Productivity Commission Inquiry into

Price Regulation of Airport Services

Response to Draft Report

October 2006

Prepared by

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Executive Summary

Melbourne Airport strongly supports the general thrust of the Commission's draft Report. The reforms recommended by the Commission, and accepted by the Government, in 2002 have enhanced investment outcomes and provided much more flexibility in an environment that has become much more volatile.

The Commission's attempt to move the monitoring regime away from a *de facto* price cap and to a conduct based regime, based on actual market behaviour rather than barren and often irrelevant arguments about return of assets however valued, is welcomed. It will, if properly understood by market participants and supported by Government, eliminate a good deal of the acrimony, whilst much less than that which prevailed up to 2002, that still plagues some negotiations.

The Draft Recommendations are supported subject to the following observations:

- The Commission is asked to revisit the detail of its recommendations on coverage. The proposal of DOTARS is internally inconsistent in some minor regards and in some others not directly aligned with the general approach of the Commission that the coverage of aeronautical services should be limited to those areas where airports have significant market power. This does appear to be an oversight.

- Whilst the Commission's approach to financial reporting is generally supported within the context of the reports as a whole, consideration should be given to the impact on the Regulation and the financial reporting requirements more generally of the adoptions of the new international financial reporting standards.

- Whilst the scope and content of the Principles is supported the Commission is asked to consider whether it would be appropriate to redraft the Principles to more closely align them with the assessment of market power and to reflect the commentary on this issue provided at various points throughout the draft Report. To an extent, the Principles as proposed do not reflect the flexible approach the Commission is advocating but rather still reflect a more mechanistic approach focused on past costs and asset valuations.

- The Commission is asked to consider the relationship between the Principles and the monitoring arrangements and the application of Part IIIA of the Trade Practices Act.

Subject to the above the Commission's recommendations will enhance a framework that is already Australian best regulatory practice providing there is a commitment from

industry participants to adhere to it and for the Government, when occasion arises, to use the relevant statutory tools at its disposal to enforce it.

Glossary

ACCC	Australian Competition and Consumer Commission
Airports Act	*Airports Act 1997 (Cth)*
Airservices	Airservices Australia
ARFF services	Aviation rescues and fire fighting services currently provided at Australian airports by Airservices.
BARA	Board of Airline Representatives of Australia
BTRE	Bureau of Transport and Regional Economics
COAG	Council of Australian Governments
Commission	Productivity Commission
Council	National Competition Council
Direction	Direction 24 made pursuant to Part VIIA
DOTARS	Department of Transport and Regional Services
DORC	Depreciated Optimised Replacement Cost
FAC	Federal Airports Corporation
ICAO	International Civil Aviation Organisation
LCC	Low cost carrier
Minister	The Minister of the Commonwealth responsible for the administration of the Airport Act
MTOW	Maximum take-off weight
NNI	Necessary New Investment
Part IIIA	Part IIIA of the Trade Practices Act
Part IV	Part IV of the Trade Practices Act
Part VIIA	Part VIIA of the Trade Practices Act
Principles	The principles made by the Government relating to airport conduct, including the current review principles and others that might apply in the future.
Regulations	The regulations made pursuant to Part 7 of the Airports Act
Trade Practices Act	*Trade Practices Act 1974 (Cth)*
Tribunal	Australian Competition Tribunal

1 Monitoring outcomes

1.1 Price and rate of return outcomes

Melbourne Airport concurs with the Commission that there is no evidence currently to hand to suggest that airports are setting prices which constitute an abuse of market power. Further, it is noted that despite recent press utterances to the contrary, the ACCC in its monitoring reports and its submission to this inquiry has similarly failed to draw the conclusion that current prices are excessive.

The Commission has rightly rejected the notion that simply because prices have risen, market power has been abused. BARA has drawn attention to pricing conduct of specific airports which it considers may constitute an abuse of market power. Whilst Melbourne Airport does not offer a view on these particular cases, it would be helpful if the Commission could use these examples to illustrate the broader propositions it advances within the draft Report.

Virgin Blue's submission attempts to go beyond a simple observation about price increases via a report prepared by the Allen Consulting Group. It seeks to make estimates of long run costs by reference to short run data provided in the regulatory accounts. The bulk of the calculations underpinning this analysis, and some key outputs such as initial asset values, are not presented.

The calculations appear to proceed on the basis that the starting asset values can be implied by other financial data. This is accepted but, given the information that is available, there are at least two significant problems.

The report seeks to value the assets at sale "consistent with the revenue earned during the previous price control period"[1]. Even if this was the correct approach then it should have been undertaken on the basis of the expected revenue and costs at the time of sale. To do otherwise would be to imply that bidders for airport leases in 1997 and 1998 should have been reasonably able to foresee the Asian Financial Crisis, the terrorist attacks in New York and Bali (which affected both revenues and costs) and the entry of Virgin Blue and Impulse and the subsequent collapse of Ansett. It is acknowledged Allen Consulting does not have access to the forecasts of individual airports and its approach might be the best it could have adopted. However, Melbourne Airport would suggest that the events described above, taken together, are more likely to have supressed earnings than enhanced then. As such, the assumptions made by Allen Consulting

[1] Allen Consulting Group (2006, p9)

effectively undervalue the earnings streams airports expected to earn in the first five (or less) years after sale.

