CANBERRA
INTERNATIONAL AIRPORT

Response to the Productivity Commission's Draft Report on the

Price Regulation of Airport Services

November 2001

CAPITAL AIRPORT GROUP
Excellence is Our Power

1 Introduction

Capital Airport Group welcomes the recommendations for the future regulation of Canberra Airport as outlined in the Productivity Commission's Draft Report on *The Price Regulation of Airport Services* (draft report). While Capital Airport Group does not necessarily agree with all of the Commission's draft findings, the recommendations for the regulation of Canberra Airport represent a positive step in addressing the well-documented practical problems associated with the operation of the price cap.

Given the problems experienced with the price cap framework to date, Capital Airport Group considers that there is substantial merit in pursuing regulatory reform at all of Australia's major airports. In this respect, Capital Airport Group considers that the Commission's Option B represents a superior approach to the regulation of Australia's major airports. However, given that Canberra Airport is recommended for prices monitoring under both the Commission's options, this submission focuses on matters relevant to Canberra Airport.

2 General Comments on the Draft Report

Capital Airport Group responds to each of the Productivity Commission's draft findings in ***Appendix 1*** to this submission. Issues that require more thorough discussion are considered below.

2.1 Market Power

Capital Airport Group has previously outlined the dominating effect of airline bargaining power in airport-airline negotiations. The collapse of the Ansett group has seen the emergence of Qantas with 90-95% of the Canberra market, making the airport critically exposed to any unfavourable conduct by its major customer.

While it would be expected that the Commission would review its position on the level and significance of airline bargaining power at smaller airports such as Canberra in light of recent events, it is equally important for the draft report to recognise the very effective substitution possibilities available for Canberra Airport's passenger market. This is a point that lacked clarity in Capital Airport Group's previous submissions, however the impact of modal substitution on the Airport has been highlighted following the collapse of the Ansett group.

2.1.1 Modal Substitution

The majority of the Canberra air travel market is on the Canberra-Sydney route, a route that is very effectively serviced by competing travel modes, in particular road transport. The draft report recognised Canberra Airport was subject to a high potential for modal substitution. However, it was argued that substitution possibilities are moderated by the high proportion of business/VFR traffic at the Airport. The contention that substitution

possibilities are mitigated by the high proportion of business traffic is incorrect given that:

- Air travel has less than 15% of the total point-to-point travel market between Canberra and Sydney; and
- Air travel has less than half the business market between Canberra and Sydney.

This demonstrates that the road between Canberra and Sydney is a very effective substitute for air travel. In fact, air travel has failed to secure the majority of travellers on this route, both in aggregate and in any particular market segment, including the business segment.

Research undertaken as part of the study on the Very High Speed Train (VHST) revealed the nature of the Canberra-Sydney travel market and the relative position of air transport in the modal mix. The study revealed the following:

- Road travel dominates the modal mix on trips less than 3 hours in duration. There is a shift in modal preferences where travel times exceed 3 hours by road. Canberra-Sydney travel time is at this margin for point-to-point travel between the two cities. Continuous improvement in the road between Canberra-Sydney was seen as an ongoing threat to market share not only for the VHST but also for air travel.
- Total size of the Canberra-Sydney travel market was almost 12 million passenger trips at the time of the VHST study in 1998. 5.5 million of these passenger trips were point-to-point trips between Canberra and Sydney (as opposed to intermediate trips).
- Air travel secured less than 15% of the total point-to-point market between Canberra and Sydney with road transport dominating with almost 85% of the total market.
- Road transport had almost 60% of the business market between Canberra and Sydney compared with 85% of the non-business market.

This illustrates that air transport has failed to secure a significant share of the market between Canberra and Sydney, due mainly to the very effective competition offered by road transport. With such fierce competition on the Airport's major route, and the growth opportunities for air travel that are available on this route, Canberra Airport is not in a position to abuse any perceived market power.

The findings of the VHST study on substitution opportunities are supported by recent events in the airline industry and the resulting impact on the air travel market between Canberra and Sydney. For example, Canberra Airport saw growth in passenger numbers in excess of 10% during the short time that Impulse Airlines operated its discount service between Canberra and Sydney. This was seen by Capital Airport Group as the first time that air travel had eroded the share of the market held by road transport.

