Submissions to the

Productivity Commission

in relation to its inquiries into

Price Regulation of Airport Services

National Access Regime

Prices Surveillance Act 1983

Sydney Airport

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EXECUTIVE SUMMARY

The inquiries being undertaken by the Productivity Commission will collectively consider airport regulatory issues of critical public policy importance. The future performance of Australia's airports has the potential to enhance, or hinder, the economic growth of Australia.

This Sydney Airports Corporation Limited (SACL) submission makes the case that complete economic deregulation of Australian airports will deliver the greatest net benefits.

Deregulation in this Submission refers to the exclusion of pricing and access control under the Prices Surveillance Act 1983 and the Part IIIA of the Trade Practices Act 1974. It does not, however, address or contest other forms of regulation or control including in relation to safety and operational issues, the movement cap, curfew or regional airline access arrangements.

Sydney Airport's Contribution – Present and Future

A current snapshot of Sydney Airport reveals a high quality facility handling over 23 million passengers and 500,000 tonnes of freight (valued at over $21 billion) each year with aircraft on-time performance that is the envy of comparable US and European airports. This environment has been created through the investment by Sydney Airports Corporation Limited (SACL) of over $800 million in a two year period, with the Sydney 2000 Olympic Games providing a focal point for the completion of a major expansion and upgrade.

It is SACL's goal to have a comparably favourable snapshot in 5, 10 and 20 years time, with Sydney Airport continuing to play an important role in the development and growth of Sydney, NSW and Australia. An alternative scenario, however, is that in 5, 10 and 20 years time, we look back on 2000-01 with nostalgia and ask "where did it all go wrong?" This is the question currently being asked by people in California in relation to their electricity industry, and by the British in relation to their once mighty world leading railway system.

The Environment Necessary to Deliver Maximum Benefits

The ability of Sydney Airport to keep pace with the expected rate of future growth and change will depend heavily on having the right economic environment. That environment must be capable of attracting investors and innovative managers, must encourage the development of, and investment in, new facilities and services, and must provide the right incentives for the maintenance and upgrade of existing facilities and services to deliver the quality standards demanded by increasingly discerning airline customers and passengers. The environment must also create confidence that services will be provided at an efficient price, ie a fair price that does not result in demand being inefficiently stifled.

The merits of an environment that delivers all of the above is unlikely to be in dispute in the course of the Productivity Commission's inquiries. Indeed, these goals are wholly consistent with the aspirations of the Commonwealth in its pricing policies established prior to the privatisation and Corporatisation of airports. The likely areas of difference between interested parties is the design and delivery of an optimal framework to create this environment.

Net Costs of Regulation

This Submission will demonstrate that there has been a "disconnect" between the Commonwealth aspirations, the final design and the ACCC implementation of the airport regulatory system. Rather than delivering the intended light-handed, commercial outcomes focused environment, the reality has been a detailed, intrusive regime that discourages negotiated outcomes by encouraging regulatory 'gaming'. The time it has taken for airport investors to fully appreciate the nature of the environment, combined with the long term nature of airport assets, means that the negative repercussions of continuing an intrusive environment may not be fully felt for several years.

It would be "courageous" for Australia to assume it has all the answers to avoid the pitfalls of California electricity and British rail tracks. These economies have been undertaking regulation over much longer periods with more extensive resources than Australia. Accordingly, it is necessary for Australia to weigh the expected benefits of regulation against the very real costs and risks of regulation, on a case-by-case basis.

Of course, not all regulatory costs are as visible as the examples cited above. Other costs of regulation come in the forms of under investment leading to congestion and over-crowding, poor quality outcomes and lack of innovation. In these cases, it is likely that regulators will point fingers at managers and vice-versa, and the costs of lack of innovation will be invisible, simply because people "don't know any better".

Airports are Different and Should be Deregulated

This Submission calls upon the Productivity Commission, and subsequently the Government, to consider the market structure of major airports and the significant differences between airports and other regulated businesses such as electricity, gas and telecommunications businesses. SACL believes that this analysis will reveal only very small economic and social risks associated with the full economic deregulation of airports. When balanced against the substantial risks that regulation may retard investment and innovation, and the social and economic costs of this, the case for complete deregulation becomes compelling.

Airports Are Not Vertically Integrated

Airports do not compete with their customer's core business, ie, they are not vertically integrated. In industries with significant degrees of vertical integration, the full set of terms and conditions of access may be important determinants of the ability of access seekers to compete with the infrastructure provider in downstream markets. This may have significant economic consequences and is at the heart of the National Access Regime and the construct of Part IIIA and Part XIC (which relates specifically to telecommunications) of the Trade Practices Act 1974.

In the case of airports, there are no incentives for an airport to restrict access to their facilities and services or to provide an inappropriate level of quality. Accordingly, most terms and conditions are optimally determined through commercial negotiations. The residual concern is related to the price of access and the incentive an airport may have to price access at a level higher than an efficient level.

It is not clear that airports would necessarily price access above efficient levels in an unregulated environment. The reasons for this are discussed under *Price Motive*, below. In any event, the application of a regulatory construct designed to address complex access

issues to a situation where the only substantive issue is price amounts to the regulatory equivalent of cracking a walnut with a sledgehammer. (In the event Part IIIA were to have some continued application to airports, the submission recommends a number of changes, although these do not fully address the concern of regulatory overkill.)

The Likely Price Motives of Unregulated Airports

Airport companies have the same value maximisation objective as all other companies. Major airports also generally accept that they have a degree of market power in some of the services and facilities they provide. It does not necessarily follow, however, that in the absence of regulatory prohibition an airport company's best value enhancement strategy would involve abusing its market power by raising prices above efficient levels.

The success of major airports and their airline customers are inextricably linked. Airlines provide airports with the potential for revenue growth through adding additional incremental aeronautical services, from increasing the level of optional services such as heavy maintenance and on-airport freight handling and additional office administration functions, and by jointly developing new products and services for passengers such as international arrival lounges and on-line services.

Airlines have a degree of choice in where they deploy new capacity or commence new services. These choices are clearly influenced by many factors, airport charges being a relatively minor one, particularly at current Australian levels. However, from an airport perspective, the benefits of an incremental new service can be very important. A strong relationship involving competitive prices and joint initiatives can, in SACL's view, make the difference between securing that new service or having it go elsewhere.

The benefits of incremental new services are multiplied by the operation by airports of competitive businesses such as retail and car parks. Attracting incremental services allow the airport to outperform the long run trends that are expected from these businesses through the expected base level of traffic growth.

The final reason that an airport will not necessarily seek to misuse market power is the potential for re-regulation. This risk, that will always exist when Governments have the power to legislate, is likely to temper any unreasonable behaviour.

Airlines Have Significant Countervailing Market Power

Electricity, gas and telecommunications industries have a large number of relatively small customers. The ability and incentives for these customers to influence pricing outcomes may be limited, although vocal user groups and larger customers have a degree of political and market influence.

Airport revenues are generated from a relatively small number of very large customers (many times larger than airports by most measures), who are sophisticated, resourced and organised.

The simplistic 'black and white' view of countervailing power considers the potential for an individual customer to completely cease operations without incurring any costs, while causing significant commercial harm to the supplier. Clearly, very few firms would be considered to have countervailing power using this measure. However, this belies the sophistication and complexity of relationships between airports and airlines which result in many shades of grey in terms of countervailing power.

One of the courses of conduct open to the airlines (and which has been used by the airlines to date) is to exert commercial pressure on airports to give airlines a particular commercial outcome using litigation as a tool.

The discretion available to airlines to divert individual flights between airports can have a significant impact on airport profitability. While this may require airlines adopting a 'sub-optimal' route structure in the short-term, the commercial cost to airlines is likely to be modest. The Domestic Terminal Lease arrangements at Sydney Airport enable airlines to direct Sydney origin or destination international passengers through either their Domestic or SACL's International Terminal by potentially hubbing at another airport. The financial significance of this discretionary action could be very significant in the event it is used as commercial leverage. Airlines can also remove or reduce tenancies for non-essential airport based activities.