The second issue is that this valuation seems only to place a value of the earnings of the first five years after sale. If the assets in question possess significant surplus capacity (for example, an airport had runway capacity that will serve it for several decades) then it would be appropriate to reflect the value of this surplus capacity by an increment to the valuation calculated by Allen Consulting as it reflects the future earnings of the assets the airport has access to under the lease and has presumably reasonably paid for. It should be noted that this is not about goodwill or some notion of expectations of monopoly profit but rather an expectation about being able to process significantly larger passenger volumes in the future (perhaps with some further investment) using the existing assets. It is not clear what assumptions have been made by Allen Consulting about the valuation of the cash flows being derived from assets in place at the time of sale for the 94 years of the lease beyond the removal of prices notification but Melbourne Airport would suggest that any such valuation would not be insignificant.

More important than the issue about return on sunk costs (however valued) is whether current price levels are efficient. The Allen Consulting Group correctly notes

> … the absence of a formal review of the level of prices at the commencement of the former price control regime (Sydney Airport excluded) implies that the possibility of an error in the level of the former price controls should not be ignored. The central consideration when deciding whether to revisit this implied value of past investments should be whether the increase or decrease in that value may affect economic efficiency."[2]

Melbourne Airport thoroughly agrees with this proposition. It is beyond question that "an error in the level of former price controls" occurred as far as future investment is concerned. It follows from the above reasoning that if the price level needed to "step up" to a new level in order to sustain future investment, then the revenues generated by those efficient prices would be excess of those calculated on the basis of the valuation undertaken by the Allen Consulting Group. Despite the concerns discussed above above, this is precisely what the Allen Consulting Group report shows.

[2] Allen Consulting Group (2006, p17)

1.2 Other monitoring outcomes

Charging structures

Clearly there are strongly held views on the issue of charging structure and the conclusions drawn by the Tribunal need to be seen in the context of the particular evidence that was placed before it in relation to Sydney Airport. Melbourne Airport does believe that the most appropriate way for it to charge is on a passenger basis but does concede that the available market evidence, is inconclusive as to which approach provides the greatest support to domestic aviation competition although no evidence market based evidence has been provided to the Commission that suggests competition has been damaged.

It goes with out saying that as a profit maximising firm Melbourne Airport would not consciously pursue a pricing policy that would inhibit competition that led to passenger growth.

Investment

Investment levels have increased since the removal of prices notification in 2002. More important however is the outlook for future investment. The reimposition of price controls would inevitably create investor uncertainty and as Melbourne Airport and AusCID have identified, the administrative task of re-imposing price controls for the six airports the Commission proposes for price monitoring would necessarily delay investment decision making for upwards of a year further exacerbating already tightening capacity.

Therefore, Melbourne Airport strongly supports the Commission's emphasis on investment as one of the reasons for not reverting to stricter price controls.

Non-price terms and conditions

Melbourne Airport notes the Commission's concerns in relation to non-price terms and conditions. The views of Qantas set out in Box 3.3 of the draft Report constitute reasonable expectations of users. Without disclosing confidential information, Melbourne Airport can assure the Commission that the five issues set out in Box 3.3 are fully dealt with in every airline agreement Melbourne Airport has entered into.

However whilst the view expressed by Qantas that users have little or no recourse in negotiating non-price terms and conditions may be true with respect to some airports, it

is not true in the case of Melbourne Airport. Indeed, in relation to the agreements in place at Melbourne Airport, after BARA had recommended the general agreement proposed by Melbourne Airport, significant further negotiations were undertaken with Qantas and modifications made to meet Qantas' specific desires.

It is almost inevitable in any negotiation that neither side gets everything that it wants. Airport access agreements are complicated by the fact that there are competing commercial interests (often between direct competitors) for access to what is common use infrastructure. Our experience indicates that incumbents can also seek to use infrastructure issues to frustrate the entry of new competitors. This point is often lost on individual airlines. Indeed, some of the non-price terms and conditions that have been sought by airlines have bordered on being anti-competitive. Clearly, these will be typically rejected by airports not only because of legal concerns but also because ultimately they will lead to airport throughput being less than would otherwise be the case.

It is inevitable that airports need to reserve to themselves control over certain operational matters to ensure the proper operation of the airport especially as in a number of important regards these relate to key security and safety compliance protocols.

Finally, it is important to draw a distinction between dispute resolution arrangements within an agreement and for disputes about future agreements. Melbourne Airport firmly believes that subject to the reservations outlined above, that there needs to be arrangements regarding disputes whilst an agreement is on foot. This not a view based on any over-riding concern for abuse of market power but rather without them, it is difficult to see why any rational contracting airline would ever agree to them.

