Capital Airport Group Pty Limited

Submission to the

Productivity Commission Review of

Price Regulation of Airport Services

March 2001

Executive Summary

Capital Airport Group has made its submissions to the Review of the Prices Surveillance Act available to the Productivity Commission for the purposes of its inquiry into the Price Regulation of Airport Services given the relevance of issues to both inquiries. The following submission supplements the material already provided to the Productivity Commission and addresses the issues that Canberra International Airport consider paramount in moving from the current unworkable regulatory framework.

The price cap framework was introduced at the core regulated airports following the privatisation of phase 1 and 2 airports in 1997 and 1998. The airport price cap was intended to be a light-handed form of 'incentive' regulation that provided a basis for commercial negotiations between airports and their users prior to its removal after the initial five-year regulatory period. Capital Airport Group contends that the price cap framework has evolved into a complex, laborious and intrusive form of regulation that not only fails to deliver the Commonwealth's regulatory policy intention, but subverts the negotiation process and restricts the investment activity of airports.

Capital Airport Group considers that the current regulatory framework is skewed toward the commercial interests of the major airlines and fails to provide airports with an appropriate incentive to invest their scarce capital resources in aeronautical infrastructure. Such an outcome is inconsistent with the objective of promoting competition and consumer welfare in the market for air travel services.

Capital Airport Group therefore advocates a substantial shift away from the current price cap regulation in favour of a workable framework that focuses on maximising total economic surplus in the market for air services and allows for the efficient, economic and profitable operation of airports in Australia. Such a framework would recognise the role of airports in the economy and encourage a timely investment in airport infrastructure so as to provide facilities of an appropriate standard for new and incumbent operators and their passengers.

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1. Introduction – The Canberra Airport Philosophy

Upon assuming control of Canberra Airport in 1998, Capital Airport Group had no prior experience in the ownership and management of airports. Rather the organisation's background was in the development and management of quality commercial properties in Canberra and Sydney. The decision to invest in the airport was in recognition of the development potential of the asset and the growth potential in the aviation market as well as the importance of the airport to the local community. However the challenges that would be faced in realising the potential of the airport were somewhat underestimated.

Airports are very significant leadership investments for cities and regional communities, they have substantial flow-on benefits to the economy with investment in the airport asset generating substantial multiplier effects. Airports and governments therefore have a strong imperative to maximise the airport's contribution to the local economy through investment in infrastructure that facilitates growth and development of the aviation market.

The importance of airports is increasingly becoming recognised:

'Some cities in the world have not yet discovered what an "uncut diamond" their little airport is. To those politicians I would like to say: you can destroy your diamond and it will be gone, or you can cut it and develop it into a wonderful gemstone that will give your city the competitive edge and unique attraction that may be the difference that makes corporations move to your city – making it prosper with more employment and taxes.'

- Bjorn Rotsman, Secretary General CCAA

'Airports say a lot about a place because they are both a city's business card and its handshake: they tell us what a community yearns to be as well as what it really is.'

- Best selling travel author Pico Iyer

'Airports are seen as key infrastructure elements for globally connected economies. The concept of airports becoming 'business parks with runways' and performing similar functions to the 19th and 20th century seaports in the next millennium, is one worth investigating.'

- Professor Lindsay Neilson

Part of realising the potential of the airport asset is to attract new business. Capital Airport Group recognised that the Canberra market had impending growth opportunities, and given the airport's inability to influence price of airline tickets (especially in a domestic duopoly comprising two premium quality carriers), the only way for the airport operators to grow their business was to facilitate growth in the market. Capital Airport Group has actively sought to establish new services and new entrant airlines in the Canberra market. While the airport has incurred the wrath of the major airlines in many instances, the increase in competition has resulted in substantial benefits accruing to travellers and the broader local economy.

The key issue for airports in the development of their asset is their ability to accommodate growth and competition in the market. With competition delivering growth in the market in the order of 30-40% airports must be responsive to the demands for necessary airport infrastructure.

Capital Airport Group has prided itself on the initiatives it has undertaken to grow and develop the Canberra aviation market and the responsive manner in which it has met the demands of both incumbent operators and new entrants. However the regulatory system is constraining the flexibility of airports to accommodate growth and new entrants and imposing a regulatory burden on airport operators that merely serves to constrain total economic surplus in the market for air services.