A further level of countervailing power is the influence of airlines politically and in the media. Airport management and shareholders are likely to be sensitive to criticism and the influence of airlines will allow them to lobby for re-regulation.

The Importance of Capacity and Congestion

Congestion is a two-sided issue. First, the market power of an operator of a capacity constrained airport (such as Sydney) may appear greater because there are limits to the extent growth can be achieved by attracting new operations. However, the efficient price (marginal cost or incremental cost of expansion) of a congested facility is likely to be significantly higher than at an uncongested airport, resulting in less concern about higher prices, within reason.

SACL has written extensively on the efficient pricing of Sydney Airport in its aeronautical pricing proposal process under consideration by the ACCC. This analysis concludes that the significant price increase proposed will improve efficiency, but is likely to remain well below the optimally efficient market clearing price, or the incremental cost of expansion of capacity on another site.

The current policy settings at Sydney Airport have been determined by the Government to balance the Airport's important role as an economic driver against community concerns regarding noise and access for regional NSW residents. Even with these settings in place, SACL has considerable scope to improve allocative efficiency and capacity utilisation.

An unregulated environment would provide the maximum flexibility for SACL to "micro-manage" the price settings of various services and facilities to generate efficient outcomes. This could include time of day (peak/off-peak) pricing, the extension of the current system of off-peak discounts for new services and greater levels of facility specific pricing to manage excess demand at any choke points where expansion is either not possible or where the incremental cost of expansion exceeds current prices.

Where continued investment on the current site can alleviate choke points, a deregulated environment will provide the best incentives for SACL to develop and proceed with innovative investment solutions. Innovative solutions to capacity on a constrained site will often be at a higher unit cost than solutions on an unconstrained site. A regulated investment environment requires the regulator to "second guess" the airport operator in terms of the best investment solution, particularly when incumbent customers seek to delay investment or reduce the regulated price by arguing that innovative investments are "inefficient" due to higher average unit cost than selective benchmarks.

There would be understandable concern on the part of airlines about the ability of the operator of a capacity constrained airport to extract economic rents from airline customers. Empirical evidence suggests that airlines currently capture significant economic rents through pricing airfares from capacity constrained airports above efficient levels. As a result, high airport prices may only have a distributional impact which is a second-order issue in terms of efficiency. In the case of Sydney Airport, which remains Commonwealth-owned, the capture of any rents by the airport is likely to have social equity benefits as compared with their capture by airlines. Such rents could then be used for funding health, education, transport etc, rather than be distributed to the predominantly foreign owners of SACL's airline customers.

The importance of Second Sydney Airport Issues

Economic efficiency objectives would see SACL pricing airport services at a point between marginal cost and customer valuations. A ceiling for such prices is generally considered to be the incremental cost of new capacity. When demand exceeds supply at a price above incremental cost, new capacity should be added. In the case of new major airport capacity in the Sydney basin, the Commonwealth clearly has a role to play in determining timing and location.

The Government announced on 13 December 2000 that it would be premature to build a second major airport. It instead decided to support the development of Bankstown Airport as an overflow facility capable of handling small jets (but not large B747s). Sydney Airport will continue to be subject to the same curfew and movement cap arrangements. The Government's announcement stated that it "is confident that the commercial decisions by the airlines and our policy measures will ensure that Sydney Airport will be able to cope with the increasing air traffic until the end of the decade." A further review of policy will take place in 2005. Subsequently, the Government announced on 28 March 2001 that Sydney Airport would be privatised by way of 100 per cent trade sale in the second half of 2001; with Bankstown and the subsidiary airports privatised separately in the second half of 2002.

The most important economic consequence of these decisions is that it establishes a very real cap on physical capacity for a substantial time. This focuses attention in the short to medium term on demand management, rather than the expansion of supply. Accordingly, an efficient price of access will be determined by customer valuations rather than a cost based approach that is favoured in many regulatory constructs.

The current administrative slot system allocates capacity, but there is little reason to believe that this system promotes efficient allocation. The grandfathering system whereby slots are held indefinitely by any party on the basis only of continued use creates significant potential for inefficient allocation. This includes "slot banking" by incumbents with an anti-competitive intent to restrict the access by or growth of competitors.

A slot auction system has been suggested as an efficient means of determining user valuations and allocating scarce capacity. SACL understands that there would be significant administrative difficulties in establishing such a system due to complexities of establishing matching slots at the origin and destination airport. Also, the strength of airline associations (such as the International Air Transport Association) may create a disrupted process with airlines reaching prior agreement not to participate competitively. SACL does not believe a slot auction is necessary to achieve efficient prices. A deregulated environment would allow regular alterations to price level to achieve prices that closely mimic the outcome of an auction. This would reduce the value of slots to a level at which they would be freely exchanged.

The issue raised by airlines in the Sydney Airport pricing context that the Commonwealth role in deciding the timing of new capacity negates the need for efficient pricing, is simply wrong. In the short term, we now know that a new major airport will not be available for 10 years, so efficient (demand based) pricing has an important role to play in enhancing allocative efficiency. In the 2005 study, the Government will likely look at the demand characteristics of Sydney Airport in determining whether or when a major new airport is required. If prices at that point are below efficient levels, this will send signals that capacity is required more quickly than is efficient. This will lead to inefficiently early investment in new capacity, the costs of which will be borne by society in some form (which could be the travelling public through higher air fares or Australian taxpayers in the event of Government investment or subsidy). The efficiency loss of building a $4 billion facility, say, 3 years too early would be around $1 billion ($4b x 9% cost of capital x 3 years).

The Likely Motivation of Contrary Positions

SACL recognises that some airlines and airline industry bodies are likely to run a "scare campaign" against full deregulation. This type of campaign is likely to be motivated in part by a genuine fear of the unknown in terms of an environment where strong commercial relationships will be paramount, rather than an environment where decisions are played out on a stage before a regulator. Another motive, however, may be that a regulatory system that delays investment may benefit incumbent airlines because it restricts the ability of competitors to enter the market or expand services, thereby allowing incumbents to charge higher airfares. A third motive is simple rent seeking behaviour, as evidenced in the so-called "single till" debate where airlines lay claim to revenues generated through competitive services provided by airports. This rent seeking is likely to be less successful in a deregulated environment.

Possible Light-Handed Regulatory Framework

In recognition of the potential for parties to seek a compromise between full economic deregulation and the current intrusive regulatory system, this Submission outlines a possible light-handed regulatory system. While lacking the full incentive benefits of deregulation, a simple system involving a medium to long term price path based on a set of objective service standards has significant benefits over the existing arrangements.

Other Required Changes to Legislation

Consistent with the above, this Submission argues that neither the *Prices Surveillance Act 1983* nor Part IIIA of the *Trade Practices Act 1974* need apply to airports. This would also require changes to the Airports Act to remove section 192 which automatically applies Part IIIA under certain circumstances.

The light-handed fallback approach, however, utilises to some degree the existing section 192 and Part IIIA structures. Accordingly, this Submission suggests improvements to these instruments in the event full deregulation is not embraced.

Conclusion

As demonstrated above, the case for the complete economic deregulation of Australian airports is compelling. Airports have a limited degree of market power which is mitigated substantially by the countervailing power of airline customers and strong incentives to develop commercial relationships to deliver growth.

The potential cost of imperfect regulation is extremely high given the importance of efficient investment in new capacity and services.

In the event total deregulation results in unexpected difficulties, the Government always retains the ability to reintroduce regulation.

INTRODUCTION

Sydney Airports Corporation Limited ("SACL") is a wholly Commonwealth owned company with a mandate to operate and manage under long-term lease the four Sydney Basin airports: Sydney (Kingsford Smith), Bankstown, Camden and Hoxton Park.

Of those four airports, only Sydney (Kingsford Smith) Airport ("Sydney Airport") is subject to the regulatory pricing and access regime that falls, wholly or partly, within each of the Commission's three public inquiries into Price Regulation of Airport Services, the National Access Regime and the *Prices Surveillance Act* ("the PSA").