However, the notion that there should be independent dispute resolution arrangements when an agreement expires is a very different question. Similar problems are posed by provisions along the lines of "upon expiry of this agreement the parties agree that the terms of this agreement will prevail until a new agreement is entered into". The fundamental problem is that both present the same asymmetric negotiating incentives the Commission has identified with negotiate-arbitrate frameworks. This issue is discussed further in Chapter 5 of this submission.

2 Should monitoring continue?

Melbourne Airport indicated in its submission in response to the Issues Paper that it felt that continuing the monitoring arrangements was appropriate for an industry where service providers possess a significant degree of market power. Needless to say, Melbourne Airport is pleased the Commission has not at this stage adopted some of the more extreme proposals for the imposition of more intrusive forms of price control.

Despite the views expressed by a number of airlines, the view the Commission has expressed about the constraining effect of the monitoring arrangements (in which one should include the threat of re-regulation presumably under Part VIIA) and Part IIIA is supported by Melbourne Airport. In considering this issue, it is instructive to consider the question "If the monitoring regime and Part IIIA are not constraining airport market power, in 2002 what stopped Melbourne Airport from increasing its prices by 50% rather than 35%".

Melbourne Airport agrees with the ACCC that for monitoring to constrain market power, the threat of re-regulation must be credible[3]. Despite the absence of any formal action by the Government under Part VIIA and the application of Part IIIA being limited to Sydney Airport, Melbourne Airport has always seen the threat of re-regulation as credible and that the outcomes of such regulation would lead to outcomes that are less desirable than those being generated under the current regime, not only for itself but for its airline customers and passengers using Melbourne Airport. If this were not the case, it is difficult to see why Melbourne Airport was not more aggressive in its pricing conduct in 2002, especially if elasticities are relatively low and airline countervailing power, as claimed by airlines, is weak.

The Commission's view that it is too early to judge whether the regime will be effective is noted and from a policy analysis perspective accepted – the data available to the Commission is relatively limited.

The Commission seems to be concerned that as the memories of prices notification fade that the monitoring regime may become less effective. Melbourne Airport is of a different view. Much of the more undesirable elements of conduct exhibited by airlines and airports (such as recent gaming attempts by some airlines and appeals to the appropriateness of mechanistic approaches price setting by some airports which have no regard for the use of market power) are actually a result of those previous arrangements (and indeed pre sale arrangements) and as time goes on they will become less prevalent and be replaced by more commercially mature conduct.

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[3] ACCC (2006, p20)

3 Changes to the implementation of price and service quality monitoring

3.1 Service Coverage Issues

Melbourne Airport welcomes the Commission's recommendation that the Principles should continue to be applied on a dual till basis. Further, Melbourne Airport supports the key points set out on page 67 of the Draft Report.

However, it does appear that there may be some minor contradictions between those key points and Draft Recommendation 5.1 which suggests, by adoption of the list of services proposed by DOTARS, some further extension of coverage beyond that set out in the key points on page 67. For example, the key points clearly put car parks (including staff car parks) outside the definition of aeronautical services but the list of services proposed by DOTARS includes them.

In addition, the Commission has not commented on the Preamble (and associated footnote) in Attachment 4 of DOTARS' submission. Melbourne Airport strongly supports the Preamble (and associated footnote) and believes they are integral to the proper implementation of the coverage definition. It would be helpful if the Commission could reflect on these in its final Report as they go to the treatment of some important airport assets, particularly domestic terminal leases.

Further, when Attachment 4 of the DOTARS submission is read in its entirety there are some minor areas of internal contradiction which require clarification. There are two areas of particular concern.

Domestic terminal leases

As the Commission is aware, there are a number of domestic terminal leases entered into by the Commonwealth which remain in place. Under current arrangements (both in the Regulation and the Direction but in different ways), these facilities are excluded from the aeronautical assets base. It is Melbourne Airport's view that under the services definition proposed by DOTARS, this would remain the case as long as those leases were on foot because they are in effect "commercial property transactions where the airport does not have a high degree of market power" – indeed it does seem that airports have no market power in relation to these facilities until these leases expire. Upon expiry, the future treatment would depend on the underlying commercial nature of the provision of access.

Clearly, to include these facilities would run counter to the general principle the Commission is adopting of only including in the coverage of aeronautical services those services where airports have a significant degree of market power[4]. Further, for reasons we have previously set out, inclusion would present significant accounting issues[5].

It does not appear to have been the Commission's intention that ongoing domestic terminal leases should be covered but it would be helpful if the Commission could make this clear in its final Report.

Airline offices

By accepting the coverage scope proposed by DOTARS the Commission by implication is accepting the inclusion of airline offices within definition of aeronautical services – these services are currently not covered either by the Regulation or the Direction. Such an extension of coverage is not mentioned in the key points on page 67 nor does the Commission discuss this issue anywhere else in the report.