Capital Airport Group therefore encourages the Productivity Commission to focus its review on maximising the economic benefits generated by airports and recommend the adoption of a simple, flexible and investment friendly approach to pricing airport services.

2. Airports – A Community Asset

Although the major airports in Australia have been privatised they continue to perform an important role as a community asset. Fundamentally, an airport's primary role is to facilitate business or people doing business. However an airport's business activity also generates economic activity in other sectors of the economy such as tourism, building and construction, hospitality and a myriad of other support industries.

In addition, airports also play a critical role in determining the competitive nature of the local air travel market. Airports therefore have the capacity to deliver substantial economic gains to their local communities. Needless to say, the motivation for airport development may not be entirely altruistic, airports and their local communities have a shared interest in realising the potential of the airport asset.

2.1 The Economic Value of Airports to the Community

Airports are arguably one of the most important infrastructure assets for their local communities and surrounding regions. Not only do airports serve the transportation requirements of air travellers but they are also key drivers of the local economy. Any future form of airport regulation must therefore recognise the importance of airports as leader investments with the potential to generate economy-wide benefits. Development of the airport asset through ongoing investment by the airport operator will ensure that airports maximise their economic value to society.

Capital Airport Group's submission to the PSA Review highlighted the contribution of the airport to the Canberra economy[1]. Broadly these benefits comprised:

- Airport businesses contributing $174 million in direct value added to the region's GDP and $361 million in turnover.
- The airport generating a further $800 million in turnover and $380 million in value added as a result of flow-on benefits to the regional economy.

The above analysis is derived from an economic study of the airport undertaken by ACIL Economics in 1998[2]. Since then however, Capital Airport Group has invested over $35 million in upgrading and developing the airport asset. This investment has been necessary to remedy quality deficiencies and address operational inefficiencies resulting from the Federal Airport's Corporation failure to maintain an appropriate level of investment in airport facilities. Capital Airport Group estimates that this investment alone has had a flow on benefit of more than $63 million to the local economy.

2.2 The Airport's Role in Delivering Competition to the Canberra Market

Access to suitable airport facilities is a critical success factor for the viability of new entrant airlines[3]. Capital Airport Group has recognised the key role played by airports in facilitating

[1] CAG submission to the PSA Inquiry (February 2001) p.16-18
[2] ACIL Consulting Pty Ltd 1998, 'Canberra International Airport and the Australian Capital Region'
[3] Key findings of a report by the FAA/OST Task Force 'Airport Business Practices and Their Impact on Competition, US Department of Transportation, October 1999.

competition in the airline industry and has demonstrated its commitment to be responsive to the infrastructure requirements of all airlines.

Upon completion of the CUCT project all airlines will have access to essential airport facilities on **equal** terms. The availability of such infrastructure and the airport's responsive attitude to the needs of new entrant airlines has resulted in Virgin Blue also expressing a keen interest to servicing the Canberra market.

The ACT economy is also benefiting from the initiatives undertaken by Capital Airport Group in bringing new entrant airlines to the Canberra market. An ACIL study commissioned by the ACT Government shows that the local economy stands to reap $93 million of direct economic benefit (or $168 million indirectly) from Impulse's decision to locate its southern hub operations at Canberra Airport[4]. Furthermore, the travelling public has benefited from reduced airfares with competition at Canberra Airport alone delivering savings of $20 million to travellers[5].

Capital Airport Group's approach to facilitating not only the introduction of new entrant airlines but also the expansion of incumbent airlines' operations has seen enormous growth in the Canberra market. Since privatisation in 1998, the travelling public have benefited from a 60% increase in airline services at Canberra Airport from 384 to 614, improving the destination and frequency of service availability for travellers.

However, the benefits that have resulted from Impulse's introduction to the market, as well as the expansion of Qantas and Ansett's operations at the airport, could not have been achieved without the investment that has been undertaken by the airport operator. With over $35 million of capital expenditure so far and a further $100 million earmarked for airport development over the next 5 years, this continued level of investment at the airport is dependent upon the current prohibitive price cap regulation being abolished.