This submission provides the Commission with SACL's views on the entirety of the airport pricing and access regime to which it is currently subject and to which, under the present provisions of the *Airports Act 1996*, it would otherwise be subject following privatisation as recently announced by the Hon John Anderson MP, Minister for Transport and Regional Services.

As such, this submission traverses matters that fall within each of the three Commission inquiries. SACL notes the Productivity Commission is releasing its draft reports on the National Access regime and the PSA at the same time as this submission is being made. SACL, accordingly, requests the Commission to consider this submission in the context of its final decision on these issues. SACL will consider the benefits of a further submission on the draft reports after an initial review.

OVERVIEW OF THIS SUBMISSION

This submission falls into five major sections:

- Section 1 analyses the need for explicit regulation of Australian airports in the context of their degree of market power in various services, the real incentives airports face to develop partnerships with their customers to grow volumes, the countervailing power of airport customers, and the existence of more general forms of regulation including the threat of re-regulation. This Section concludes that there is little risk, and potentially significant benefits, in genuinely de-regulating airports and allowing commercial relationships to determine investment, pricing and quality outcomes.

- Section 2 sets out SACL's views on an alternative new light-handed regulatory regime which could be implemented if for any reason the Productivity Commission and/or Government is not convinced by the merits of complete de-regulation. The framework outline in this Section is an airport-specific pricing and access regime that would be administratively simple, speedy, economically sound and far better aligned to achieve the policy intentions of the Government than the current intrusively administered framework.

- Section 3 provides SACL's views that the PSA should no longer apply to Sydney Airport, even if the approaches in Sections 1 or 2 are not adopted. This Section includes an extracted version of the separate submission lodged with the Commission in relation to its PSA inquiry by the Australian Airports Association. SACL supports the views advanced by the Association in that submission and includes the extract in this submission for convenience and to reinforce SACL's views on the entirety of the present regime.

- Section 4 sets out SACL's recommendations for an alternative reform of Section 192 of the Airports Act in the event the approaches in Section 1 or 2 are not adopted. Section 192 acts as a "trigger" for automatic application of Part IIIA of the *Trade Practices Act 1974* ("the TPA") to core regulated airports. While it does not currently apply to Sydney Airport, it would ordinarily be expected to apply following the announced privatisation of Sydney Airport unless a new regime such as that proposed in Sections 1 or 2 is adopted following the Commission's report into Price Regulation of Airport Services. Accordingly, thus SACL has a clear interest in ensuring that its possible future application is appropriate and has no unintended adverse effects.

- Section 5 sets out SACL's views on how Part IIIA of the TPA should be amended. SACL's clear preference is that Part IIIA should not apply to it or other core regulated airports but that, instead, a new regime such as that set out in Section 1 or 2 should be introduced. However, if Part IIIA is to have any continuing application to Sydney Airport (even as a potential fallback measure under a regime such as that outlined in Section 2), there are a range of legislative amendments that SACL believes should be made in order to ensure that Part IIIA operates effectively and without unnecessary administrative or cost burdens on those affected by it. Even if Part IIIA is to no longer apply to Sydney Airport, SACL suggests that these amendments warrant more general consideration by the Commission in the course of its National Access inquiry.

THE PRESENT REGULATORY REGIME AT SYDNEY AIRPORT

The pricing and access regime that applies at Sydney Airport is similar to that which applies at other core regulated airports, but a number of significant differences were quite deliberately introduced by the Government:

- "Aeronautical services" at Sydney Airport are declared under the PSA and are thus subject to price control by the ACCC. The definition of "aeronautical services" is the same as that at each of the core regulated airports.

- But Sydney Airport is not subject to a CPI-X price cap of the nature that applies at each of the other core regulated airport.

- The Government thus intended that there be no historical limit on, or progressive reduction in, the total allowable revenue that Sydney Airport was able to earn from price -controlled services. Instead, it intended that the Australian Competition and Consumer Commission ("the ACCC") should simply assess the reasonableness of SACL's proposed prices for declared aeronautical services having regard to the cost of their provision.

- "Aeronautical related services" at Sydney Airport are subject to price monitoring by the ACCC. The definition of "aeronautical-related services" is the same as that at each of the core regulated airports.

- Section 192 of the Airports Act has the effect that a range of "airport services" are effectively declared for the purposes of Part IIIA of the TPA at core regulated airports. This means that an airport user seeking access to any such airport service has an immediate right of access on terms and conditions agreed with the airport operator or arbitrated by the ACCC. This right arises without the need for the access

seeker to seek and National Competition Council ("NCC") recommendation and Ministerial declaration under Part IIIA.

- But Section 192 does not currently operate at Sydney Airport and would not do so until up to 12 months after the privatisation sale of SACL by the Commonwealth. This means that, in the event that an airport user was denied access to facilities at Sydney Airport, they would need to seek an NCC recommendation and Ministerial declaration under Part IIIA before they would accrue a right of access on terms and conditions agreed with the airport operator or arbitrated by the ACCC.

REGULATORY POLICY OF THE COMMONWEALTH

The policy objectives of the Commonwealth at the time that it introduced the present pricing and access regime were set out in the 1996 *Pricing Policy Paper* of the then Department of Transport and Regional Development.

Significantly, key elements of that policy were confirmed by the Minister for Transport and Regional Services, the Hon John Anderson MP, in a letter to the ACCC dated 12 January 2001. A copy of that letter is at Attachment A to this submission.

The *Pricing Policy Paper*, Minister Anderson's letter and the Terms of Reference for the Price Regulation at Australian Airports inquiry issued to the Commission on 21 December 2000 by the Assistant Treasurer, Senator the Hon Rod Kemp, provide a clear statement of the objectives sought to be attained by the Government in any regulatory pricing and access regime at Australian airports.

SACL's clear view, detailed in this submission, is that those objectives are not achieved efficiently under the present regulatory regime. In developing this submission, and particularly in proposing the new regime outlined in Section 1 or 2 of this submission, SACL has been mindful to propose changes that would ensure that the Government's policy objectives are in fact achieved.

SECTION 1. THE NEED FOR EXPLICIT REGULATION OF MAJOR AUSTRALIAN AIRPORTS

1.1. Overview

If the Board of Airline Representatives of Australian Inc (BARA) is correct about the nature and extent of interdependencies at airports, then, in the view of Professor Alfred Kahn, no regulation would be required[1]. However, as Professor Kahn and SACL do not believe this is generally the case, further analysis is required. This further analysis reaches the same conclusion, but for different reasons.

Airports are different to other regulated industries such as electricity, gas and telecommunications due to the fact that they:

- are not vertically integrated (they do not generally compete directly with their airline customers who rely on them for services and facilitates), reducing access issues largely down to questions of price; and
- have a relatively small number of highly motivated and well-resourced customers.

In common with other regulated businesses, the key issues in airports are ensuring the timely investment in capacity to meet efficient demand and the maintenance of facilities and services at an appropriate level of quality and reasonable price. However, the differences outlined above mean that the optimal solution to achieving these goals may differ between airports and other regulated industries.

In SACL's view, there are strong reasons to genuinely deregulate the pricing of all services provided by Australian airports. In a deregulated environment, decisions will be made about investment, quality and price on their commercial merits. Unregulated prices will also increase the flexibility for an airport operating in a constrained or congested environment to respond rapidly to variations in market conditions to maximise capacity and improve allocative efficiency.

The reasons that Government and regulators should not be concerned about this resulting in inefficiently high prices includes the benefits of strong commercial partnerships, the extent of competition at important margins, the countervailing power of airlines and the threat of the re-regulation.

A deregulated environment may not *guarantee* that no airport can ever earn more than its cost of capital in providing services in which it may possess some market power. Having assessed the likely extent of any overpricing, and the potential for efficiency losses arising thereon, SACL considers this is a low risk issue with insufficient negative consequences to counteract the benefits of deregulation.

