



INTERNATIONAL AIR TRANSPORT ASSOCIATION (IATA)

Response to the Draft Report of the
Productivity Commission's inquiry into price
regulation of airport services

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This submission presents the response of International Air Transport Association (IATA). IATA's mission is to represent, lead and serve the airline industry and brings together 260 member airlines whose flights account for 94% of all international scheduled air traffic. IATA welcomes this opportunity to submit its response to the Draft Report of the Productivity Commission's inquiry into price regulation of airport services. IATA's comments are from an international perspective and are based on the requirements of, and practices in, international civil aviation.

1. Executive Summary

IATA is disappointed with the overall Draft Report as the recommendations are weak, ambiguous and run a high risk of failure. Given that the Productivity Commission has recognised the potential for monopoly abuse, it is surprising to see the Draft Report recommending an approach that basically leaves the pricing outcomes in the hands of the airport. If the Productivity Commission continues the 5 year monitoring period under the recommended framework, there is nothing to stop airport monopoly pricing during and after this monitoring period.

Instead a robust, independent economic regulation is needed as a powerful catalyst to drive airline-airport agreements and the development of close airline-airport partnerships. This will lead to lesser reliance on the regulator and even if partnership discussions on cost efficient performance and charges should fail, the robust regulation is there to protect airlines and consumers.

An effective regulatory framework should at a minimum provide:

- clear guidelines on acceptable and unacceptable pricing behaviour
- imposition of penalty actions in event of unacceptable behaviour
- mechanism to ensure transparency in airport performance on pricing and non-pricing items
- an effective process for quick and efficient dispute resolution

While there are some positive recommendations in the Productivity Commission's Draft Report, IATA is disappointed to note that a number of messages are not in line with the IATA Positions specified in the original IATA submission. IATA's positions on the overall regulatory framework are not repeated in this submission but IATA urges the Productivity Commission to take them into consideration during the subsequent stages of this inquiry. The subsequent sections focus on IATA's responses to the Productivity Commission's views expressed in the Draft Report. In addition, IATA's detailed views on the following key issues are included:

- Section 2 :IATA's positions and expectations from the Productivity Commission
- Section 3 :Evidence of Abuse of Monopoly Position
- Section 4 :Facilitating Commercial Negotiations

- Section 5 :Asset Revaluation
- Section 6 :Impact on Tourism and the Economy of Australia
- Section 7 :Airports benefit from Effective Regulation

IATA urges the Productivity Commission to give due consideration to the views included in this submission. It is IATA's intention to participate in the subsequent stages of this inquiry based on our members' positions. The Commission is also requested to contact IATA at any stage of this inquiry if additional information or clarification is required.

2. IATA positions and expectations from the Productivity Commission

2.1 IATA would like the Productivity Commission to take the following key facts into account:

1. Airports are natural monopolies with considerable market power
2. Airlines do not object to new airport investments that create additional capacity, provided these investments are cost effective. Increased capacity should lead to increase in cost efficiency (economies of scale) and thus lead to a decrease in the unit rate of airport charges.
3. The Australian government has recognised the need to prevent airports from using their market power for windfall gains
4. Price Monitoring in itself is not an effective deterrent to prevent airports from realizing windfall gains
5. If the Government continues with the current price-monitoring framework, effective pricing guidelines and efficient access to third party arbitration needs to be developed.

2.2 Outcomes of the current arrangements

- The current arrangements have not provided adequate incentives for all airport operators to reach effective agreements with airport users
- Data currently gathered in the ACCC's price and quality monitoring reports, though useful, cannot be solely used to judge the effectiveness of the price monitoring regime or consistency with the regime's objectives as laid out in the Terms of Reference
- Price and service monitoring in its current form is ineffective in meeting the Government's objectives:
 - Lack of Pricing guidelines
 - Lack of Effective access to third party arbitration in case commercial agreements are not reached between the airport and its users
 - proliferation of fuel throughput levies

2.3 Future arrangements

- IATA firmly believes that the Government objectives as specified in the Terms of Reference can only be met by re-introducing a price cap based regulatory mechanism of airports.