The Productivity Commission's review of the regulation of airport services must therefore be undertaken in consideration of the role played by airports in the local economy and the influence that airports have on the competitive structure of the airline industry. Airports around Australia have demonstrated a willingness to actively expand the market for air services with a resultant positive impact on both the local economy and airline competition. However, the current airport regulation merely serves to inhibit the efficient operation of the airport business through an unreasonable restraint on prices. The cost to the community of the current regulatory framework has the potential to be substantial given the level of airport investment and the distortionary impact on long-term investment decisions.

[4] ACIL Consulting 2000 'Impulse Airlines and the Canberra Economy: Impact of Direct Air Services Triggered by the Relocation of Impulse Operations to Canberra'
[5] CAG submission to the PSA Inquiry (February 2001) p.18

3. Airports Specific Regulation – Fundamentally Unnecessary

The price cap framework was initially intended to assist the transition to private ownership of airports and promote commercial negotiation between airports and their users. Having failed its original policy intent it has been argued that the price cap prevents airports generating excessive rents on the provision of airport services by virtue of their natural monopoly characteristics. However it is the experience of Capital Airport Group that external forces in the air travel market make specific regulation of airport pricing redundant.

There are a number of factors that limit the power of airports to set prices for aeronautical services above efficient market levels. These include the competition for air traffic and airline operational/maintenance bases and, more significantly, the countervailing market power of the major airlines in Australia. In addition, the relative insignificance of airport pricing to consumers suggests that the economic costs of regulation far outweigh any negligible consumer benefit derived from restraining prices below their efficient market levels.

3.1 Competition for Services

Airports face competition for the services they provide on a number of fronts. Firstly, airports compete with substitute modes of travel such as rail, coach and private vehicle. In the case of Canberra Airport, competition for air services is particularly prevalent from road transport. Studies show that air transport is preferred by travellers on journeys greater than 3 hours. With Sydney services counting for over 50% of the Canberra air travel market and the continual improvement of the dual carriage highway between Canberra and Sydney, travel time between the two cities can be achieved in under 3 hours making road transport a very viable alternative to air travel on what is the airport's most important route.

The joint Commonwealth/Speedrail surveys indicated that there were in excess of 4 million weekday **business** trips on the road between Canberra and Sydney each year. When contrasted to the 930,000 total air trips on the Canberra-Sydney route each year, it is clear that with air travel only capturing less than 25% of the market (excluding rail) for travel between Canberra and Sydney that road transport competes very effectively with air services, and thus the demand for airport services at Canberra Airport.

Secondly, airports readily compete for airline business, in particular for the opportunity to handle more of an airline's hub traffic and as the location of an airline's operational and/or maintenance base. Within reason an airline's base of operations and maintenance is not location specific and this flexibility provides the airline with a degree of discretionary power. For example Brisbane Airport has just secured a deal with Qantas to relocate their B767 maintenance facility from Sydney Airport. Brisbane Airport was facing competing bids from Sydney, Melbourne and Auckland airports for the location of the maintenance facility. Similarly, Canberra Airport has been involved in a number of bids to host the operational and/or maintenance bases of Kendell, Hazelton, Virgin and Impulse airlines.

Given the value that such a facility can add to an airport and the local economy, airport operators and often state/territory governments collaborate to deliver the incentives necessary to secure the facility. It is the total cost of operation at an airport that guides an airline's decision, and as such airport operators are motivated to prepare a competitive bid. Consideration of the total cost of operation at an airport includes the cost of landing fees and other relevant aeronautical charges.

While landing fees are likely to present a minimal contribution to the total cost of an airline's operation, it is clear that if they were prohibitively expensive then this would adversely impact the airport's bid for the airline facility and ultimately present a greater economic cost to the airport.

Thirdly, airports also compete for both international and domestic hub traffic. Canberra Airport is a particularly viable alternative to Sydney's Kingsford Smith Airport as a regional hub for aviation services. In fact, Capital Airport Group has actively sought to establish Canberra Airport as a regional hub and has developed price incentives to establish new regional services from Canberra. However, due to the irrelevance of airport pricing and the preferred strategy for airlines to service passengers through their dominated hub airports, new route development at Canberra Airport has been limited.