In contrast, the collapse of the Ansett group has seen the gains in air travel's share of the market returned to road travel. Passenger traffic volumes at Canberra Airport since the collapse of the Ansett group demonstrate that alternative transport modes are readily available. Two examples serve to support this.

1) Prior to the Ansett collapse there were approximately 80,000 passengers per month on the Canberra-Sydney route. Following the cessation of Ansett services there were only 52,000 seats in the market, leaving an estimated shortfall in supply of 28,000 seats per month.

   Since then Hazelton and Kendell have resumed flying the Canberra-Sydney route and passenger numbers are slowly returning. However the 10,000 seats per month offered by Hazelton and Kendell have not been utilised at significant levels. Both airlines have had to extensively promote their product to entice the market back to air travel. Capital Airport Group considers that many of the travellers may have been lost to road travel, at least in the short-term until there is recognisable capacity back in the market and an availability of reasonably priced fares. Once there is awareness of, and confidence in, the smaller regional airlines that have emerged from the Ansett collapse, Capital Airport Group sees this situation improving.

2) Canberra Airport has seen a downturn in passenger numbers of between 30-35% even after allowing for the resumption of Hazelton and Kendell services. However, this downturn has not been passed on to the Canberra tourism, which appears to have held up well despite the Ansett collapse.

   Preliminary numbers for the month of October (the only full month since the Ansett collapse) indicate that visitor numbers may be up by as much as 10% on October 2000. Major attractions such as Floriade (held during September and the first week of October) had visitation numbers almost double on the previous year. While a small decline was expected in business sector tourism due to the Federal Election (when parliamentary and government travel through Canberra is particularly low) it appears that business tourism has held up well.

   Overall the tourism sector in Canberra remains well positioned despite the decline in passenger numbers being seen at the Airport. The serves to demonstrate that:

   a) Air travel is a small proportion of total travel market (therefore conferring no significant market power); and
   b) Visitors to Canberra have merely substituted air travel for alternative modes of transport, such as by road.

In consideration of the above, Capital Airport Group would like to see the final report amended to reflect the highly effective substitution possibilities available to all travellers using Canberra Airport on the Canberra-Sydney route (which is delivers greater than 50% of the Airport's business).

Recognising Canberra Airport as having no significant market power compares favourably with the (correct) finding in relation to the market power of Coolangatta Airport. Where Coolangatta Airport could lose 10-15% of its total market share in competition with Brisbane, Canberra Airport has already lost 85% of its most significant market to road travel between Canberra and Sydney.

2.2 Taxi Charges

Capital Airport Group has previously provided evidence to the Commission's inquiry in support of the position that taxi charges were outside the scope of the airport price cap based on the representations that had been made to bidders during the airport sale process and the nature of the taxi charge in the context of the relevant directions/declarations. However, from a consideration of market power in the provision of taxi facilities/services Capital Airport Group provides the following comments:

- A charge of $2 applies to taxis that make use of specified facilities and services at Canberra Airport. The use of taxi facilities by either a driver or passenger at Canberra Airport is a **choice**. Both passengers and drivers have very viable alternatives if either chose not to use the specified taxi facilities provided by the airport.

- Land transport options available to passengers at Canberra Airport include self-drive (private vehicle and rental car), coach, shuttle, public bus or taxi. The public bus has recently been introduced following extensive promotion and lobbying by the Airport. The bus provides a very cheap and effective form of transport between the Airport and the city (where it links to Canberra's public bus network).

- For taxi drivers, the Airport is generally viewed as a high yield pick-up point. Drivers picking up from the Airport have been known to reject passengers travelling to nearby suburbs in favour of longer journeys. However, it is these nearby suburbs that provide an alternative to picking up at the Airport. Taxi drivers are lured to the Airport by the guaranteed pick-ups and typically larger fares that can be earned from the Airport. While the airport-taxi relationship is a mutually beneficial one, the two are not solely dependent upon each other since viable alternatives exist for both parties. In this respect, the Airport cannot be said to be providing a service in which it has the potential to abuse monopoly power.

