value chain. The grant of an exclusive licence (or a fixed number of licenses) is likely in many cases to simply reflect the fact that the premises that are sought by operators are in fixed supply.

This is the case with car rental premises in the short-term car park at Melbourne Airport. There are a fixed number of sites that are let for fixed terms to operators. It is important to note, however that these premises were let on a competitive basis and that operators do compete with each other to provide these services. That airports derive significant revenue from these sites is a reflection of the market valuation of these sites by the downstream industry – it is clearly locational rent. That the airport is effectively integrated with the downstream industry as a whole seems to be no more problematic than the interdependencies that airlines so often put forward which clearly imply significant integration of the airport with the downstream airline industry.

We note Qantas is concerned by these issues but provides no examples (at least publicly) of competition being effected in either upstream or downstream markets. We also note Qantas provides an integrated valet car-parking product at many airports and has strategic relationships with a number of car rental companies. Does it suggest that its activities in these industries should be regulated?

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