3.2 Countervailing Power of the Airlines

Qantas and Ansett control over 95% of the Canberra air travel market and therefore represent the primary source of airport revenue. Consequently the major airlines exert substantial buying power in the market for aeronautical services at Canberra Airport. Although Qantas or Ansett alone possess substantial market power when negotiating with the airport, Capital Airport Group has found that the incumbent operators will often collaborate to present an even more potent bargaining presence in the market.

Capital Airport Group has experienced the combined resistance of both Qantas and Ansett on necessary new investment proposals, paying rent for the counter terrorist first response (CTFR) service from the AFP (which itself is free in Canberra), the introduction of a passenger based landing charge and the wholesale rejection of the airport's conditions of use. The major airlines' collusive approach against Capital Airport Group on the issue of CTFR is illustrated in the appended letters. As you can see the letters from Qantas and Ansett are almost identical.

On more significant issues such as the Sydney Airport Pricing Proposal the major airlines will engage the Board of Airline Representatives of Australia (BARA), the International Air Transport Association (IATA) as well as their alliance partners to present a substantial bargaining and political force in the market. The major airlines therefore represent a well-organised and strategic presence in the market with sufficient power to redress any perceived unjust action by an airport operator. This has been demonstrated by the Qantas-led party of 19 airlines threatening not to make payment for use of facilities at Sydney Airport should the ACCC ratify its draft decision on the Sydney Airport Pricing Proposal, regardless of whether the ACCC deems the proposal to be based on fair and equitable charging principles.

Qantas and Ansett have controlled the aviation industry in Australia virtually since its inception and they continue to dominate the market despite microeconomic reform of the industry. They have the resources, the inclination and the means by which to counteract any unfavourable action by an airport operator. While airports may exhibit some characteristics of a natural monopoly enterprise, market power in the pricing of airport services is certainly not one of them.

3.3 The Impact of Airport Pricing

The demand for an airport's services is derived from the demand for airline services at a given airport location. Therefore an airport's business activity and profitability are totally dependent upon the commercial decisions of the airlines. Airlines determine the profit maximising level of

ticket price versus volume and this is a decision that has a substantial impact on the airport business given that airport profitability is volume driven. With evidence suggesting that Qantas and Ansett have adopted a high price-low volume position in the market, this is a decision by the major carriers that has a detrimental impact on airport revenue which is effectively outside the control of the airport operator.

Airport revenue is therefore controlled by the airlines. With airports representing between 0.5-3% of an airline's cost of operation, airports do not possess the supply side power to influence the price/volume mix. Airports recognise that the only way to grow their business is to facilitate growth in the market. Hence airports are committed to new route development and the accommodation of new entrant airlines due to the additional traffic volume that is generated from these initiatives. For this reason, the access provisions in airport regulation also appear to be redundant as it is not commercially attractive for an airport to refuse access to any airline on reasonable terms.

The relative insignificance of airport prices in the airline cost structure suggests that airport prices do not have a pervasive effect throughout the economy. In fact airport prices represent less than 0.8% of an air ticket from Canberra to Brisbane.

4. The Regulatory Experience So Far

Capital Airport Group has found the price cap framework to be incapable of delivering the desired outcomes of airport price regulation. It is Capital Airport Group's experience, as well as that of many other airport operators, that the price cap constrains the investment capacity of airports and limits the responsiveness of airports to meet the infrastructure requirements necessary to accommodate growth and new entrants in the market. Furthermore, current airport regulation engenders inefficiencies and uncertainty in the regulatory process making airport investment inherently more risky and less attractive to investors.

4.1 Investment Impacts

The price cap regulation is constraining the investment activity of airports by denying airports a fair return on capital invested. The returns on aeronautical assets for all of Australia's major airports are negligible at best, if not negative as is the case at Canberra Airport[6]. With current regulation not permitting a recovery of investment costs associated with replacement capital expenditure outside the price cap, airport operators have very little incentive to invest in maintaining aeronautical facilities knowing that any additional capital investment will not improve the current return on aeronautical assets. This creates an economic distortion where new aeronautical investment is preferred to replacement or maintenance investment, even where there is a substantial cost benefit in favour of the latter.

However airports also face little incentive or even the capability to undertake **new** investment. The power of veto handed to the major airlines by the regulatory framework effectively stifles the investment activity of airports. The ACCC's user support criterion is a major stumbling block for airports seeking a price cap pass-through of new investment recoveries. The undue emphasis placed on this criterion by the ACCC effectively enables the major airlines to exert control over the development of new infrastructure projects at airports.