- The nature of Capital Airport Group's agreement with the taxi companies for the introduction of the charge reflects that it was not prompted by the use of any perceived market power. Capital Airport Group negotiated a formal agreement signed and agreed by both Canberra Cabs and Queanbeyan Taxis for the introduction of the taxi charge at the Airport. The taxi charge was well supported by government and the taxi industry and has been generally well accepted by the travelling public.

- Comments made by Mr John Muir, the Chief Executive of Canberra Cabs, on the morning of the introduction of the taxi charge support the commercial basis of the taxi charge. In a radio interview in which the presented opened the door for criticism of the taxi charge Mr Muir responded that the taxi charge is:

  '….a product of the development of the airport, which has come from privatisation.'

  And that,

  'We've been talking about this for some time. Its not, as I think I've said to you previously, it's not a surprise to us.'

  A full transcript of this interview is provided in Appendix 5.

Capital Airport Group acknowledges the importance of having taxis servicing the Airport, if for nothing else than providing an alternative form of land transport for passengers. However, Capital Airport Group rejects the suggestion that Airports may use some perceived control over landside access to influence demand for on-airport car parking. Rather than limit landside access, Capital Airport Group has endeavoured to improve land transport options through negotiating the removal of government restrictions preventing independent bus operators (Deanne's Buslines) and a second taxi cooperative (Queanbeyan Cabs) servicing the Airport.

2.3 Other Access Issues

Capital Airport Group does not agree with the Commission in regard to draft finding 7.8 - that is, that airports may have an incentive to restrict front door access to off-airport providers. The conduct of Capital Airport Group since the privatisation of Canberra Airport serves to demonstrate that access has not only been provided, but that new land transport providers have been actively encouraged to service the Airport.

2.3.1 Car Parking

Capital Airport Group is not as well positioned to comment on draft finding 7.8 in respect of competition with off-airport car parking, however we note the following:

- Despite the abundance of land around the airport, no third party has found it commercially viable to establish an off-airport car parking operation.
- The price of car parking at Canberra Airport is competitive with parking in Canberra city.
- The Airport has recently undertaken substantial investment aimed at improving the capacity and level of service offered by the car parking operation.
- Car parking at Canberra Airport is an efficient operation and could withstand competition without any restrictions being imposed on access.
- Capital Airport Group has not sought to restrict access to third party service providers and would not seek to in the future on a reasonable basis.

2.3.2 Land transport

Similarly, Capital Airport Group has not attempted to restrict access to alternative transport modes. This is demonstrated by:

- The recent investment undertaken by the Airport which was designed to improve the coordination of taxi and coach operations in the terminal precinct.
- Capital Airport Group's efforts in seeking out a bus operator willing to operate services to and from the airport and subsequent lobbying of the ACT Government to remove restrictions that only allowed the government's own bus line to run the service.
- Capital Airport Group's lobbying of the ACT Government to remove restrictions that prevented a competing taxi cooperative from operating at the airport, thereby protecting the incumbent taxi cooperative's monopoly rights to service the Airport. Capital Airport Group reached an agreement with **both** taxi companies and the ACT Government to rectify this situation.

There are therefore numerous instances where Capital Airport Group has sought to increase the accessibility to the 'front-door' of the Airport for alternative modes of transport. Capital Airport Group therefore rejects the suggestion that it would attempt to limit access for land transport operators under reasonable terms and conditions in order to prop up car parking revenues.

2.4 Flight Catering

Appendix D of the Australian Competition and Consumer Commission's response to the draft report branded an erroneous 800% increase in charges levied by Canberra Airport to Hyatt In-Flight Catering as evidence of abuse of market power in the provision of aeronautical related services. The following information serves to clarify this inaccuracy:

- Hyatt Hotel Canberra previously operated an off-airport flight catering service for Qantas Airways. The licence arrangement negotiated by the FAC with the Hyatt entitled the Airport to a fixed monthly fee plus a percentage fee on turnover. It was agreed by both parties that the licence arrangement should be reviewed, particularly in relation to the turnover fee.
- The removal of the turnover fee component of the licence was negotiated through an increase in the fixed fee component of the licence. The fixed component of the fee did initially increase by some 350% (due mainly to the exceedingly low starting base), although the Hyatt's total liability under the licence was initially reduced by some 30%. The removal of the turnover fee component was a significant win by the Hyatt considering the flight catering operation made an annual profit in excess of $1.5 million.
- The above changes to the licence arrangement were negotiated in good faith by both parties. Hyatt has since sold the catering operation (with only 12 months left to run on the contract) to one of its on-airport competitors for a substantial profit and that organisation has chosen to continue to operate under the pre-existing licence arrangement rather than terminate that agreement.