The real benefits of a truly deregulated environment will be seen in the optimisation of investments, from the perspectives of timing and quality, meeting the needs of airline customers and the travelling public.

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[1] The BARA assumptions that lead to this position and Professor Kahn's testimony are discussed in Section 1.3.5

1.2. Structure of this Section

The balance of this Section of the Submission analyses the market conditions in Australian aviation by addressing the following areas:

- *The economics of efficient airport pricing* – primarily with reference to the extensive work undertaken and commissioned by SACL in the context of the aeronautical pricing proposal that has been underway for around two and a half years. Issues considered include opportunity, marginal and incremental cost approaches, the importance of capacity and congestion and the single vs dual till debate;

- *Market power and competition* – SACL provides many services and facilities that range from having natural monopoly characteristics to highly competitive. While this section identifies the existence of market power in certain areas, it concludes that regulation is only desirable where there is evidence of that market power having been abused;

- *Countervailing power of airlines* – looks at the issues of both the incentives for airports to develop strong partnerships with airlines and the powers airlines possess in the event they are dissatisfied with the relationship;

- *Investment incentives in regulated and deregulated environments* – the most significant cost to society of unnecessary airport regulation is the potential to blunt investment incentives and to result in sub-optimal investment decisions. Investment incentives are equally important in capacity constrained and unconstrained environments;

- *Quality of service, consultation and reporting* - these are all important factors in commercially focused unregulated environments;

- *Costs and Benefits of Regulation* – examines a number of high profile international regulatory cases where imperfect regulation has led to very high costs to society through stifled investment, as well as the less visible efficiency losses which accompany all regulation. This section also looks at the potential benefits of regulation in an airports context in order to conclude a net cost/benefit position;.

- *What is deregulation? – threat of re-regulation* – in the context of this Submission on prices oversight, de-regulation means no application of the Prices Surveillance Act, no automatic declaration of Part IIIA of the Trade Practices Act and an exclusion form general application of Part IIIA. Other Trade Practices Act provisions (such as Part IV and section 46 would continue to apply. While a formal mechanism for consideration of re-regulation would not be consistent with deregulation, the continued application of quality and financial performance reporting requirements under the Airports Act would provide an overview mechanism; and

- *Conclusion* – concludes that no regulation of Australia's major airports is required.

1.3. The Economics of Efficient Airport Pricing

SACL, with the assistance of National Economic Research Associates (NERA) in particular, has widely canvassed efficient airport pricing issues as part of the aeronautical pricing proposals for Sydney Airport. This material includes the compelling insights of Professor Alfred Kahn and analysis of the views of various consultants to the ACCC and airlines who have expressed opinions in this area.

SACL has also had an opportunity to review the submission prepared by Melbourne Airport. The Melbourne Airport analysis is consistent with SACL's previous work, although its focus is on airport environments that are not necessarily characterised by limited capacity and congestion.

In view of this body of existing material, this section has accordingly been kept relatively brief, making only a few key points and providing references to other material.

1.3.1 Short Run Marginal Cost and Long Run Marginal or Incremental Cost

Short run marginal cost is the natural place to start in a discussion of efficient pricing. Indeed, as Professor Kahn notes in his expert evidence on aeronautical pricing at Heathrow airport:

> As I pointed out in The Economics of Regulation, "Short-run marginal costs (SRMC) are the place to begin," because the ideal is for every individual consumption decision, at every instant, to reflect the marginal cost to society at that particular point in time.[2]

A characteristic of short run marginal costs is that they are likely to be very low when there is spare capacity, and very high when capacity is insufficient (because they include the costs of congestion).[3]

This means that short run marginal cost and long run marginal cost, averaged over periods of time, will be aligned. As noted by Professor Alfred Kahn:

> Moreover, the two alternative measures of marginal cost [ie, long run marginal cost and short run marginal cost] are closely linked, and should on average correspond closely to one another, because the signal that an expansion of capacity is economically efficient is an increase in short-term marginal cost (including congestion cost) to such a point that the marginal costs of expanding capacity are lower than of operating with existing capacity. Conversely, it is more efficient to operate with existing capacity when the short-run marginal cost of doing so is lower than the cost of abating congestion by adding to capacity.[4]

In reality, it is not always practical to put in place a pure short run marginal cost pricing arrangement due to the transactions costs and lack of perfect information. In his evidence on the appropriate approach to pricing at Heathrow, Professor Kahn draws this same conclusion:

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2 Professor Alfred E Kahn, *Evidence on Behalf of the Government of the United Kingdom of Great Britain and Northern Ireland*, US/UK Arbitration Concerning Heathrow User Charges, May 1991, p12.

3 Congestion costs comprise the marginal cost of *crowding* and *crowding out*. In airports these are experienced in the first instance as queuing, discomfort, unscheduled delay or, at the extreme, the inability of some potential users - whose willingness to pay exceeds the published tariff - to access the airport at their preferred time.

4 Professor Alfred E Kahn, *Evidence on Behalf of the Government of the United Kingdom of Great Britain and Northern Ireland*, US/UK Arbitration Concerning Heathrow User Charges, May 1991, p13.

> Short run marginal cost will vary from one moment to the next, in a world of perpetually changing demand. It could be prohibitively expensive for sellers to put into effect the highly refined and constantly changing schedules reacting instantaneously to and reflecting those constantly changing costs, and that kind of pricing would be highly vexatious to buyers. The kind of averaging over time and the greater degree of stability provided by prices based on LRIC [long run incremental cost] are likely to have considerable value in terms of minimising supplier costs and customer vexation.[5]

The potential benefits of pricing at long run marginal cost were also recognised by the UK Civil Aviation Authority in its recent Consultation Paper as part of the review of airport pricing at four airports in the UK:

> The main advantage of LRMC pricing of airport charges is that it sets efficient dynamic incentives to provide the right capacity over time because with this approach the airports are able to assess whether users are prepared to meet the costs of additional facilities.[6]

Nevertheless, the desirability of pricing at short run marginal cost – which goes to the heart of pricing in line with opportunity costs – remains a fundamental underpinning of SACL's pricing proposal. As noted by Kahn, in his landmark text on regulation:

> … the practically achievable benchmark for efficient pricing is more likely to be a type of average long-run incremental cost, computed for a large, expected incremental block of sales, instead of SRMC, estimated for a single unit of sale. This long run incremental cost (which we shall loosely refer to as long-run marginal cost as well) would be based on (1) the average incremental variable costs of those added sales and (2) estimated additional capital costs per unit, for the additional capacity that will have to be constructed if sales at that price are expected to continue over time or to grow. Both of these components would be estimated as averages over some period of years extending into the future.[7]

The above discussion is in relation to supply side price efficiency. Where demand exceeds supply at incremental cost, capacity should be expanded. In the case of Sydney Airport, Government policy and environmental issues may influence the timing of new investment. The implications of this are discussed in Section 1.6, below.

1.3.2 Uniform Treatment of New and Existing Capacity

In applying opportunity cost concepts to pricing decisions, economic efficiency requires there be no distinction between a service provided by a brand new or an existing facility, assuming the service delivered by both is exactly the same. The identical toll applying to motorists irrespective of whether they use the Sydney harbour bridge or the much newer harbour tunnel is a pertinent example.

Similarly, where a facility is congested there is no case for different treatment of users according to whether they are incumbent (eg, a motorist has driven across the bridge every

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5 Op cit, p14.

