BOARD OF AIRLINE REPRESENTATIVES OF AUSTRALIA INC.

Supplementary response to the Productivity Commission's Draft Report on Price Regulation of Airport Services

BARA

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1. Introduction

This note provides further views and comment by the Board of Airline Representatives of Australia (BARA) on the Productivity Commission's Draft Report, *Price Regulation of Airport Services*. Specifically, further comment on the Commission's preferred option of price monitoring is provided. BARA considers that this option would lead to large increases in aeronautical prices, higher airline ticket prices, and reduced demand for air travel. Moreover, airlines and airports alike will be subject to a period of considerable uncertainty surrounding future regulatory arrangements, which will not promote investment or growth in the industry.

The Commission's recommendation for price monitoring relies on the threat of regulation to induce acceptable behaviour on the part of airports. Whether airports have been well behaved is to be decided by an independent third party (not the regulator) in a review to be conducted in five years' time.

The Commission has not described criteria to be used in this review in its Draft Report. As discussed in BARA's previous submission, this is a crucial element of the policy recommendation. The absence of suggested criteria limits BARA's ability to comment meaningfully on the Commission's proposal.

In BARA's view, the draft report also contains significant gaps in its assessment of practical issues surrounding the review, and the incentives created by the price monitoring approach.

2. Practical issues surrounding the review

BARA has assumed that the review of airport behaviour will examine the behaviour of all monitored airports at one time, and will involve an examination of airport costs in relation to prices. (Indeed, it is difficult to see how any sensible examination of the use of market power could occur without scrutinising costs and prices.)

BARA would like to point out the practical difficulties associated with reviewing costs at all monitored airports at the one time. As noted in its previous submissions, reviewing costs is a difficult and time-consuming exercise.

BARA considers that airline input into the review is important. As shown in the review of aeronautical prices at Sydney Airport, independent third parties (in this case, the ACCC) have great difficulty in assessing the veracity of airport claims as to their costs. Input from airlines is important in identifying assets that should not be classified as 'aeronautical' assets, or whose valuation is excessive.

In practical terms, airlines do not have the resources to be able to undertake cost reviews of several airports at once. First, specialist engineering and quantity surveying expertise needs to be contracted in. There is a limited supply of such technical experts in Australia with experience in the airport sector. Presumably, airlines, airports and the body conducting the review will all be vying to hire this expertise. Putting this issue to one side, potentially a much more important limiting factor relates to the time inputs required from airline staff. Experience from the Sydney Airport pricing exercise has shown that significant input from experienced airline staff with detailed, practical knowledge of the relevant airports is required. Finding time in the normal working week of these operational staff is difficult enough when reviewing one airport – airlines are concerned that it would be extremely difficult to devote sufficient time to do justice to the review of several airports at once.

If all airports are to be reviewed at once, airlines are concerned that they will not be in a position to participate fully in that review, which is clearly unsatisfactory. Reviewing all airports at once would also be very difficult for the body conducting the review. BARA requests that the Commission take these factors into consideration when considering its price monitoring review proposal.

BARA also notes that the need for a major cost study of each airport could be avoided if the Commission's option of renewing price cap arrangements were implemented. As suggested by the ACCC, a review of price cap arrangements could leave existing price levels in place, and confine its attention to setting a new X factor, based on expected productivity trends.

3. Likelihood of the abuse of market power

BARA does not consider that the threat of re-regulation is likely to be an effective constraint on the use of market power by airports. This is because:

- the behaviour of Coolangatta and Canberra Airports upon their release from price caps does not bode well for the behaviour of larger airports facing fewer constraints on their behaviour;

- if price monitoring seeks to constrain prices to the levels that might prevail if airports were regulated on a dual till basis, airports might be better off pricing at monopoly levels for five years and then reverting to price regulation; and

- it is doubtful whether Governments will credibly commit to (potentially) large downward price shocks in five years' time if prices need to be re-regulated.

3.1. Lessons from Coolangatta and Canberra Airports

Having recently been released from their price cap arrangements, Coolangatta and Canberra airports have since raised their aeronautical prices by 171 per cent and 112 per cent respectively.

