A Submission to the Review of the National Access Regime

Australia Pacific Airports Corporation

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Introduction

Australia Pacific Airports Corporation (APAC) is an airport management and ownership company. It has four shareholders:

- AMP Funds Management (49.9%)
- Deutsche Funds Management Australia (25%)
- BAA plc (15.1%)
- Hastings Funds Management Limited (10%)

APAC owns Australia Pacific Airports (Melbourne) Pty Ltd (APAM) which acquired on 2 July 1997 a 49 year lease (with a 50 year option) from the Commonwealth Government to operate Melbourne Airport. APAC also has a 90% interest in Australia Pacific Airports (Launceston) Pty Ltd (APAL) which acquired a similar lease over Launceston Airport on 29 May 1998. The Launceston City Council has the remaining 10% interest in Launceston Airport. These interests were acquired for $1,300 million and $17.1 million respectively.

The airport industry reform process embarked upon by successive Commonwealth Governments has by and large been successful. At Melbourne Airport, APAM and its partners have invested over $230 million since July 1997 including the construction of a new multi-user domestic terminal to facilitate the operation of domestic and regional carriers not associated with Qantas and Ansett.

The importance of the break-up of the Federal Airports Corporation (FAC) network must be seen as the core of this policy success. Not only have pricing and investment decisions become more focused on individual airport activities, but more importantly, business development has become keenly focused on the markets that individual airports serve. This has led to competition in certain markets between airports at the same time as the bargaining strength of the FAC was eliminated.

Airport services are declared for the purposes of Part IIIA of the *Trade Practices Act 1974* (TP Act) by virtue of provisions of Section 192 of the *Airports* Act *1996* (Airports Act). A variety of airport charges are subject to formal surveillance under s21 of the *Prices Surveillance Act 1983* (PS Act) whilst other are subject to monitoring under s27. In addition, a number of other Acts address various aspects of economic activities on airports.

In our submission to the Commission's review of the PS Act we suggested that one option for airport regulation may be to allow airports and their customers simply to negotiate with any outstanding issues being resolved under the provisions of Part IIIA. Upon reflection, for reasons set out in this submission, we have formed the view that Part IIIA in its current form is not well suited for application as a prices surveillance device for non-vertically integrated firms.

This submission reflects our experiences in dealing with Part IIIA and related issues as well as regulation under the PS Act although we have tried to avoid repeating arguments and material presented in our submission to the Commission's inquiry into that Act. Our principle focus in this submission is the application of Part IIIA to non-vertically integrated businesses and its suitability as a prices surveillance mechanism and in doing so, we leave the other issues in the Commission's reference for others to comment on.

Underlying economic principles

National Competition Policy rests on the basic economic proposition that competition enhances economic efficiency and therefore tends to maximise total economic welfare. It is important to note that this underlying ideal says nothing of distributional outcomes and nor should it – the issue here is efficiency, not distribution. The provisions of TP Act that are subject to this inquiry, as well as a number of other parts of the TP Act, give legislative force to this basic economic proposition.

Part IIIA of the TP Act is designed to provide a framework whereby firms can gain access to the services provided by certain facilities that are large and of national significance and where necessary to resolve disputes about the terms and conditions of that access. It appears to be designed to address the problem where a vertically integrated firm controls access to a piece of essential infrastructure that its competitors need access to in order provide services in competitive downstream markets. However, its application is not restricted to that problem alone and can be applied to non-integrated infrastructure providers as well.

Part IV of the TP Act deals with what could be considered to be deliberate anti-competitive conduct where as Part IIIA provides a set of arrangements to provide pro-competitive outcomes that may not arise because of naturally occurring industry structures. In doing so, it provides a set of arrangements that are supposed to be less costly and more effective than what may arise from reference to the Courts in the first instance. It is probably also fair to say that Part IIIA seeks to address some issues which could be dealt with by an anti-trust law if such a statute was available.

Anti competitive conduct versus use of market power

By its very nature, the non-vertically integrated firm does not provide services to its competitors. This removes most of the incentive to deny access that is predicated by Part IIIA. Indeed, if there is surplus capacity available in a facility, it will generally in the provider's interest to grant access give that these types of businesses are dominated by fixed sunk costs.