- In case the Australian government continues with light-handed regulation, immediate steps need to be taken to rectify the deficiencies identified in the current regulatory regime.
- In particular, the use of Asset revaluation tactics to inflate the cost base (and thus higher prices) should not be permitted as it results in windfall gains at the expense of the users – airlines and passengers.
- Improvements are also required in the guidelines related to fuel charges and non-revenue neutral pricing policies as the current arrangements do not lead to equitable outcomes

2.4 IATA's views on the key messages included in the Productivity Commission's Draft Report can be summarised as follows:

- The PC states that *"Price monitoring was intended to maintain a constraint on misuse of market power by airports.....there is no evidence of systematic misuse of market power by airports in setting charges for aeronautical services"*. IATA believes that though the PC lists its intentions, it fails to:
 - adequately and consistently qualify the criteria and definition of "misuse of market power" used in its report
 - undertake an objective analysis of the individual performance of each airport
- The PC states that *"the behaviour of airports in relation to some non-price terms and conditions of access has arguably been less satisfactory and negotiations at Sydney Airport have been protracted. Also, some aspects of the monitoring process have not been well targeted to objectives"*. IATA agrees with the PC's assessment and improvements need to be made to the regulatory framework to prevent such behaviour.
- The PC states that *"it is still too early to judge whether price monitoring, in conjunction with the Part IIIA national access regime, will provide a reasonable constraint on misuse of market power by airports..."*. IATA believes and will demonstrate that there is already enough evidence to show that price monitoring is not meeting the objectives as specified in the Government's Review Principles.
- In identifying the changes needed for the future, the PC states that *"....This new monitoring regime should be configured.....to give stakeholders greater opportunity to comment on the reasonableness of outcomes....and...streamline the monitoring of service quality and reporting requirements"*. IATA believes that this will only be effective if there are clear guidelines on the review principles and all stakeholders are allowed to comment in a timely fashion in order to prevent long term abuses. Such comments from key stakeholders must be taken fully into account.
- The PC also states that the regulated till should *"encompass a slightly wider range of aeronautical services"*. IATA supports the PC's finding that airports wield market power over the provision of the services identified.
- The PCs states that *"Revaluations made by airports up to 30 June 2005 to the asset bases submitted for price monitoring purposes should be allowed to stand. But any subsequent revaluations should be excluded."* While IATA fully supports the PC's stance that asset revaluations should not be used to justify increases in airport

charges, the PC needs to provide additional clarification (in line with its intent) to also prevent any future increases in charges based on revaluations made before 30 June 2005.

- Lastly, the PC states that *“It would be premature, and quite possibly counterproductive, to introduce an airport-specific arbitration regime at this stage”*. IATA believes that one of the key deficiencies of current regulatory framework is the lack of an effective mechanism to deal with market power abuse by specific airports.

3. Evidence of abuse of Monopoly Position

One of the key messages from the Draft Report is that *“there is no evidence of systematic misuse of market power by airports in setting charges for aeronautical services”* and the price increases have been *“modest”*. In response to this finding, IATA would like to strongly reiterate that there has been abuse of monopoly power and the price increases are excessive. The Commission compared charges for international carriers at Australian airports against their North American and European counterparts to arrive at this conclusion of *“modest”* increases. However, such direct comparison largely ignores purchasing power parity considerations.

Secondly, with regards to this subject matter, despite the Commission stating that the profitability of Australian airports is comparable to their counterparts in Europe and Canada and therefore price increases to date is *“modest”*, this fails to acknowledge the current imbalance in the aviation supply chain. Based on an IATA economics study entitled, *“Value Chain Profitability”*, an airport needs to invest a lot more capital than an airline to generate a dollar of revenue. On average \$1.2 of invested capital in airlines generates \$1 of revenues. Airports need to invest an average \$3.4 to generate \$1 revenue. That means while an airline needs a 10% EBIT margin to be able to pay investors its cost of capital, an airport will need an EBIT margin of around 25%. However, based on latest reported financial figures, SACL had a 57% EBIT margin, which is more than double the 25% necessary to pay investors a 'competitive' or 'normal' return on their invested capital. Together with the fact that the TRL rankings show relatively low costs at SACL, this extremely high profit margin is clearly a sign of the airport exploiting its monopoly power over its customers.

Lastly, the Commission states *“... the projected continuation of steady growth in passenger demand, and thus greater capacity for airports to spread fixed costs, should put downward pressure on prices”*. As such, IATA expects gradual decreases in prices in the next round of price negotiations; this also serves to highlight the strong need for proper guidelines for negotiations between airports and airlines. Also, however, having given past incidences of abuse of monopoly power, there exist strong possibilities of continued stable and even increased prices in the face of increased traffic growth. There is a need to see the imposition of penalty action against airports that exhibit unacceptable pricing behaviour.

4. Facilitating Commercial Negotiations

The Commission pointed out that there has been positive developments concerning commercial negotiations between airports and airlines, with it being more evident with *“considerably more negotiations between airports and airlines since the commencement of price monitoring”* and some of these negotiations being *“intense and sometimes protracted”*. However, IATA disagrees with this notion because the increased frequency and the intensity of negotiations are mainly due to heightened disagreements between airlines and airports concerning the pricing of aeronautical charges and new investments. Despite numerous consultations at Sydney Airport on the new charges regime since March 2004 and till date, there has been no outcome.