Capital Airport Group considers that this is evidence that the licence fee arrangement was a commercially negotiated outcome that did not price the rights enjoyed by the operator above a fair value.

3 Response to Request for Information

3.1 Market Power (chapter 6)

Capital Airport Group provides a detailed consideration of Canberra Airport's market power in the provision of aeronautical services in section 2.1.

In terms of other services provided by the Airport, Capital Airport Group notes the following:

- Capital Airport Group has recently been approached by a wholly owned subsidiary of a major airline to provide office accommodation for their staff after the offer they received from their parent company for accommodation within the airline's leased terminal premises was considered to be too excessive. Canberra International Airport structured a very competitive deal (approximately 20% cheaper) and this was accepted ahead of the offer made by the parent airline.

- Capital Airport Group recently agreed terms for the construction of a new freight facility for a subsidiary of one of the major airlines. The major airline quoted a cost to undertake the construction of the freight facility on behalf of its subsidiary, one that was considerably greater than that offered by the Airport. In general terms, the facility rent offered by Capital Airport Group was approximately half of that offered by the freight company's parent.

- Capital Airport Group has supported the introduction of Canberra Airport's first independent ground handlers, Aero Care. Capital Airport Group has no interest in this company other than to see an independent service being provided as a cost effective alternative to the incumbent airlines' ground handling operations.

- Capital Airport Group has actively sought to increase land transport options to and from the airport (see *Section 2.3.2*).

3.2 Rationale for Passenger Based Charging

Capital Airport Group introduced a passenger based charging mechanism in June 1999. This was in response to the following:

- Change in the dynamics of the industry with airlines moving to a single class cabin resulting in increased passenger numbers for a given aircraft size. This was seen as a risk to future revenue that could be avoided by converting the existing MTOW charge to an **equivalent** passenger charge.

- The move to a passenger based charge also served to align airport revenue with airline revenue. The risk of passenger number downturns is therefore shared with airlines thereby allowing an airline's exposure to airport charges to become a variable factor.

- Passenger based charging was seen to provide an incentive to new entrants and airlines developing a new market/route. In this respect airlines would benefit from being able to grow their passenger numbers and avoid the burden of a fixed aeronautical charge per aircraft during a start-up or development phase that typically has low passenger numbers.

- Capital Airport Group saw the potential for passenger based charging to encourage airlines to pursue new route development opportunities and marginal routes given that the Airport is willing to share the risk of low passenger numbers through correspondingly low aeronautical charges on a per aircraft basis.

While the passenger based charging regime was rejected by the major airlines for over 18 months it is now becoming accepted by the major airlines and it has generally been embraced by new entrants and more recently regional airlines seeking to re-establish themselves following the collapse of Ansett.

3.3 Additional evidence in relation to draft finding 7.5.

Capital Airport Group provides a detailed consideration of the Airports pricing and investment strategy under a regime of prices monitoring in *Section 4*.

3.4 Comments in relation to default price cap option

Capital Airport Group is not convinced that the default price cap option would address the problems associated with investment incentives and commercial negotiation that have plagued the price cap framework to date. Furthermore, potentially increasing the complexity of the price cap framework to define service levels is likely to increase debate between airports and users in its practical application.

3.5 Promotion of commercial agreements between airports and users.

While still in the early stages of the new arrangements, Capital Airport Group considers the prices monitoring regime to have been the single most positive step in the airport-airline relationship at Canberra Airport since privatisation.

In recent weeks Capital Airport Group has:

- Negotiated an agreed Conditions of Use document with a further two airlines, taking the total to four. There is now only one airline left to formally agree terms, conditions and charges for its use of the Airport.
- Offered significant rebates to **all** airlines to assist in the recovery of available capacity at the Airport in the wake of the Ansett collapse.