As set out in Box C.2 in the draft Report, in its 2002 Report, the Commission formed the view that airports possessed low to moderate degrees of market power with respect to offices – this appears to remain thew view of the Commission. In its 2002 Report the Commission identified two other sets of services where airports have low to moderate degrees of market power - car parking and taxi facilities. The Commission is not proposing that these should be included in the definition of aeronautical services nor any that have previously been rated low.

It is accepted that airports have a limited degree of market power in relation to the setting of rents for airline offices as previously noted by the Commission. Inclusion of these services in the definition of aeronautical services is however somewhat problematic. First, it will be necessary to determine what is essential for aeronautical operations at the airport concerned - some airlines have corporate staff not essential for operations located at airports rather than at other locations. Secondly, it needs to be understood that there is competition for the space occupied by airlines (and indeed between the airlines themselves) and in many cases long term tenancy agreements have indexed rents with periodic market reviews – prices may rise simply because of the operation of the rental market rather than an abuse of market power. Indeed, the arrangements entered into with airlines are actually in large part commercial property transactions and therefore under

4 Draft Report p.68

5 Melbourne Airport (2006, pp46-47)

the DOTARS proposal (taken fully) might actually not fall within the definition of aeronautical services.

Monitoring of ground access services

As a separate issue, Melbourne Airport supports the Commission's view that if car parking prices, and indeed the prices of other ground access services, are to be monitored they should be monitored separately from aeronautical services and only prices should be monitored. That said, Melbourne Airport does not believe that even this is necessary. This is consistent with the Commission's view that only those services where airport possess significant market power should be subject to monitoring.

Clearly, the primary determinant of market power is competition, or at least the lack of it. It is clear that the degree of competition airports face in relation to the provision of ground access services is largely reflected in the length of time a vehicle spends at the airport – the shorter the stay, the greater is the capacity of the airport to exercise market power. It is Melbourne Airport's view that if it does possess significant market power in relation to car parking services, it is limited to stays under three hours duration. It is accepted that it does possess a degree of market power similar to that of short term car parking with respect to terminal kerb access for operators such as taxis and hire cars.

It is therefore suggested that if ground access prices are to be monitoring in the way the Commission has suggested that such monitoring be limited to the terminal kerb and parking of no more than three hours.

3.2 Quality of Service Monitoring

Melbourne Airport agrees with the general view of the Commission that the overall value added by the current quality of service reporting arrangements is very limited. Further, as the commercial arrangements between airlines and airports develop and deepen it is likely that quality issues will become more fully incorporated in contractual arrangements obviating the need for extensive, and often irrelevant, data collection by the monitoring agency.

Melbourne Airport however is concerned by the potential for more informal processes to be gamed by respondents. It would not be surprising to see some users seek to make comments under the veil of commercial confidentiality much in the way that some participants have in this inquiry in the hope that their veracity could not be tested. It

would be highly undesirable if the sort of quality gaming that we identified in 2001[6], that we acknowledged the ACCC has largely eliminated[7], were to re-emerge.

Further, Melbourne Airport is concerned that the Commission does appear to be suggesting that the views of the Australian Customs Service should still be considered. Not only has this organisation possibly been the most prolific gamer of the quality regime, it seems illogical to consider its views and not those of the Civil Aviation Safety Authority, Airservices Australia, the Australian Quarantine and Inspection Service, the Department of Immigration and Multicultural and Indigenous Affairs and various Commonwealth and state law enforcement agencies – all of who access the airport by statutory right and over whom airports have no capacity to exercise market power in relation to the monitored services as there are no market transactions occurring.

3.3 Monitoring of Financial Outcomes

Draft Recommendation 6.1 brings into question the appropriateness of the partitioning of the statutory accounts as required by the Regulation. The adoption of Australian version of international accounting standards has resulted in a number of changes to the carrying value of assets and liabilities. It will difficult, if not impossible, for airports to report 30 June 2005 aeronautical assets values a subset of the statutory accounts in the same way as was previously the case or as envisaged in Draft Recommendation 6.1. Auditors will need instructions that allow them to form a view on the airports regulatory presentation that might be quite separate from a simple partitioning of the general purpose statutory accounts.

International accounting standards have also had an impact on tax and goodwill. These changes result in some goodwill being allocated to aeronautical assets as the permanent difference between accounting value and the tax depreciable value. The impact of this on the reported earnings is not insignificant as a significant tax cost has now been recognised as a liability at point of acquisition and will never be expensed through the profit and loss statement. These adjustments increase the reported profit as the reported tax expense, but not the real tax liability, is lower.

Clearly, the details of the construction of the regulatory accounts going forward will be the subject of further consultation with airports and airlines. Given the technical accounting issues associated with these questions, it is hoped that the relevant agencies will source professional advice on these issues with a particular emphasis in trying to

6 Melbourne Airport (2001, pp40-41)

7 Melbourne Airport (2006, pp49-50)

minimise compliance costs. It would be expected that this advice would be shared with airports and airlines as part of that consultation.