6 Civil Aviation Authority, *Issues for the Airport Reviews, Consultation Paper*, June 2000, p18.

7 Kahn, Alfred E., *The Economics of Regulation*, MIT Press, 1988, p85.

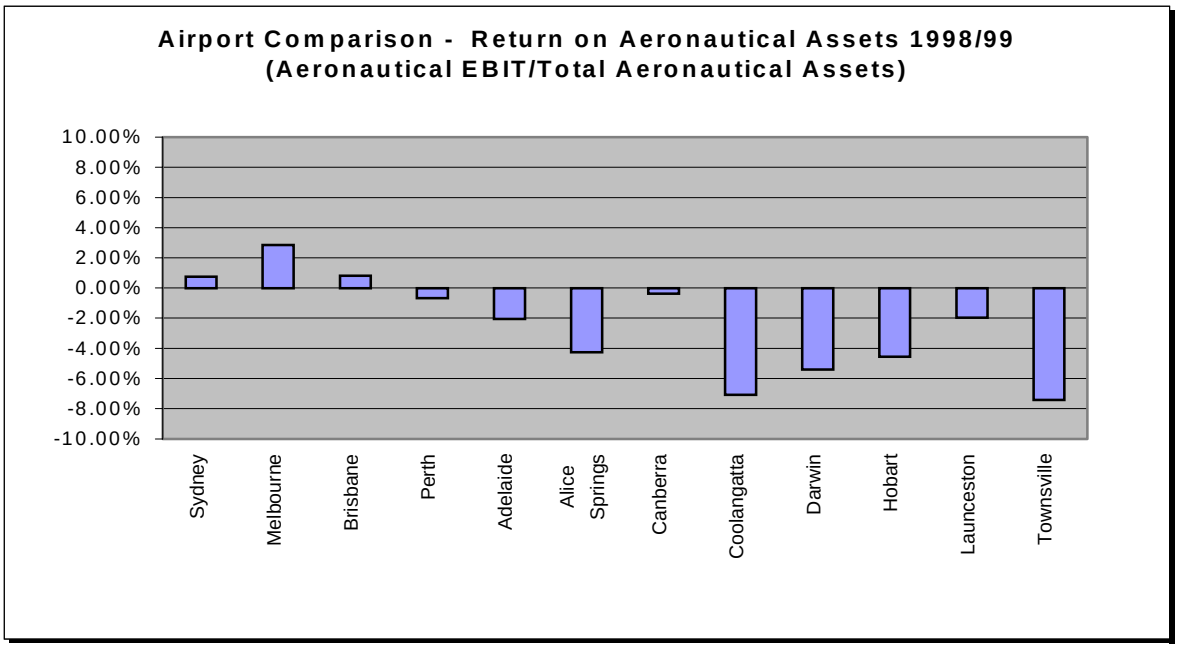
day for years) or a new entrant (ie, a motorist is using the bridge for the first time). Without prior commitment by way of long term contract, economic efficiency does not allow an incumbent user to claim a reduced tariff on the basis they have `already paid for' the facility.

1.3.3 Efficiency of Existing Prices

There is little reason to believe that the existing prices at Australian airports are at efficient levels. Prices have largely just rolled along from historic determinations at times when aviation required significant public subsidies.

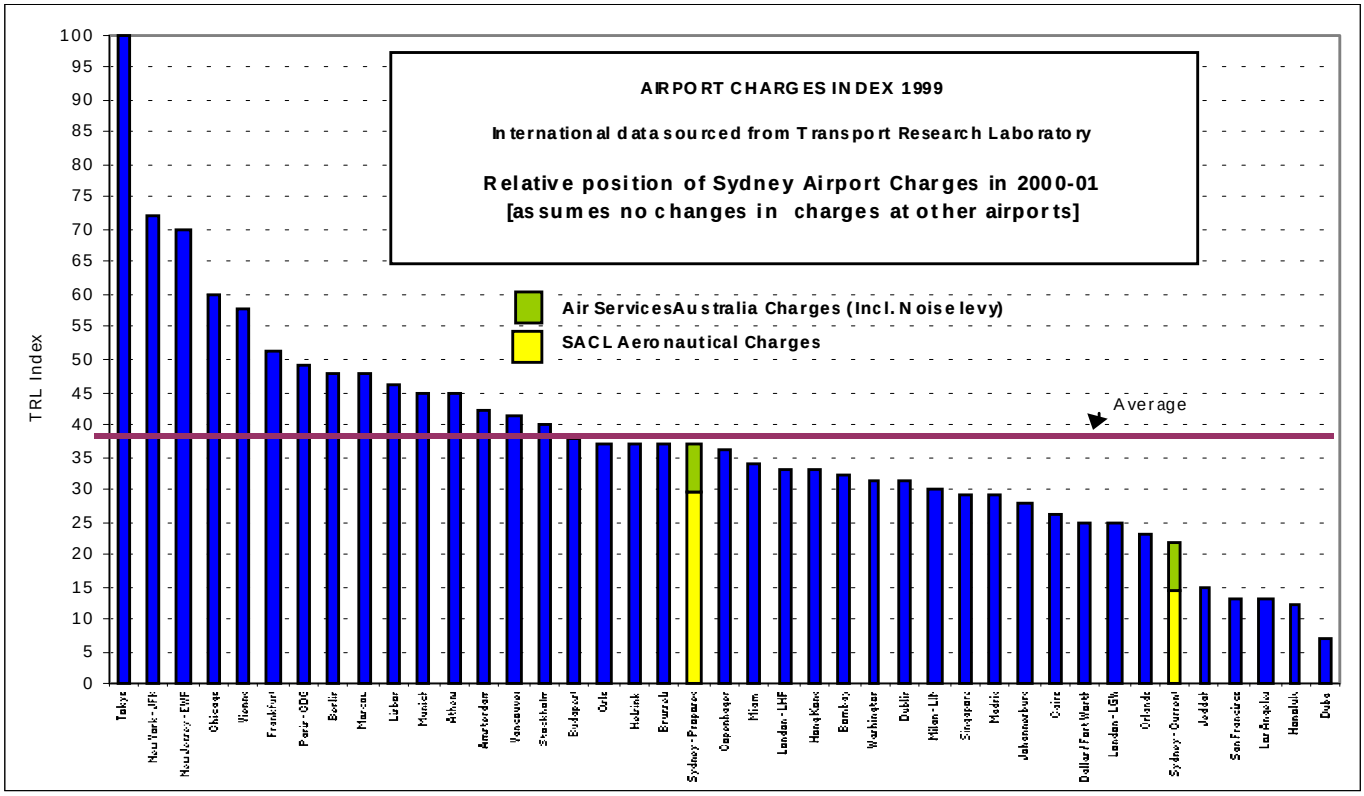
SACL has demonstrated in its aeronautical pricing process that current prices at Sydney Airport are significantly below efficient levels. The ACCC Draft Decision, released on 9 February 2001, accepts this proposition in relation to both existing and new assets.

The Regulatory Reports submitted by major privatised airports are prima facie evidence that existing prices for aeronautical services are below efficient levels. SACL understands that the approach taken by many of the privatised airports to determine asset values and returns is largely consistent with the "building blocks" approach used by SACL to demonstrate that prices at Sydney Airport are inefficiently low.



Source ACCC Regulatory Reports 1998/99.
Aeronautical asset values exclude lease premium amounts.
Note: Estimate for Hobart after exclusion of non-aero revenues.

Further prima facie evidence that current prices are below efficient levels is the fact that the aeronautical charges at Australian airports are substantially below the average charges at comparable international airports in other countries.



1.3.4 Efficiency of Existing Regulatory Regime

The existing regulatory regime for privatised airports is based on a price cap that reduces current (inefficiently low) prices with a system to pass through price increases for new investment.

In terms of allocative efficiency, this is likely to be inefficient primarily for airports with significant capacity constraints. Many airports will have capacity constraints at points in time for different services. Simply because an airport may not have runway capacity constraints (ie, in the short run, most airports other than Sydney) does not mean that marginal or incremental costs are very low. Many airports have recently required investment in new apron and/or terminal capacity. The allocative efficiency of these investments is unknown, and will depend on the extent to which prices are below incremental costs and the elasticity of demand[8].

At Sydney Airport, the allocative efficiency losses may be very high given the capacity constraints at nearly all points in the supply chain. These are discussed further in Section 1.3.6.