However, it is possible to conceive of circumstances where access may be denied leading to anti-competitive outcomes. Consider the situation where an airport terminal is reaching capacity. Incumbent airlines may enter into an arrangement with the airport to increase prices on the understanding that no additional capacity will be provided. Alternatively, airports may raise prices to drive out financially weaker operators so that they can provide the services concerned to stronger competitors.

This sort of conduct is effectively prevented by Part IIIA where the service concerned is declared. However, it seems to us that in these instances, there are remedies available in Part IV of the TP Act as it could easily be found that the actions of the airport might reduce competition in another market.

Part IV however does not provide a universal remedy for the abuse of market power by non-integrated infrastructure providers. It would be possible for a firm with market power to use its market power in such a way that does not lessen competition. For example, if a firm with market power provides services to an industry downstream where there is strong competition and end demand is relatively inelastic, a price increase would simply result in a transfer from the end consumer to the upstream infrastructure provider. Whilst such a transfer may not necessarily impact on

competitive outcomes in other markets some form of prices surveillance may be perceived as desirable for other public policy reasons.

Access regulation and prices surveillance

This leads to the question of how the use of market power for purposes other than those prescribed by s45 should be dealt with. Part IIIA is clearly one option, the PS Act is another, industry specific regulation is yet another example.

Part IIIA by its design deals with the situation where a specific access seeker is in dispute with an access provider and is largely predicated on the assumption that the two parties are competitors. Whilst declaration makes arbitration available to all users the only remedies available are one-on-one arbitration between the access provider and each user. The enforcement of access undertakings would seem to get around this problem but as they are voluntary on the part of the access provider, they don't seem to form the basis for a regulatory system.

It is probably fair to say that surveillance by way of Part IIIA was what was hoped would arise in the airports industry but given the difficulties that were encountered by airports in negotiating access undertakings with the ACCC, this was not achieved.

It does seem however that the access problem presents a different situation to that where prices surveillance may be required. In those situations where there are multiple users of facilities (who in the case of intermediate industrial services will often be competitors) and where there is no apparent reason for access to be denied by the access provider, it is by no means clear that declaration under Part IIIA is the best or most appropriate regulatory response.

Generic versus industry specific regimes

If access is the issue and a large number of applications is to be expected then an industry specific arrangement may be appropriate. Such an arrangement should deliver more predictable outcomes for both access seekers and providers but at the same time it should deliver outcomes which are consistent with a more generic structure. In such a regime it is important that the scope of the regime is clear, especially where a firm provides both regulated and unregulated services. In particular, the decision as to which services are subject to the regime should ideally rest with an authority other than that administering the scheme and at least be subject to appeal to a body such as the Australian Competition Tribunal (ACT).

We understand it is the view of many in the telecommunications industry that the current industry specific arrangements are far more onerous for access providers than those that would arise from the application of Part IIIA. That said, it might still be desirable to keep a generic device on the statute book to deal with isolated novel cases and provide a more dynamic regulatory structure. However, if firms are subject to an industry regime, there should be no double jeopardy and they should be protected from action under the more generic regime in relation to the services caught by the industry specific arrangement. In other words, the should be no "regulatory double dipping".

It seems to us that prices surveillance regimes, whatever their form, tend to lend themselves more to industry specific arrangements. Such arrangements should lead to less intrusive forms of regulation and can range from simply monitoring and

reporting of prices to price caps. Such arrangements need to be carefully designed not only to ensure regulatory certainty but also to pay attention to the specific characteristics for the firms being regulated and the markets in which they may be thought to possess market power. These include

- the nature of competition in the markets for the services regulated, markets related to those services and other markets the regulated firm operates in. The bias must be to restrict regulatory activity to those areas where market power may exist;
- the structure of demand including any countervailing market power possessed by users;
- the general level of returns and productivity;
- the nature of capital expenditure, especially in relation to the appropriate size of incremental capacity additions; and
- the risk of capacity being stranded either by technological obsolescence or loss of demand for services.