It is recognised that the Commission may not wish to make specific recommendations on these quite technical accounting issues. However it would be helpful if the Commission's report draws this issue to the attention of DOTARS for consideration when it comes time to implement the Government's response to this review.

3.4 Changes to reporting arrangements

Whilst the proposed new reporting arrangements will effectively only cover three financial years following the implementation of the new Principles, as the proposed changes are relative minor, Melbourne Airport supports the proposed reporting timeframe. The consolidation of the financial and quality reports is also supported.

It is noted that the Commission has not explicitly considered whether the ACCC continues to be the appropriate body to undertake the monitoring role as opposed to the BTRE. Given its arbitration role under Part IIIA, the possibility of formal inquiries under Part VIIA and the greater emphasis on the monitoring reports informing Government rather than regulatory decision making, it is Melbourne Airport's view that such a switch would be appropriate. Further, it would place in the hands of one agency the collection of aviations statistics which could only help to inform policy makers and potentially reduce administrative costs.

In any event it would be hoped that if the ACCC is to continue to be the monitoring agency that it desists from headlining the release of its monitoring reports with references to price increases since the removal of prices notification in 2002. Further, it is Melbourne Airport's very strong view that the ACCC should limit its commentary to those services that the Government has directed its attention to. There is no policy purpose serviced by the ACCC reporting on overall airport profitability particularly when it deliberately distorts its reporting by excluding goodwill/lease premium which in the case of Melbourne Airport accounted for around half the purchase price of the business.

Melbourne Airport particularly welcomes the Commission's view, surprisingly endorsed by the ACCC, that excess returns earned by more efficient airports are not of themselves an abuse of market power. Whilst it is not clear the mechanism the Commission has in mind in relation to how these productivity benefits might be shared, it seems likely that overtime, there will be a separation in the rates of returns earned by individual airports around some sort of industry average. Obviously, this will be a long run phenomena as

years by year returns will be influenced by exogenous shocks to individual airports and the inevitable accounting effect of the capacity cycle.

Melbourne Airport in principle supports retention of the existing Principles and the addition of the two proposed in Draft Recommendation 5.5. However, as the Commission proceeds to its final report, it should be mindful that its views expressed in the final Report will be taken by commercial parties as somewhat precedential. There are a number of suggestions elsewhere in this submission as to how the Commission may be able to provide additional guidance and clarity that would be helpful to all concerned.

4 Asset valuation issues

Melbourne Airport supports the Commission's view that the economic arguments for the continuing revaluation of assets for pricing purposes are weak. As such, Draft Recommendation 6.2 is supported.

It appears that throughout the Draft Report the Commission is attempting to move the monitoring arrangements away from being some sort of *de facto* shadow price cap (which has been the view of some airport operators) to a tool for the initial detection of abuse of market power. This approach is supported and if successful should further ameliorate the overhang of the previous price control period and eliminate the sorts of distortions that come with formal price caps. However, for it ultimately to be credible with all parties the Government will need to show real commitment to dealing with behaviour that breaches the Principles via a greater preparedness to use Part VIIA.

Further, given the Commission's view that airports need to be given more latitude in their pricing behaviour and that the monitoring framework should present the opportunity to all parties to comment on financial outcomes, providing the coverage issues addressed in section 3.1 are dealt with, then the need to bring intangible assets into the aeronautical asset base is greatly reduced. As such, subject to this proviso, and the accounting issues raised in section 3.3 being properly addressed, Melbourne Airport supports Draft Recommendation 6.1.

It is appropriate to take this opportunity to clarify what has occurred with asset revaluations at Melbourne Airport. Melbourne Airport undertook a valuation of the land and assets in place at the time of sale. The ACCC notes that the FAC undertook a valuation at the same time (well two days apart) [8]. It appears that the two valuations were undertaken in the same way except a major part of the valuation (the assets other than land, plant and buildings) was undertaken by the FAC rather than an independent expert[9]. Without access to the details of the FAC valuation, it is not possible to form a view on the source of the differences in these valuations although it should be noted that the valuations recorded in Melbourne Airport's accounts have been accepted by Melbourne Airport's directors, their auditors and generally as a fair and reasonable basis for price setting by airline customers. Since that time, Melbourne Airport has undertaken periodic revaluations in accordance with its statutory accounting requirements but has not booked these revaluations nor used them for pricing purposes.

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[8] ACCC (2006, p58)

[9] See note 11 to the 1996 FAC Annual Accounts

Melbourne Airport strongly believes that airport operators are entitled to earn a proper return on the value of the assets they came into possession of when the airport lease was granted and that is what it has done. It is accepted that some airports may have taken assets into their books at inappropriately low values and that it is appropriate that assets values for pricing purposes may need to be adjusted.