In terms of productive efficiency, a price cap is likely to be relatively efficient, particularly compared to strict cost-based regulation. Efficiency losses may occur to the extent operators expect future arrangements to be set with reference to past (cost-based)

8 While (the generally accepted) low elasticity of demand may result in low allocative efficiency losses of low prices at uncongested airports, the corollary is low allocative efficiency losses if prices were above incremental cost.

performance. This would remove some incentive for productive efficiency towards the end of the regulatory period.

Dynamic efficiency is likely to be the most significant concern of the existing regulatory regime. A dynamically efficient environment provides the correct investment signals for efficient capacity enhancement. The Necessary New Investment (NNI) criteria are likely to distort dynamic efficiency as a result of:

- administrative burden and timing issues;
- the potential for customers to 'game' the arrangements to delay investment or seek concessions; and
- the potential for the regulator to misjudge parameters, deterring investment.

The reason that an NNI arrangement is required is that existing prices are below incremental cost. If prices approximated incremental cost, new investment could be funded from expected increased revenues from the volume growth, rather than unit price increases.

Presumably the existence of an NNI arrangement was considered in the context of setting "X" values in the current regulatory regime. If no new investment pass-through were included, "X" would need to be set with reference to maintaining unit prices at (or moving unit prices towards) incremental cost over time. All other things being equal, this would include "X" values that are lower or negative (ie potentially CPI+X). In an unregulated environment, the complexities of determining "X", and the risks to investment of setting "X" too low due, do not arise.

SACL does not currently have as extensive direct experience with NNI arrangements as other airports, although the *Domestic Express* terminal charges were determined under this arrangement. Accordingly, SACL assumes that other airports will be able to best illustrate the distortions of the current arrangements. That said, the artificial distinction between "new" and "replacement" investment appears to create unnecessary distortions in investment decisions.

1.3.5 Single Till vs Dual Till

Airports provide a wide range of services on site, some of which are fundamental to the function of an airport – such as aeronautical services - and others which are complementary – ie, non aeronautical facilities such as leasing retail space and car parking facilities. The dual till versus a single till approach to pricing relate to the relative pricing of these different services provided at the airport. In particular, the single till approach implies that aeronautical charges should be set to recover the residual of the total costs of the airport after deducting net revenues from non-aeronautical activities.

The merits of the dual till versus a single till approach to pricing aeronautical services have been debated widely recently in the context of Sydney Airport's pricing notification, and indeed in regulatory contexts elsewhere such as in the UK. As such, there is extensive material available on this issue. SACL encourages the Productivity Commission to consider the following:

- SACL's draft (December 1999) and revised draft (September 2000) pricing proposal;
- the transcripts from SACL's consultation meetings with the airlines;

- the transcript from the ACCC public forum on 13 December 2000;
- the ACCC Draft Decision, and SACL's response;
- NECG's papers on the issue prepared for the ACCC, and NERA's critiques; and
- Professor Kahn's testimony (attached to SACL's response to the ACCC draft decision).

At the time of writing, most of these were available on the ACCC's website, however, SACL would be pleased to provide copies of these documents if this was of use to the Commission.

The following summarises the main discussion that has surrounded Sydney Airport's pricing notification, and in particular the reasons why SACL contends that the dual till approach has significant economic merit and is a superior approach to the single till.

1.3.5.1 Efficient Pricing

For prices to provide efficient signals for the use of capacity, and investment in new capacity, they must reflect the underlying cost (including the opportunity cost) of providing that service. As noted by Professor Alfred Kahn:

> The most fundamental corollary of the principles of efficient pricing is that to the extent goods or services have separate or separable costs, they must, to the greatest extent feasible have correspondingly separate prices based on these costs.[9]

Also, as noted by the Prices Surveillance Authority:

> Where separate goods or services are produced by a multiproduct enterprise, economic efficiency requires that each good or service be priced separately.[10]

This fundamental economic principle is widely recognised. This is basis of the dual till approach. Establishing prices in this way ensures that the most fundamental role of prices will be achieved; that is, prices will:

- provide signals for investment in new/expanded capacity; and
- ensure that capacity is allocated to those who value it most.

However, the airlines have argued that a "single till" approach to pricing at airports, where the revenue from non aeronautical services is taken into account in setting aeronautical charges, is economically superior to the dual till approach. However, the single till approach does not ensure that prices for separate services reflect their costs, and is therefore inefficient. In fact, the single till approach can result in under-priced aeronautical services

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[9] Professor Alfred E Kahn, *Evidence on Behalf of the Government of the United Kingdom of Great Britain and Northern Ireland*, US/UK Arbitration Concerning Heathrow User Charges, May 1991, p3.

[10] Prices Surveillance Authority, *Inquiry into the Aeronautical and Non-aeronautical Charges of the FAC*, August 1993, p63.

which, particularly in the case of a congested airport such as Sydney Airport, will lead to both supply side and demand side inefficiencies. We discuss these below.

1.3.5.2 Supply Side Inefficiencies of the Single Till

In its draft decision on Sydney Airport's pricing notification, the ACCC concludes that the dual till approach to pricing generally provides an airport operator with more appropriate incentives for new investment in non-aeronautical assets:

> … [i]f all profits from non-aeronautical services are translated into lower aeronautical charges, the airport operator has no particular incentives to invest in these non-aeronautical services. The single till can therefore amount to the imposition of a 100% tax on a relatively competitive activity to fund a non-competitive service (aeronautical services). … Thus there is the potential under a single till for the incentives for efficient investment in non-aeronautical services to be blunted.[11]

This assessment is a well-established problem with single till regulation. It is one of the arguments that SACL has made throughout the pricing notification process, and it is also recognised by the ACCC's advisers, other regulators, and even the airlines. For example, the UK Civil Aviation Authority in a recent consultation paper on the regulation of UK airports has noted that:

> The 'single till' might perhaps also lead to poor incentives to develop the aeronautical business because the total of airport charges is reduced below the stand alone/incremental costs at the margin, which is relevant for investment decisions.

Indeed, mandatory application of a single till would encourage a range of sub-optimal responses by airport operators, for example:[12]

- capitalising the returns from non-aeronautical assets by disposing of land and other business assets (car parks, retail terminal space); and

- the squeezing of aeronautical activities, eg, through failing to relocate non-essential activities off-site, so as to accommodate expansion of aeronautical facilities close to runways.

This outcome is clearly inconsistent with economic efficiency. It is also inconsistent with government policy, given that the approach, for example:

- is inconsistent with the government decision late last year relating to the expansion of aeronautical capacity in the Sydney basin[13];

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11 ACCC, *Draft Decision*, February 2001, p63.

12 SACL has provided specific, real-life examples of mixed incentives under a single till in various documents relating to its pricing notification (most recently in its response to the ACCC's draft decision).

13 The government decision highlights that there is scope to make better use of existing aeronautical facilities, namely Sydney Airport, Bankstown and Canberra airport in the short-term. As such, efficient pricing of aeronautical services will be crucial in achieving optimal use and expansion of capacity at Sydney Airport.

- artificially discriminates against asset ownership or corporate form and is therefore in-consistent with the "no disadvantage test" put forward by the Department of Transport and Regional Services (DoTRS).[14] DoTRS note that the regime should not "artificially favour the lease or hire methods of financing over direct ownership";
- is inconsistent with an economic interpretation of the term "direct cost", which is to apply to the recovery of costs incurred to provide security requirements at airports in Australia.[15]; and
- is inconsistent with the broader principle of competitive neutrality, an integral part of the National Competition Policy agenda endorsed by all Australian governments in April 1995.

1.3.5.3 Demand Side Inefficiencies of the Single Till

The second fundamental problem with arguments for the single till is that they ignore the role of price as a mechanism for allocating capacity amongst users and uses. Prices have a crucial role in allocating capacity when there is strong competition between both potential users (ie, for landing slots, terminal capacity, apron space), and potential uses (eg, more carparks, hotels, retail space or additional terminal/apron capacity). This becomes particularly important where different services compete for scarce land – as is the case at Sydney Airport.