Surveillance regimes should be incentive based and should give equal weight to investment, quality and price. The level of profits should be a secondary consideration. Where possible they should recognise and facilitate commercial agreements between providers and users (providing those agreements themselves are not anti competitive). Where regulatory intervention is required it should be prompt, predictable and accountable with the system as a whole being subject to regular independent review, that is, a review by a party other than the regulator involved. In short, any regime should represent regulatory best practice.

Section 192 of the Airports Act

The Commission observed in its report on International Air Services that *the Airports Act access provisions are not consistent with the principles of the Trade Practices Act, and are potentially highly interventionist*[1]. Given our experience in dealing with the ACCC on these issues, we would have to say that the Commission's fears were justified.

As mentioned above, it was hoped that access undertakings for airport services would put them beyond the scope of the arbitration provisions of Part IIIA. However, no airport subject to this regime has had an access undertaking approved. Some may present this as evidence of the avarice of airport operators. Others may present it as a reflection on the inflexibility of the ACCC and its processes and its desire to extend the scope of regulation well beyond that intended by the Parliament. No doubt the Commission will form its own view on this question.

In relation to Melbourne Airport, we entered into discussions with the ACCC that proceeded up to the point of the ACCC publishing a Draft Determination in May 1998. We did not persist beyond that point as we had formed a view that any undertaking that would be acceptable to the ACCC would actually leave us in a worse position than if we were to be subject to declaration and subsequent arbitration. This was particularly the case where the ACCC was seeking an undertaking that effectively extended into operational and commercial areas not intended to be subject to Part IIIA.

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[1] Productivity Commission (1998) *International Air Services*, Inquiry report, Report No. 2, Canberra, p204.

We made no attempt to put an undertaking in place for Launceston Airport largely on the basis of our Melbourne experience. It is also interesting to conjecture whether certain airport services at smaller airports would meet the national significance criteria of Part IIIA if they were not declared by the Airports Act. We would also observe there exist pairs of apparently competing airports, such as Cairns and Townsville and Launceston and Devonport, where one is subject to declaration and the other is not.

We have also had experience of the process where by the ACCC may determine what is and what is a not an airport service. This was in relation to an application to the ACCC by Delta Car Rentals for drop off points on the terminal kerbside at Melbourne Airport. Without going into the details of the matter, it is again questionable whether this matter would have passed the national significance test contained in Part IIIA.

Section 192 of the Airports Act provides a significantly weaker test for declaration than is contained in Part IIIA. Moreover, it is less accountable not only because the arbitrating body effectively is the declaring body (the NCC is not involved) with the only recourse to the ACCC's declaration decision being to the Parliament, not the ACT.

There appears to be no compelling reason why the access test should be lower for airports than other essential facilities and why airports should have lesser rights of appeal than other facility providers. As such, we feel it would be appropriate for the Commission to recommend that Section 192 of the Airports Act should be repealed with airports being subject to the same general access arrangements as other essential facilities. As a minimum, its scope to be reduced to only major airports and the definition of the declared services refined to cover only those where airports have significant market power. If the declaration remains, a more appropriate appeal mechanism should be put in place.

Pricing rules

Pricing under any regulatory structure should as far as possible replicate processes that occur in competitive markets. Ideally, users and providers should be able to agree on the terms and conditions of supply free from intervention by the regulator. This not only ensures that operators are receiving an adequate return but it properly reflects on the value that users place on services provided. We saw this in the case of Melbourne Airports new Domestic Express Terminal where Melbourne Airport and Impulse Airlines reach agreement on a charging regime that the ACCC initially sought to undermine. Fortunately, the commercial agreement ultimately survived although the incident has led airport operators to be less prepared to invest in regulated assets than before. However, as a result of the ACCC's conduct, the Board of APAC will now no longer approve investment in new aeronautical facilities until such time as a final pricing decision is available. This will have the effect of delaying deliver of new services for many months when compared to a situation where we could invest with pricing certainty.

It is interesting to note that when regulators look at pricing mechanisms the sole focus of attention is the provider of the service. This stands in contrast with a competitive market where equilibrium is arrived at as a result of the commercial interests of the seller and the utility valuation of the buyer. This was born out in the

case of our Domestic Express Terminal where the apparent willingness to pay of a customer was not even mentioned in the ACCC's draft decision.