However Melbourne Airport is concerned about how the establishment of the arbitrary cut off date of 30 June 2005 may be approached by some market participants. The Commission should make clear this is not a "back door" endorsement of further price increases not related to future investment or previously agreed pricing outcomes. Whilst it is understood that the Commission needs to find a pragmatic approach to dealing with this issue, Melbourne Airport believes that it is not appropriate for asset price inflation between 1997 and 2005 in relation to assets in place at the time of sale to lead to further significant price increases at Australian airports.

This issue needs to be addressed explicitly. Having actively sought to comply with the Government's policy, it would be totally iniquitous for Melbourne Airport's shareholders to be denied access to income that their competitors in the capital market who have actively sought to game the policy could have access to as a result of this recommendation. To allow this to happen will undermine the very sound views that the Commission has put forward about rewarding efficiency. Further, if previous strategic gaming conduct is allowed to stand, it will send a clear signal to those who have indulged in this inefficient conduct in the past, and indeed potentially those who have not, that they may be rewarded in the future.

A way forward might be much like the way Draft Recommendation 6.2 precludes price increases based on future increases in asset valuations without customer agreement, price increases motivated primarily by increasing returns on sunk assets (at 2005 values) should similarly require user support, or at least previous support from users if such increases were to fund recent investments.

Given the level of profitability associated with the monitored airports as a group, and the associated strong investment performance in recent years, it would seem that current prices, or at least their agreed trajectories, should be sufficient to remunerate investors for their past investment irrespective of the current level of return on book value. If these prices are not sufficient one is left to ask why the airport in question did not set even higher prices when prices notification was removed in 2002, or at least secure user agreement for future planned increases to finance past and what at the time would have been current investment plans.

As the Commission has said itself "given the past price increases, there may be little reason for further rises, other than to pay for specific investments and additional security upgrades"[10] – a point Melbourne Airport agrees with subject to the flowing proviso.

It has been Melbourne Airport's experience that users generally prefer relatively stable price paths (be that in nominal or real terms). Providing significant investments can be funded initially an airport should be able to set relatively stable price paths into the future to finance such investments. Further, parties may actually agree to rising prices over time to encourage early take-up of a service as capacity it taken up, to reflect the relative scarcity of surplus capacity going forward, or to reduce the initial impact of a necessary price rise. It is understood that such a pricing policy was adopted by Cairns Airport to fund its international terminal development at the request of airlines.

Whilst it is clearly not the intention of the Commission to discourage agreed efficient pricing outcomes of this type, there is a risk that some market participants may seek to take the Commission's observations about constant prices being an abuse of market power and traffic growth providing downward pressure on price out of context. Clearly, irrespective of whether prices are rising, falling or constant, an assessment of the reasonableness of a pricing policy depends both on its trajectory and its absolute level.

As noted above, Melbourne Airport supports the Commission's general analysis and view of pricing conduct and the need to move away from mechanistic approaches to assessing, or at least identifying, potential abuses of market power. However, the quality of this analysis is lost in the Draft Recommendations. Indeed, it is probably the case that what the Commission is seeking to achieve generally cannot be captured by the addition of a couple of dot points to a set of principles that probably reflect different, or at least partially superseded, policy logic.

[10] Draft Report, p25.

5 Facilitating commercial negotiations

Melbourne Airport agrees with the Commission it is very difficult to design a dispute resolution mechanism that presents equal incentives to access seekers and access providers although such an attempt was made in our previous submission. Similarly, the Commission's general reluctance to recommend the development of negotiating or behaviour guidelines and by inference "required clauses" is supported by Melbourne Airport.

Melbourne Airport welcomes the increased emphasis the Commission has placed on the use of Part VIIA inquiries to fully investigate potential abuses of market power that have been *prima face* identified via a reformed monitoring process. However the efficacy of that recommendation will depend heavily on the extent of the perceived preparedness of the Government to order such enquiries.

Melbourne Airport also agrees with the Commission that the judgement of the Federal Court in relation to the Sydney Airport Part IIIA matter will shed considerable light on this issue and is relevant for the consideration of future policy. Further the recent reforms to Part IIIA, especially in relation to the need for declaration to lead to a material increase in competition, reduces but does not eliminate the legitimate concerns about the application of Part IIIA held by airports. Similarly, the clearer timeframes for decision making should, where declaration is warranted, give airlines more rapid redress of their grievances.

The introduction of pricing principles and multilateral arbitrations further improves Part IIIA. Melbourne Airport feels that final offer arbitration is not appropriate for airports generally as it is difficult to see how it will address the common use aspects of supply. Further, it is not clear how it would be determined that the alternative offer could be implemented and if it couldn't, how would such a situation be addressed. At then end of the day, it may become just a less transparent form of a Part IIIA arbitration.

Melbourne Airport understands there is a general reluctance on the part of Commonwealth policy makers to implement industry specific access regimes. That said, given the preference for monitoring regimes expressed in the COAG Communiqué in February, there is a more general policy question as to how these monitoring regimes will relate to Part IIIA.