The Commission's proposal for price monitoring relies heavily on the threat of re-regulation to induce airports to resist the incentive to use their market power.

The actions of Canberra and Coolangatta Airports under a price monitoring regime has increased BARA's concerns regarding the likely behaviour of major airports under such a regime.

The Commission considers that Coolangatta and Canberra Airports have significantly less market power than airports such as Sydney, Melbourne, Brisbane and Perth. Moreover, a range of other factors would suggest that the constraints on airport pricing are greater now than they would be ordinarily.

Firstly, Coolangatta and Canberra Airports knew that their actions would be closely scrutinised by the Government, airlines and the press, since these were the first price increases to occur under the new system of price monitoring.

Secondly, the Commission's final report is in the process of being completed, and evidence of actual behaviour under price monitoring would likely be included in its analysis. The airports must have assumed that their behaviour could potentially influence the Commission's recommendations for pricing constraints in the future.

Finally, the airline industry is in turmoil following the events of September 11 and the collapse of Ansett, both of which have created difficult times for local tourist industries at both the Gold Coast and Canberra.

In short, it is difficult to imagine a time when there could be more pressure on airports to constrain aeronautical prices. However, despite the combined effects of these constraints, Canberra and Coolangatta felt able to impose large price increases, which would result in revenues far in excess of the lost revenue suffered as a result of the collapse of Ansett. This does not augur well for the behaviour of larger airports with greater market power under more 'normal' circumstances.

3.2. Incentives for good behaviour

Although the Commission failed to specify its criteria for 'good behaviour', the Commission appears to endorse pure dual till pricing outcomes. Presumably, pricing in excess of this level would constitute at least *prima facie* evidence of the use of market power.

If this is the case, airports are essentially faced with an ultimatum: 'Price as if you were regulated under a dual till or else you will be regulated under a dual till in five years' time.' In this case, the profit maximising strategy is likely to be to price at monopoly levels for five years, and then be regulated on a dual till basis thereafter.[1] Unless there are very large compliance costs associated with price regulation, which airports would prefer to avoid (ie large enough to outweigh five years' worth of monopoly profits), monopoly pricing seems to be a reasonably likely outcome of such a regime.

BARA suggests that the Commission examine the incentive effects its recommendations establish more closely. Pricing at levels that take advantage of airport market power should not be a probable outcome of its recommendations.

[1] As discussed in the Commission's Draft Report, airports have an incentive to take non-aeronautical profits into account when setting aeronautical prices . The interdependency between aeronautical and non-aeronautical demand suggests that the profit maximising price level for aeronautical services would be lower, and the corresponding output higher, than if this interdependency did not exist. However, this interdependency provides no guarantee that the profit maximising price would create no significant impact on demand. The impact on aeronautical demand would be a function of the relative slopes of the demand curves for aeronautical and non-aeronautical services, as well as the strength of the interdependency.

3.3. Would the Government credibly commit to price shocks if airports abuse their market power?

The Commission's discussion of the price monitoring option does not provide details of what the options are for regulation at the end of the five year period if airports are found to have been abusing their market power. If regulation is to be re-introduced, there seems to be two obvious options:

- reduce prices to 'appropriate' levels (we assume the Commission considers pure dual till levels to be appropriate), and apply an X factor into the future (which could be positive, negative, or zero); or

- leave prices where they are at the end of the five year period, and apply an X factor to apply from then on.

The key issue to be addressed by the Commission is the penalty that would be imposed on airports that abuse their market power in the period prior to the review. If incentives to abuse market power are to be counteracted, the former seems the more logical choice.

However, this obviously raises the issue of price shocks to the airports, which could potentially be very large. BARA questions whether airports will believe that Governments will impose such large price shocks. If the threat of re-regulation starting at more reasonable prices will not be taken seriously by airports, then it is unlikely that the Commission's price monitoring option will adequately constrain the abuse of market power. Further, it is highly likely that such price shocks, if they occurred, would create uncertainty and deter efficient investment in the aeronautical industry.