Pricing rules should not distort investment or production decisions and this issue is the subject of an extensive academic literature. We are very concerned with the pricing approach that has been adopted by the ACCC for determining price increases that result from new airport investment. The ACCC has sought to enforce an approach that sees airports effectively leasing assets to airlines rather than providing services.

It is our view that once a service is introduced and its price is set, it is up to the airport to provide it. In particular, prices should not be reduced (or perhaps eliminated) once the assets providing the service reach the useful life assumed in the pricing proposal. Similarly, the price should not be increased if the asset providing the service is replaced at any time before or after the end of its expected useful life. These are the same conditions that apply in competitive markets. They clearly place the risks of ownership and operation of assets and the provision of services on the airport owner. They provide clear incentives for owners to innovate in the production of services and in particular in achieving the right mix of maintenance and asset replacement whilst the CPI-X mechanism ensures users get their share of the benefits of such innovation. Consider the alternative. If prices fall once an asset reaches the end on an arbitrary assumed useful life and a price increase is allowed for its replacement, there is little incentive for airport operators to extend effective asset lives irrespective of the overall economic benefits of doing so. Statutory service quality reporting and possibly voluntary service level agreements should be designed to ensure services are provided at an appropriate level on an ongoing basis.

Regulatory instrument choices

At the current point in time, airports are subject to declarations under the PS Act, section 192 of the Airports Act and for major international airports such as Sydney, Melbourne, Brisbane and Perth, general declaration under Part IIIA. As access is generally not the issue, this means there are effectively three ways in which prices at airports can be controlled. Not only is this unnecessary, it is confusing and unclear and therefore acts as a disincentive to investment.

It should not be assumed that pricing decisions under Part IIIA and the PS Act would be the same:

- PS Act decisions are subject to various directions from the Minister whereas the TP Act directs the ACCC in arbitrations.
- The PS Act itself does not require the ACCC to have any regard to the commercial interests of suppliers and seems to be driven towards cost based outcomes that are now not generally considered to represent regulatory best practice.
- Effective appeal under the PS Act involves defying the ACCC at the risk of the Minister ordering an inquiry. One can conceive of situations where a Minister may have a strong incentive to support the ACCC not on the merits of the particular matter but because of other activities the ACCC may be involved with at the time.

We have outlined elsewhere the problems we have encountered with the price cap put in place under the PS Act. It is probably fair to say that neither Part IIIA of the TP Act nor the PS Act were designed with the purpose of ongoing regulation of an industry in mind and this in large part why neither is an entirely effectively regulatory instrument. We note that most regulated industries in Australia are subject to some form of specific code that is enforceable under statute. Regulated industries in the UK actually have individual regulators.

Despite the noble aspirations of the architects of the airport regulatory arrangements for there to be a transitional period of light handed regulation prior to normal commercial outcomes prevailing, it seems likely that some regulatory system will exist for the foreseeable future. It is our view that both the PS Act and Part IIIA do not provide a basis for some form of ongoing prices surveillance arrangement that would provide incentives, maximise economic efficiency and minimise compliance costs. That said, depending on what regulatory system emerges from the forthcoming airport review, it may be possible to draft appropriate instruments under the PS Act although we do see significant problems with the PS Act itself. Further we see no reason why airports should be placed beyond the general reach of Part IIIA (as opposed to the more narrowed and flawed processes of section 192 of the Airports Act).

The basic problem seems to be the Commonwealth lacks an adequate statutory basis under which economic regulatory regimes can be constructed. The solution to this problem seems to be either

- a major overhaul or replacement of the PS Act with the specific intent of making it into a statute under which best practice regulatory systems could be implemented;
- the incorporation of new part of the TP Act that serves the above purpose; or
- where the need or potential for regulation of an industry is identified, the incorporation of appropriate provisions in industry specific legislation, such as the Airports Act.

Whatever route is chosen we do not see the need for a separate regulatory agency and would support ongoing regulatory administration by the ACCC providing that best practice procedures are in place. Such arrangements would provide an independent mechanism for appealing decisions of the ACCC (such as the ACT) and a regular review (say every five years) of the regulatory system by an organisation other than the regulatory (such as the Productivity Commission)