Capital Airport Group has found that the user support criterion to be virtually impossible to fully satisfy with the major airlines engaging in regulatory gaming to minimise the cost passed through the cap. Even where an investment is absolutely necessary and demanded by the airlines, full user support from Qantas and Ansett is not forthcoming. The effect of the necessary new investment provisions is that airports, airlines and the regulator are engaged in a long and arduous process that effectively prevents airport investment being undertaken in a timely manner, if at all, and creates unnecessary uncertainty and cost for airport investors.

4.2 Competition Impacts

The major airlines have also utilised the user support criterion to deter airport investment that will provide facilities or capacity for new entrants. This is especially true of common-use facilities. The major airlines recognise that they are able to prevent, or at the very least delay, the development of infrastructure necessary for new entrant airlines.

In moving from the previous inefficient duopolistic arrangements at airports where Qantas and Ansett developed separate terminal facilities and imposed this inefficiency on passengers through

[6] CAG submission to the PSA Inquiry (February 2001) p.10

higher prices, Capital Airport Group considers that economic efficiency and competition can be promoted through the development of common-use infrastructure[7]. Capital Airport Group has therefore pursued common-user principles wherever possible in its development of Canberra Airport. This is consistent with the best-practice initiatives advocated by the US Department of Transportation for the development of airports so as to promote competition and efficiency in the aviation industry.

The current common-user terminal development at Canberra Airport will enable all airlines to cater for growth in their operations and better manage peaks in demand without the need for additional dedicated terminal areas. While common-use infrastructure is not necessarily commercially optimal for airports, Capital Airport Group considers that common use infrastructure provides important benefits in terms of passenger convenience, operational and economic efficiency and accessibility for new entrant operators.

4.3 Inefficiencies and Uncertainty

The current form of regulation engenders inefficiencies and uncertainty in the operation and development of the regulated airports. The regulatory process is costly, laborious and unnecessarily intrusive. Airports devote substantial resources to satisfying regulatory requirements, however the regulatory process has proven to be far from certain and consequently has further increased the burden of regulation on airports.

Airports expend vast resources in preparing new investment proposals to ensure that the regulator is appropriately informed of the elemental components of a project and appreciates the strategic objectives behind the airport's investment. Regulatory gaming activity undertaken by the major airlines creates ambiguity for the regulator on the merits of a project. In many instances airports are not privy to the submissions made by the major airlines and Capital Airport Group has proven a number of assertions made by Qantas in its submissions to be false.

As a result a necessary new investment proposal is analysed to the very last cost detail. Capital Airport Group has recently had to provide the airlines with construction invoices detailing and justifying costs associated with concreting, carpentry, metalwork and a number of other trade costs. No assertion has ever been made that the project cost was excessive but the focus of the regulator and the airlines is to analyse each project in miniscule detail. This merely serves to extend the approvals process and hence the failure of Capital Airport Group to have any project, no matter how small (such as a $78,000 runway lighting system) to complete the regulatory process in under six months[8].

Airports must cover off a vast number of issues in proposals to appropriately inform the regulator of issues surrounding the project and enable an informed decision to be made on an investment proposal. However, there will always be an information asymmetry between the industry and regulator and as such it is not appropriate that the regulator have de facto control of an airport's business activity. Airports know their market, they are familiar with the nature of the industry and are appropriately positioned to make commercial decisions regarding the operation of their

[7] CAG submission to the ACCC 'Common-Use Infrastructure Development at Airports' 10 January 2001
[8] CAG submission to the PSA Inquiry (February 2001) p.20

business. The best a regulator can hope for is second hand knowledge of the commercial pressures and investment requirements faced by airports.

Quite simply, airport operators would be much more effective in their operation of the airport business if they were provided the freedom to focus on developing and improving the airport asset for all airlines and their passengers instead of spending an inordinate amount of time on regulatory matters. Rather than spending upwards of 80% of senior management time engaged with the airlines and the ACCC disputing the unquestionable need for projects at the airport and devoting countless resources to the regulatory approvals process, airport operators would be much more productive if they could get on with the task of managing the airport business. The resource drain from the regulatory processes is a particular burden for small airports such as Canberra, and in consideration of alternative projects that can be undertaken, it is a sufficient deterrent to future aeronautical investment at the airport.