In fact, the reason for past negotiations being protracted is due in our view to the current lack of guidance in the form of guidelines and principles for negotiation and dispute resolution. For there to be progress, the first step is to address the deficiencies in this area. Responding to the Commission’s request from users to provide commentary on how an arbitration mechanism should be configured to provide all stakeholders with a strong incentive to continue to pursue negotiated outcomes. We fully support Qantas’ proposal that such an arbitration mechanism would require establishing a set of rigorous and binding guidelines that facilitates negotiations that are based on full and transparent exchange of information. This prerequisite addresses airlines’ concern that consultation meetings generally lack transparency with regards to the basis for offers. The Commission has commented and taken note that some airports like Canberra have operated on an *“open book basis whereby they have provided with airlines with their accounts and any modelling work underpinning proposed charges”*. IATA see this practice as one that will *“foster the attitudes, trust and commercial relationships between parties that could, at some stage in the future, obviate the need for prices oversight”* and we would recommend that this be implemented across all airports as a requirement for consultation between airports and airlines.

Specifically, IATA concurs with BARA that we should move away from the current setup of airlines lodging their complaints concerning commercial negotiations in the monitoring reports. Instead, a process should be put in place whereby the parties can lodge their complaints with DOTARS. Suitability of DOTARS as the independent moderator stems from the fact that DOTARS also advocates a strong need to develop a commercial arbitration model. In reviewing these cases, DOTARS would then appoint an independent arbitrator/negotiation to resolve the matter through enforceable final offers from one party to the other.

Lastly, IATA believes that the arbitration mechanism must be extended to third parties. This is because with non-existent guidelines for negotiations, and airports having a natural upper-hand as a monopoly, third party providers like fuel suppliers are forced to agree to the terms of the airport. As airlines are the end users of most third party suppliers at airports, all costs tend to be passed on to airlines.

5. Asset Revaluation

As the initial steps to resolving this issue, IATA agrees with the Commission that asset revaluations should be prohibited; as such efficiency benefits are actually non-existent because there is zero opportunity cost for land marked for aviation use and price revaluations does not translate to operational efficiency. While the general cut-off date

has been recommended as 30 June 2005, it is necessary for stakeholders to have the details and basis for such a cut off date and it would be more appropriate to review asset revaluations on a case by case basis, requiring full cost justification to determine the efficiently incurred purchase price for setting aeronautical charges. In particular, urgent attention needs to be given to the case of Brisbane airport that is attempting to justify increases in charges based on Asset Revaluations booked before the 30 June 2005 deadline – and can lead to an additional \$300m cost burden to the users.

In addition, IATA has the same view as the Commission that the asset valuation issue is indeed a major barrier to the further development an effective commercial relationship between airlines and airports. Thus, draft recommendation 6.2 stating that *“the principles governing the operation and end-of-period review of the new price monitoring regime should stipulate that, unless agreed with customers, further asset revaluations should not provide a basis for higher charges for monitored aeronautical services”*, is a good starting point and gives airlines the opportunity to work with airports to determine how aeronautical charges are set.

While the Commission has effectively addressed the baseless use of asset revaluations as a source of costless profit, the Commission also has opened up another avenue for airports to increase costless profit through discussions on the cost of capital, specifically, on asset beta. The Commission suggested that the current asset beta is probably understated as the *“risks associated with the operation of major airports in Australia are now probably higher than in the past”*. The Commission firstly states that *“the emergence of low cost carriers flying point to point and withdrawing services if they are not profitable, has increased underlying traffic risk somewhat.”* However, we wish to point out that the bulk of the traffic is still being brought in by international airlines and as such, the low cost carriers create negligible additional risk to the operations of the airports. In addition, should airports enter into risky new routes with low cost carriers; this business uncertainty should not translate into higher charges and passed onto international carriers.

Secondly, the Commission acknowledges that there has been an upward trend in passenger numbers but goes on to suggest that this actually adds more variability and thus increases asset beta. On the other hand IATA’s forecasts show that the upward trend in traffic for Asia-Pacific is sustainable and stable. Thus, what the Commission has stated provides reason for a lower asset beta and in turn, a lower cost of capital.

6. Impact on Tourism and the Economy of Australia

The Commission states that a lack of price controls encourages airport investments while price regulation impedes its growth. Given that IATA forecasts international air passenger traffic will increase at an average annual growth rate (AAGR) of 4.8% between 2006 and 2010, and international air freight traffic to increase at an AAGR of 5.3%, it is indeed vital that airports continue to undertake new investments to increase capacity, in order to cater for strongly growing demand for air travel.