To the extent that aeronautical prices are artificially constrained to below the opportunity cost of providing aeronautical services, due to the inclusion of returns from non-aeronautical prices, this encourages artificially high demand for aeronautical services.[16]

As noted by the Prices Surveillance Authority:

> If this is not the case [each service is not priced separately], revenue from one service (or group of services) may be used to subsidise another service (or group of services). Such cross subsidisation is inefficient.[17]

In the UK, the 'single till' has been employed in airport regulation. However, the approach has received much criticism due to the congestion at London airports, particularly Heathrow and Gatwick. In a recent visit to Australia, Mr Bob Cotterill, a Director with the UK Civil Aviation Authority, shared his experience of the single till:

> The main criticism of the single till has been that, contrary to the considerations of economic efficiency, it forces down charges at congested airports below market

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14 This was issued when the ACCC sought to clarify the regulatory regime applying to the recovery of costs incurred to provide government-mandated security requirements.

15 ACCC, *Government-Mandated Security Requirements: The meaning of "direct costs" as it relates to the price cap pass-through provisions*, Position Paper, March 2000.

16 For example, this might take the form of schedules involving increased frequency by smaller aircraft.

17 Prices Surveillance Authority, *Inquiry into the Aeronautical and Non-aeronautical Charges of the FAC*, August 1993, p63.

> clearing levels and may well reduce them to below the actual resource costs of providing airport services.…
>
> Given heavy congestion at London's two main airports, current price regulation fails to provide efficient signals for the use of existing capacity. The administrative slot allocation system encourages airlines to use slots whether they value them at their full opportunity cost or not. Incumbent airlines gain an advantage as access to slots is allocated using historical precedence with access secure provided only that the slot was used sufficiently in the previous year.[18]

Indeed, as noted elsewhere, the UK Civil Aviation Authority is considering these very issues in the regulatory reviews of London and Manchester airports.

A recent article in a UK newspaper suggests that:

> Analysts believe that a "dual till" approach, whereby BAA's airport charges are ring-fenced from its retail revenues, will be broadly positive, giving the company greater incentive to develop retail operations and transport links such as the Heathrow Express.[19]

Another article notes that the low prices at Heathrow that result from landing charges being subsidised by the profits from retail operations:

> ..creates massive distortions in transport planning and investment priorities, sucking ever more passengers into the South-east, thereby creating ever more congestion….There is a powerful case for ring-fencing the amount BAA raises by charging airlines to land and park from the revenues generated by its retail activities.[20]

In contrast, in its draft decision on Sydney Airport's pricing notification, the ACCC concludes that the dual till is likely to be allocatively *inefficient*. The ACCC notes that:

> Under dual till, prices for aeronautical and non-aeronautical services are likely to be higher than the single till. One reason for this is that there is an incentive for the airport operator to shift common costs to the regulated (aeronautical) services, thereby increasing the regulated revenue requirement. Secondly, the airport operator may still charge the profit-maximising prices for the non-regulated (non-aeronautical) services, many of which generate relatively high returns. Therefore, across all airport services, the dual till is likely to result in revenues in excess of the total cost of providing all aeronautical and non-aeronautical services.

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18 R.M Cotterill, *Experience with Price Caps in UK Airport Regulation*, Paper delivered at the ACCC's Incentive Regulation and Overseas Developments Conference, November 1999, p4.

19 Michael Harrison, *UK: Air Passengers Face Fare Rises in Overhaul of BAA Charges*, Independent, 5 July 2000, p17. We note that both this article and the following one suggest that there will be pressure to increase airfares if a dual till is introduced. However, Sydney Airports Corporation believes that the empirical evidence regarding Heathrow airfares and slot values suggests that current fares are already at 'market' prices, and that currently the rent from underpriced landing fees is captured by airlines.

20 *UK: Outlook – The Case for Breaking BAA's South-East Monopoly, Independent*, 5 July 2000, p19.

> These high prices for aeronautical services cause a net welfare loss to society as consumers' valuations of aeronautical services are not reflected in the level of charges. This is referred to as allocative inefficiency.[21]

As SACL submitted in its response to the draft decision, the ACCC assessment is flawed and superficial. The ACCC's assessment does not recognise that:

- the allocation of common costs between regulated and unregulated activities is not unique to airports, but rather is a feature of a large number of regulated businesses. However, these cost allocation uncertainties does not provide an automatic justification for adopting a single till approach. Rather, such difficulties should be addressed via an appropriately established and administered cost allocation methodology;
- it is simply not correct to assert that, because many of the non aeronautical services generate high returns (when measured against an asset base determined – in highly controversial circumstances - by the ACCC itself), prices for these services are "above cost" and therefore too high. Rather, the prices or returns for some important aeronautical related and non-aeronautical services simply reflect true economic rents associated with their location. These are similar to those earned by owners of, for example, major highway service centres or 'high street' boutique stores;
- low prices *per se* are not always appropriate, and high prices *per se* are not always inappropriate. Determining efficient prices is an empirical question, and is a question that the ACCC avoids; and
- SACL does not hold monopoly power in the provision of non aeronautical services.

1.3.5.4 Pricing Approaches in Other Contexts

Pricing services on the basis of separate costs – ie, according to the dual till approach - is universally accepted in regulated industries in Australia, and indeed is the same approach that can be expected from competitive markets.

There are many examples of regulated companies that face interdependencies in the provision and pricing of regulated and non-regulated services, eg:

- telecommunications companies generally provide internet and mobile services, which are unregulated, but utilise customer fixed lines which are price controlled;
- most electricity networks are able to support the provision of telecommunications infrastructure, and many provide this as a separate service; and
- electricity distribution networks and gas pipelines are regulated, but the network company may also provide competitive retail services.

In none of these circumstances do regulators suggest that revenues or returns from one business should be used to subsidise the prices of another. Rather, regulators generally focus on ensuring that adequate 'ring-fencing' arrangements between the regulated and non-regulated businesses prevail, often involving guidelines on appropriate cost allocation

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[21] ACCC, *Draft Decision*, February 2001, p64.

between them. In some cases the regulated business has been separated from the non-regulated business, and there is no opportunity for revenue from one activity being used to lower the prices of another. For example, electricity distribution businesses have been separated from the retail businesses in New Zealand and in South Australia, whilst gas network businesses operating a 'covered' pipeline in Australia are required to be separate legal entities and are not allowed to undertake related business activities.

The airlines have argued that the single till approach to pricing is consistent with a competitive market. In particular they use the concept of 'interdependency' - the phenomena that pricing one service at below its incremental cost will lead to an increase in demand for the other service sufficient to generate revenue to fund the under-recovery plus additional profits – to support their case. They raise 'free' car parking facilities at supermarkets, and the offer of 'free' mobile phones as examples of the application of (essentially) a single till in the competitive market. As SACL and its advisers have continued to argue in and at various forums, the airlines' argument is a superficial one.

Supermarket owners must decide whether or not to offer carparking (some do and some do not, depending upon the attractiveness of their location), and whether or not to charge for carparking (again, some do and some do not). These decisions are taken with regard to the opportunity cost of offering carparking, including the cost of land, and the incremental benefits in terms of increased demand by customers. For example, a supermarket located in the central business district is less likely to offer free parking, given the high opportunity cost of the land (relative to the benefits of attracting customers). Suburban supermarkets, however, are much more likely to offer free carparking, given the lower opportunity cost.

In the case of mobile phones, the main reason service providers are able to offer cheaper handsets is that users are committed to fixed term contracts for network usage – in effect, handsets are paid for in instalments. Of course, mobile network service providers offer a range of tariff structures which involve different combinations of up-front payments, contract term, minimum monthly charges, call tariffs, etc. These are examples of service providers who have market power seeking to segment demand by Ramsey pricing. It is misleading to suggest that, amongst all of this complexity, handsets are somehow `free'. It is also misleading to hold up the market for mobile network services as being highly competitive.