Another element of uncertainty that has arisen is what is covered by the airport price cap. Throughout the airport sale process airport bidders were promised that ground transport charges could be introduced at airports outside the airport price cap in line with plans initiated be the Federal Airports Corporation. However despite the policy intention of the Commonwealth Government the ACCC has taken a view that ground transport charges fall within the price cap. This severely constrains the revenue potential of airports and further reduces the recovery from aeronautical operations and the incentive for airport operators to invest in aeronautical facilities. Capital Airport Group intends to address this matter separately in a further submission to the Productivity Commission.

Therefore the regulatory experience to date has had a substantial negative impact on investment activity at airports. The power handed to the major airlines through the price cap regulation, and the regulatory process itself, serves to restrain an airport’s ability to develop necessary infrastructure to allow for growth and competition in the market. Furthermore airport regulation imposes unnecessary costs on airports, airlines and the regulator and, more importantly, on broader economic welfare.

5. The Future of Airports Regulation

In consideration of the impact that the current regulatory framework is having on investment and the commercial operation of airports, and its subsequent failure to deliver optimal social outcomes, Capital Airport Group advocates a substantial shift away from what has become a very heavy handed and intrusive form of regulation. Any future approach to airport regulation should promote the efficient operation of airports and encourage investment activity so that airports maximise their contribution to the economy. The only way that this can be achieved is if airports are permitted the flexibility to make commercial business decisions regarding the operation and development of the airport.

To this end Capital Airport Group is not opposed to an extremely light-handed form of monitoring whereby periodic 'checks' of aeronautical price structures are undertaken to ensure that airports are not charging prices that result in revenue exceeding a fair rate of return on aeronautical assets employed. Such an approach would not be inconsistent with the building block approach adopted by Sydney Airports Corporation and subscribed to by the ACCC in determining allowable revenues in many privatised public utility industries. Qantas and Ansett have always indicated to Capital Airport Group that pricing should be based on a transparency of costs. Capital Airport Group considers that an informal monitoring arrangement that provided for such transparency of costs would demonstrate that airports where not generating excessive economic rents in the provision of aeronautical services.

A reprieve from the intrusive form of airport regulation that has been experienced by airports since privatisation would allow airports to get on with their job of making necessary investments in aeronautical infrastructure to cater for growth and competition in the market. Most importantly, the anomaly in the current regulatory framework that permits incumbent airlines to inhibit an airport's ability to develop infrastructure for new entrant operators must be abolished.

Furthermore, with the regulator adopting a more 'hands-off' approach to airport pricing the airlines would have less incentive to engage in regulatory gaming and thereby encourage the major airlines to engage in productive negotiations with airports. A more hands-off role of the regulator would also avoid the situation whereby the ACCC takes a prominent role in the decision-making processes of the airport operator. Given the complexity of issues involved the regulator is not particularly well placed to gauge the relative benefits of a project, nor does it have an appreciation of the strategic objectives and significant commercial pressures in the industry.

Finally the outstanding issue of taxi and ground transport charges in relation to the price cap must be resolved once and for all. This is an issue where clearly the regulator has adopted a position in contrast to the Commonwealth Government's stated intention and with total disregard to commercial agreements between Capital Airport Group and the taxi industry.

6. Conclusion

Capital Airport Group considers that there the current regulation of airports has adverse impacts on investment at airports, on competition in the airline industry and on the commercial negotiations between airports and their users. Capital Airport Group encourages the Productivity Commission to focus its review on the total economic welfare impacts of airport regulation which suggest that the cost of regulation far outweighs any negligible **airline** benefit. Consumer interests are best served by airport regulation that encourages investment and competition in the airline industry such that the travelling public can benefit from improved quality of facilities, cheaper airfares and improved route networks and services. The role of airports as leader investments implies that economy wide benefits will accrue to society as a result of development of the airport asset.

Therefore, to avoid long-term negative economic impacts the current price cap regulation must be abolished in favour of framework that is truly light-handed and delivers appropriate incentives for airports to maximise their value to society.