The lack of a nexus between the Principles (and the monitoring framework more generally) and decision making under Part IIIA is in Melbourne Airport's view the principal inadequacy of the framework currently proposed by the Commission. Depending on the outcome (and associated reasoning) of the Federal Court's

consideration of the Sydney Airport declaration there is a real possibility that significant doubt will remain as to whether an airport complying with the Government's Principles would be exposed to declaration and in the event that it was declared, the extent to which the ACCC would undertaking any arbitrations in a way consistent with the Principles.

To be frank, it may well be the case that if a particular view of the competition test was adopted, such as that suggested by the ACCC, that airports only argument against declaration be that as they comply with the Commonwealth's Principles and policy that it would be contrary to the public interest for them to be declared. This is unlikely to give investors very much comfort given the reasoning of the Tribunal and to a lesser extent the Council. Conversely, a different view might make it virtually impossible for airlines to use Part IIIA to get redress of unacceptable airport conduct.

What Melbourne Airport was trying to do in its dispute resolution proposal was to create a nexus between Part IIIA and the Principles. An alternative way forward would be a general amendment to Part IIIA that required all relevant Part IIIA decision makers (the NCC, the relevant Minister, the Tribunal and the ACCC) to have proper regard to any formally stated policies (such as the Principles), especially in relation to the assessment of the public interest, when considering firms that are subject to monitoring under Part VIIA. Indeed, it might even be appropriate for compliance with any stated policies and principles to be an alternative test in those cases where an industry is clearly vertically separated and promotion of competition is likely to be a secondary issue to general excessive pricing. This would greatly comfort airports that comply with the Principles and provide a better policy framework for monitoring as a general policy tool.

That said, none of this addresses the key problem that has been faced by airports and the Commission, at least implicitly acknowledges – the desirability of forcing airlines to make a reasonable counter offer. From a practical perspective, any recommendations that the Commission makes in this review that are ultimately accepted by Government will not affect the outcome of current negotiations if they require statutory amendment. Put simply, it is difficult to see how relevant legislation would be amended in time to effect negotiations that need to be completed by 30 June 2007.

Given the still lengthy time frames involved with Part IIIA, this means that if the policy changes arising from this review are to be enforced in cases of breach, the Government will need to rely on the inquiry and notification processes of Part VIIA. In order to address the incentive issues around the provision of airline counter offers, a key feature of the principles should be that the Government expects airlines to negotiate in good faith and in the case of intractable disputes, as a precondition to the use of Part VIIA, the Government will expect a *bona fide* (that is, one that complies with the Principles) counter offer to have been advanced by airlines.

6 Other matters

6.1 ARFF Services

Melbourne Airport welcomes the Commission's view that ARFF services should be priced efficiently – the reality is they currently are not. Melbourne Airport believes that Airservices is charging users around $10 million per annum (around 10% of Melbourne Airport's aeronautical income) more than the cost of providing the ARFF service at Melbourne Airport whilst at other locations it is recovering less than 10% of avoidable cost.

The over recovery is largely sourced from international carriers and distributed to small airports – the notion that this is some form of efficient network pricing is simply absurd. Alternatively, this approach has been justified on the basis that the operators of larger aircraft (to mean international carriers) have a higher capacity to pay than the operators of smaller aircraft. This is an equally absurd proposition especially in the light of challenges facing the future growth of Australia's international tourism industry.

We agree with the Commission that efficient pricing would be enhanced by greater contestability. However, Melbourne Airport believes that contestability is unlikely to lead to a reduction in total ARFF services costs – Airservices is a relatively efficient provider. Further, Airservices may possess some scale economies in training, staff relief and insurance relative to a model where the ARFF service was provided by location specific providers.

The problem is one of allocative efficiency, a problem that can be easily fixed by Airservices adopting an efficient pricing policy. Contestability is likely to be sufficient to solve the allocative efficiency problem but may actually lead to greater total costs.

The economic issues with Airservices pricing approach have long been understood – this is what makes the ACCC's recent pricing decision even more suspect. It is interesting to note that until as recently as 2004, the most strident opponent of network based charges, other than BARA, was Qantas.