Air travel in turn supports Australia’s all important tourism industry, which makes up an approximate 3% of the country’s GDP. However, while growth rates remain positive in the next few years but with the higher airport charges in the post privatisation period,

airlines are provided with less incentive to increase capacity to support this growing demand. With escalating fuel costs squeezing airlines' margins, airlines are constantly reviewing the profitability of all routes being operated and in order to quickly react to changes in the profit margins of each route operated. The need to be act fast and be adaptable in cutting back capacity has already been evident in the recent case of Air New Zealand ceasing all flights to Singapore with effect from October 2006, as other routes to North Asia provided greater profitability. And with higher Australian airport charges being an essential feature of light handed regulation, airlines would need to recoup their costs in the form of increasing airfares or reducing capacity for Australian flights and increasing capacity which offers higher profits through lower costs of operating a flight.

In the above-mentioned, while we have pointed out that airlines are highly sensitive to increases in basic costs for physically operating a flight, a similar argument can be made for airlines' customers. A reputable study, 'Air Travel Demand Elasticities: Concepts, issues & Measurement' by Gillen, Morrison & Stewart (2003), determines that the price elasticity for leisure air travel to be 1.5, meaning a 10% increase in prices will result in a 15% decrease in demand. However, this estimated price elasticity tends to be underestimated because the study has been largely based on data from the 90s. In today's environment, air travel is likely to be more sensitive to prices. The internet has brought about price transparency, deregulated markets and no frill carriers have caused a switch from schedules-based competition to competition on price for short haul, and corporate travel buyers have transformed the previous relative insensitivity of business travellers to price. As such, air travellers, especially tourists would need to be given additional incentives to travel as compared to the past.

In the case of the Australian tourism scene, higher airport charges that come with light handed regime hurts tourism in two interrelated ways:

1. airlines raise airfares to Australia to partially recoup costs from higher airports charges, this in turn reduces demand for air travel to Australia
2. most of the charges at Australian airports are directly passed through to the passenger.

With increases in passenger based charges, this adds to the increased cost for travelling to Australia and again has the effect of decreasing demand. The synergistic combination of the both would be very detrimental to the tourism industry in Australia. For example, in 2004, the number of air travellers bound for Australia was 41.6 million and based on the estimated price elasticity for all air travel is 1.1, assuming a +5% change in charges, the estimated loss in tourism revenue due to an increase in airport charges is an astounding 0.229 million passengers. Assuming each passenger spends an approximate \$4933 for her trip, this works out to be an approximate loss of \$11.29 billion!

7. Airports benefit from Effective Regulation

In a recent Financial Times article (dated 22 August), Joseph Stiglitz, the Nobel Prize laureate pointed out that airports are natural monopolies and the needs of airlines, their passengers and other stakeholders are too often relegated, particularly in the case of privatised airports. The article points to the need for strong and independent regulation of a privatised airport.

While the Australian Government has recognised the monopolistic nature of the airport business, it seems to be averse to an effective regulatory framework due to the perceived disincentive for investment and associated regulation costs.

A properly-functioning independent economic regulatory regime for airports can provide significant benefits to both the airports and to their airline users. If used correctly, it is not a “zero-sum” game where a financial gain to one side is equivalent to a financial loss to the other. Both sides can benefit from good regulation, in terms of greater efficiency and low financing costs.

For airports, a key benefit comes from stable and low debt costs. A well-structured, independent regulatory regime is seen by credit rating agencies as a “credit positive”, helping to boost credit ratings and lower debt financing costs. Fair and transparent regulation reduces – not increases – risk and uncertainty for airports. Less risk means that investors provide capital at stable and low rates, supporting investment for long-term growth.

Evidence from the credit rating agencies show no sign that airports under effective, independent economic regulation have higher financing costs. It is not the case that good regulation comes at the expense of higher financing costs and uncertainty, while it also helps to provide the benefit for both sides of greater efficiency. Regulation can also help to mitigate negative factors for credit ratings in the sector:

- The regularity of regulatory reviews provides important safeguards.
- It provides clear and up-to-date information on costs, efficiency and outputs.
- It helps to provide sufficient liquidity for large investments, where efficiently delivered, and flexibility in the event of negative external factors.

An independent economic regulatory framework can provide both:

- constraints on an airport’s “monopolistic” power and
- a long-term boost to the airport’s efficiency, ability to raise finance and growth.

Effective regulation ensures that airport investment is undertaken for sound financial reasons, not to exploit airline users through higher charges.