- Agreed new charging levels with all airlines and initiated a process of price review to be finalised in 2002.

Capital Airport Group is not suggesting that the negotiation process in respect of the above has been 'smooth sailing', however there has been a noticeable shift in the approach to negotiations by all concerned.

3.6 Criteria for Good Behaviour

Capital Airport Group supports the development of criteria that can be used to assess an airport's performance at the next regulatory review. However, assessment criteria need not be complex and can rely on the single premise that *revenue from aeronautical services should not exceed the fair and reasonable cost of providing those services*.

Care needs to be taken in developing the criteria to prevent them from becoming overly prescriptive, which may restrict the flexibility of airports in developing innovative pricing structures that encourage market growth. Capital Airport Group has found that its rebate program has been very effective in partnering with airlines to pursue market growth through increased services to and from Canberra Airport.

Capital Airport Group would support criteria that were not overly prescriptive but which could be effectively used to assess airport performance against the above premise.

4. The Way Forward

Some respondents to the Commission's draft report have found it instructive to engage in an economics lesson to explore the **possible** implications of the draft recommendations. Capital Airport Group considers that the Productivity Commission is appropriately qualified to assess the merits and motivation of these arguments 'dressed' in economic theory.

Capital Airport Group does not provide commentary on the economic arguments presented in favour of retaining the price cap. These arguments generally all suffer the same flaw - they reject a move away from what has proven to be an inefficient and costly framework and fail to provide an superior alternative regulatory option.

Given that there is broad agreement between the Productivity Commission and the Australian Competition and Consumer Commission that prices monitoring is appropriate for Canberra Airport (and that these arrangements have already been implemented), it may be constructive to provide some consideration of how Capital Airport Group has responded to the Ansett collapse and the approach that will be adopted in future under a regime of prices monitoring.

4.1 Canberra Airport's Response to the Collapse of Ansett

The Commission would have been made aware that aeronautical charges at Canberra Airport have increased since the release of the draft report. This was not a decision that

was taken lightly and was one that was to a large degree outside the control of the Airport. The collapse of the Ansett group placed severe financial strain on Canberra Airport, as it no doubt has across all Australian airports.

After taking immediate steps to minimise costs across the business (albeit with only $100,000 in annual cost savings achievable even after allowing for a complete shutdown of much of the Ansett business) Capital Airport Group initially adopted a wait and see approach on pricing in response to the collapse of the Ansett group together with aggressive efforts to rebuild capacity. However, there was increasing disquiet amongst the Airport's lenders regarding the financial position of the Airport, summarised as follows:

- Existing losses on the aeronautical business pre-Ansett collapse ($400,000 EBIT as at 30 June 2001).
- Immediate loss of 45% of the aeronautical business ($2.5 million annually).
- Estimated further losses from aeronautical related business of more than $2.2 million.
- Facing a credit default of over $600,000 from the Ansett group alone.
- Approximately $5 million in capital outstanding on necessary new investment projects that were supported by the airlines but with no recovery mechanism yet in place due to delays in the NNI approval process.

Understandably the above numbers did not sit well with our debt providers and Capital Airport Group was instructed to immediately improve its financial position. The ACCC and the Department of Transport and Regional Services were understanding of the Airport's position and undertook to consider a price increase within the price cap. However, concern was raised that given this would place the Airport in a position of substantial price cap over-recovery that would have to be refunded to users in future periods. This price increase was therefore seen as nothing more than a short/medium term loan that addressed the Airport's short term cash position through increasing its future liabilities – this did little to comfort nervous lenders.

As part of the approach to the ACCC, a necessary new investment proposal was also submitted. In June 2001 Capital Airport Group finalised a necessary new investment proposal for a completed $5 million terminal facility. Negotiations for user support from the airlines had been typically time consuming and at the time of the Ansett collapse the Airport was literally expecting the formal letter confirming the long standing user support from the airline within days. In the days leading up to Ansett's collapse the airline had stalled on providing the letter. On 14 September 2001 Ansett advised that it could no longer provide a letter of support.