The Commission (in its previous incarnation as the Industry Commission) observed in 1992

> "… cross subsidisation distorts production and consumption patterns and can impose considerable costs on the community. These shortcoming has been recognised by governments throughout Australia, especially over the last two or three years. During this period, governments have, to varying degrees,

> committed themselves to eliminating, or at least reducing, cross subsidisation which has been identified in a wide range of public owned business enterprises"[11].

and

> "To encourage a more efficient pattern of use of CAA[12] facilities and services, the Commission recommends that where practicable, CAA charges be modified so as to better reflect the differences that exist in services provided and the cost of their supply at different locations"[13]

When the Prices Surveillance Authority (PSA) examined the uniform pricing structure of the FAC it argued

> "On efficiency grounds, the **incremental costs of specific services** should at least be recovered by charges for the specific services and any joint costs allocated in a way that reflects (in an inverse manner) the elasticities for the demand for individual services."[14] (emphasis added)

The PSA went on to say

> "… where most costs are separable – as is the case here, there are not large joint costs between airports, in the sense that costs occurring at one airport are the causal responsibility of traffic at that airport only – then there is a solid equity argument for saying that the **revenue from charges for the use of airport A should *not* be used to cover expenditure at airport B**"[15] (emphasis added)

More recently, when the ACCC was considering prices of aeronautical services at Sydney Airport, the Commission again noted "total revenues from any subset of services should **not be less than the incremental cost** of providing those services"[16] (emphasis added).

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11 IC (1992, p150)

12 At the time, the Civil Aviation Authority (CAA) was the provider of ARFF and air navigation services.

13 IC (1992, p151)

14 PSA (1993, p xxi)

15 Ibid, p127.

16 ACCC (2001, p158).

The Commission will no doubt recall the observations made by Professor Alfred Kahn in the same case:

> "For common products the demands for which are independent of one another, the familiar Ramsey conditions apply - **no price below incremental cost**, and mark-ups above incremental cost inversely proportional to demand elasticities."[17] (emphasis added)

It is accepted that the application of Ramsey prices may not in all cases be appropriate. In particular, as NECG noted in its advice to the ACCC, the estimation of the relative demand elasticities may be impractical and an alternative maybe an equi-proportionate mark-up over directly attributable cost[18]. However, this debate surrounds the allocation of common costs above the directly attributable, avoidable or incremental costs of the service. It does not suggest that prices should be set below the avoidable cost of provision. Such a policy could only be justified if demand at different locations was dependant (indeed, the services would need to be compliments in consumption), something the ACCC has correctly ruled out[19].

DOTARS is currently undertaking consultations on the range of ARFF related issues. It appears from those consultations that the motivation of the current Airservices pricing policy is to assist in the development of regional aviation services. Melbourne Airport passes no comment on whether this is a legitimate policy objective or not.

However the approach that has been adopted is not the appropriate for the implementation of such a policy objective. There is a deep and rich academic literature supported by numerous applied studies that leads one to the conclusion that the manipulation of input prices is a very poor regional policy tool. In this case, it is particularly poor as the source of the revenue providing the subsidy is a tradable export sector – primarily international aviation services.

In effect, Airservices is taxing international aviation (and to a lesser extent domestic operations on trunk routes) to provide what it, and presumably the Government, consider to be community service obligations (CSOs) at regional airports. For a decade in Australia government business enterprises (GBEs) providing CSOs have been required under the Competition Principles Agreement to identify CSOs explicitly. The general approach has been for these to be funded either by way of a direct appropriation or through a reduction in dividend payments to their shareholders, namely the relevant the Government in question.

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17 Kahn, A,.E. (2001)

18 ACCC(2001, pp157-8)

19 ACCC (2005, p39)

The effect of Airservices approach is wider than providing assistance to regional airports. It creates a transfer from large airports to small airports irrespective of their location or specific regional need – this is a very blunt policy instrument. In particular, it is creating transfer between airports that are competing with each other in south-east Queensland (Brisbane to Maroochydore and the Gold Coast) and the Port Phillip Basin (Melbourne to Avalon). By confecting a situation whereby services are provided at smaller airports at below their economic cost, Airservices policy may lead to inefficient over-investment at small airports in circumstances where there is surplus capacity in the aeronautical assets at the larger airports, as is the case for both Melbourne and Brisbane. This issue was recognised by the Commission in 1992 when it opined correctly

> "… network pricing as practiced by the CAA can encourage the over-use of facilities which are under-priced and the under-utilisation of those which are overpriced. This can affect patterns of demand and, as noted previously, can result in inappropriate investment decisions in costly aviation infrastructure"[20]

If the Commonwealth wishes to pursue a policy of assistance to regional aviation it should do so in an open and transparent way. Moreover it should do so in a way that can be demonstrated to actually benefit regional communities rather than just benefit one group of airline shareholders over another. It should also ensure that it does not impact on emerging inter-airport by excluding those airports mentioned above from such arrangements.

The level of overcharging at Melbourne Airport, and indeed Brisbane and Sydney, is of a level that if pursued by those airports would rightly lead to calls by airlines for Government or regulatory intervention. The efficiency issues associated with this over charging are not determined by whether the profit of such an abuse of market power is distributed to airlines through lower than efficient charges on the Queensland coast or given to airport shareholder – the issue is the appropriateness of the pricing policy at each location.

Melbourne Airport calls on the Commission to endorse and restate the views expressed by the Industry Commission in 1992 that the sort of pricing policy currently imposed by Airservices, and erroneously sanctioned by the ACCC, "can impose considerable cost on the community".

[20] IC (1992, p150)

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