The ACCC was made aware that approval of the new investment proposal was critical to improving the Airport's financial position. However, while sympathetic to the Airport's requirements the ACCC indicated that it was unlikely to be able to approve the proposal in the necessary timeframe. Capital Airport Group was pursuing discussions with the ACCC on this as well as an increase in aeronautical charges under

the price cap when the regulatory instruments were changed to place Canberra Airport under a regime of prices monitoring.

Following the move to prices monitoring Capital Airport Group has sought to implement the price adjustments previously put forward to the ACCC. Capital Airport Group's consultation with our airline users on this price adjustment has yielded a significant level of understanding regarding the Airport's position with a formal agreement on the new charging arrangements having been reached with three of the four airline users at Canberra Airport. While a formal agreement has not been reached with the fourth airline, indications are that the new arrangements will be accepted.

The new aeronautical charges at Canberra Airport have also been well received in business and government circles. The Canberra Business Council, ACT Chamber of Commerce, Canberra Tourism and Events Corporation, Tourism Industry Council and Australian Hotels Association have all expressed support for the Airport's move. Similarly local and federal politicians from both sides of politics have been understanding of the Airport's need to move to a more commercial pricing structure, this is perhaps more remarkable considering that both federal and local governments were in preparation for upcoming elections.

4.2 Beyond 2001

Capital Airport Group has had to move swiftly to restore viability to the airport business in the wake of the Ansett collapse. It is readily conceded that external pressures have made it near impossible to make the transition to the new regulatory arrangements as smooth as would have been hoped under stable business conditions. However, Capital Airport Group's initial response has been measured and will provide the necessary certainty in airport pricing as the industry emerges from the recent tumultuous market conditions.

The October 2001 price adjustment at Canberra Airport was sufficient to reduce the financial pressure on the business. However, it has not shielded the Airport from substantial losses resulting from the Ansett collapse. The Airport will bear losses on car parking, taxi revenues, terminal rents, concession revenues and its new investment projects.

New investment recoveries have been based on passenger forecasts that will no longer be met and, given investment of some $35 million in the aeronautical and aeronautical related businesses over the past 18 months, there remains significant exposure to the Airport from a continued downturn in passenger numbers. Similarly these investments were conferred a weighted average cost of capital based on an assumed negligible risk and low asset beta. The Airport is therefore faced with a revenue target that will not be met due to severe passenger downturn and the inability to adequately compensate investors for the current and future risks facing the business due to the low returns conferred to aeronautical investment by the regulator.

Capital Airport Group recognises that it will take time to rebuild the aeronautical business and therefore has not sought price increases to immediately bring about the returns required from the aeronautical business. Capital Airport Group will work with

its airline partners to introduce capacity to the Canberra market and adopt a longer-term strategy of pursuing profitability through passenger growth. Capital Airport Group forecasts the return on aeronautical assets growing from current negative levels to 2.5-3.6% by 2005.

Nevertheless the current pricing structure has been implemented during a time of considerable uncertainty. Capital Airport Group recognises the importance of providing a degree of certainty in airport charges going forward. Therefore Capital Airport Group will proceed with initial plans to undertake a full price review with airline users in the first half of 2002 with a view to developing a 3-year aeronautical pricing and investment charter. It is hoped that by this time both the airport and airlines will have an improved understanding of the nature of the aviation industry to enable forward estimates of pricing and investment parameters to be undertaken with some certainty.

5. Conclusion

Capital Airport Group accepts the outcome of prices monitoring as recommended for Canberra Airport by both the Productivity Commission and the Australian Competition and Consumer Commission. The information provided in the submission serves to support much of the Commission's analysis, although some points of contention have been raised (particularly in relation to Canberra Airport's relative position in the airport substitution matrix).

The future for airports remains difficult and challenging, however the recommendations in the Commission's draft report (and their subsequent adoption for Canberra Airport by the Commonwealth Government) have served to assist the airport through a very difficult time. However, most importantly the draft report has signalled a move to the next phase in the transition to a deregulated airport industry, which will hopefully provide incentives for both airlines and airports to improve their commercial relationships for their mutual benefit.

Capital Airport Group looks forward to operating under a truly light-handed regulatory regime that will enable airport resources to be devoted to improving the quality and efficiency of Canberra Airport for its users, both airlines and passengers.