SACL recognises that in some market circumstance, that the application of a single till type of approach may be efficient – such as the market for razors and razor blades. What the airlines call 'interdependency', however, is essentially a pricing strategy or marketing tool, which, appropriately applied, maximises a businesses' profits. Following the language of standard, micro-economic textbooks, the concept relates to the pricing of services for which the demands are complementary *and* their supply involves joint or common costs. In the context of an airport, the applicability of the interdependency concept depends on the extent to which the demands for aeronautical and aeronautical related services (which are supplied under conditions of joint or common cost) are complementary, and in particular the size of the cross elasticity of demand between the two.

Blanket application of the single till is not appropriate. Rather, an assessment needs to be made of the specific market circumstances. Moreover, consideration of the facts of Sydney

Airport would demonstrate that the application of the single till at the airport is not appropriate. To quote Professor Alfred Kahn:[22]

> And, indeed, the *facts* of the Sydney Airport situation—which BARA does not examine—similarly argue for a conclusion precisely the opposite of the one they reach, for the following reasons:
>
> - That Airport is already close to full utilization. This means that lower aeronautical fees could not appreciably increase its use for aeronautical purposes, and, therefore, the demand for the non-aeronautical services.
>
> - As I have already pointed out, the congestion to which it is already subject would seem to call far more strenuously for an increase in its charges. To ration access to its scarce facilities more efficiently would seem unequivocally a more powerful consideration than the modest ability of air traffic and, in consequence, non-aeronautical usage to respond to a decrease in its aeronautical fees.
>
> - An ironical aspect of the BARA proposal is that—just as I have observed in the case of the pricing of common products whose demands are not interdependent—so here, if the respective cross-elasticities were such as to make the kind of pricing that it recommends economically efficient, it would also be profitable for a privatized Sydney Airports Corporation. Even, that is to say, if the regulator were to permit it to price its aeronautical services at their full incremental costs, it could increase its profits by reducing them below that level in order to increase its sales of non-aeronautical services and, in the process, its total profits. If, in other words, the BARA proposal were correct in terms of economic efficiency, it would not be necessary for a regulator to order it!
>
> - This consideration is lent additional force by the prospective construction of additional airport capacity elsewhere. If it is or will shortly be economic to do so, by far the more powerful consideration would be the importance of pricing Sydney aeronautical services at full incremental costs—and to incorporate the external costs of the noise imposed on nearby residents—in order to provide the right signals for the correct timing, sizing and location of that additional capacity.

1.3.5.5 Conclusion

In an unregulated environment, questions of dual or single till do not directly arise. However, in assessing whether prices are at efficient levels, and in consideration of the need for regulation, these issues can be relevant.

SACL contends that a dual till approach to pricing is most appropriate for pricing aeronautical services at Sydney Airport and would be the outcome generally observed in an unregulated environment. SACL acknowledges that some degree of interdependency may exist in the provision of aeronautical and non-aeronautical services, as they do for many other multi-product businesses. The fact that they exist however, does not undermine basic economic principles as they should be applied in the context of Sydney Airport, ie:

- that separable investment decisions must be taken with regard to their separable opportunity costs; and

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[22] Kahn, Professor Alfred, *Evidence on behalf of Sydney Airports Corporation*, 17 January 2001, p17-18.

- that prices are important for solving the allocation problem, and particularly important where a monopoly facility is nearing full capacity.

As noted by Professor Kahn:

> ….it does not suffice from the standpoint of economic efficiency that the services collectively or in aggregate be priced in a way that total revenues are equated to total costs; it is essential – indeed, from the standpoint of economic efficiency, even more essential – that the separate services provided by airports be priced separately on the basis of their individual marginal costs. [23]

And finally, equity concerns arise if non-aeronautical services are used to subsidise aeronautical services. Some users of aeronautical services do not use non-aeronautical services, but would nonetheless benefit from prices below their economic value. As recognised by the Prices Surveillance Authority in its discussion of single till issues in 1993:

> Equity considerations reinforce the principle of separate prices for separate services as equity requires that users of a service should not pay for facilities they do not use (or do not want to use).[24]

1.4. Market Power and Competition

1.4.1 Airports Are Not Vertically Integrated

Airports do not compete with their customer's core business, ie, they are not vertically integrated.

While to SACL's knowledge no airports own airlines, some international airports, particularly in Europe, are vertically integrated in so far as they are the sole providers of significant services on airports related to the handling of aircraft. This creates a 'legislated' monopoly and there would potentially be efficiency benefits from the application of access arrangements. This is not the case in Australia.

Indeed, SACL and other airports have made significant moves to increase the competition of service provision on airport in areas such as ground handling, and freight facilities. SACL has introduced a major new ground handler, Jardines, to the market that was previously dominated by only two incumbents, Qantas and Ansett. In addition, SACL has set up a freight by-pass facility to enable off-airport freight handlers to avoid having to use the facilities of a competitor to get freight off the airport. SACL is also commencing the development of further on-airport freight facilities to introduce further competition and choice. SACL's has undertaken these initiatives on the basis that they provide improved quality and lower cost services for customers, which is expected in turn to improve the efficiency and attractiveness of the airport to new carriers.

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[23] Professor Alfred E Kahn, *Evidence on Behalf of the Government of the United Kingdom of Great Britain and Northern Ireland*, US/UK Arbitration Concerning Heathrow User Charges, May 1991, p3.

[24] Prices Surveillance Authority, *Inquiry into the Aeronautical and Non-aeronautical Charges of the FAC*, August 1993, p63.

1.4.1.1 The Relevance of Vertical Integration

In industries with significant degrees of vertical integration, the full set of terms and conditions of access may be important determinants of the ability of access seekers to compete with the infrastructure provider in downstream markets. This may have significant economic consequences and is at the heart of the National Access Regime and the construct of Part IIIA and Part XIC (which relates specifically to telecommunications) of the Trade Practices Act 1974.

In the case of airports, there are no incentives for an airport to restrict access to their facilities and services or to provide an inappropriate level of quality. Accordingly, most terms and conditions are optimally determined through commercial negotiations. The residual concern is related to the price of access and the incentive an airport may have to price access at a level higher than an efficient level.

It is not clear that airports would necessarily price access above efficient levels in an unregulated environment. The reasons for this are discussed under *Price Motive*, below. In any event, the application of a regulatory construct designed to address complex access issues to a situation where the only substantive issue is price amounts to the regulatory equivalent of cracking a walnut with a sledgehammer. (In the event Part IIIA were to have some continued application to airports, the submission recommends a number of changes, although these do not fully address the concern of regulatory overkill.)

1.4.2 The Likely Price Motives of Unregulated Airports

Airport companies have the same value maximisation objective as all other companies. Major airports also generally accept that they have a degree a market power in some of the services and facilities they provide. It does not necessarily follow, however, that in the absence of regulatory prohibition, an airport company's best value enhancement strategy would involve abusing its market power by raising prices above efficient levels.

The success of major airports and their airline customers are inextricably linked. Airlines provide airports with the potential for revenue growth through adding additional incremental aeronautical services, from increasing the level of optional services such as heavy maintenance and on-airport freight handling and additional office administration functions, and by jointly developing new products and services for passengers such as international arrival lounges and on-line services.

Airlines have a degree of choice in where they deploy new capacity or commence new services. These choices are clearly influenced by many factors, airport charges being a relatively minor one, particularly at current Australian levels. However, from an airport perspective, the benefits of an incremental new service can be very important. A strong relationship involving competitive prices and joint initiatives can, in SACL's view, make the difference between securing that new service or having it go elsewhere.

The benefits of incremental new services are multiplied by the operation by airports of competitive businesses such as retail and car parks. Attracting incremental services allow the airport to outperform the long run trends that are expected from these businesses through the expected base level of traffic growth.

The final reason that an airport will necessarily seek to misuse market power is the potential for re-regulation. This risk, that will always exist when Governments have the power to legislate, is likely to temper any blatantly unreasonable behaviour.

1.5. Countervailing Power of Airlines

The simplistic 'black and white' view of countervailing power considers the potential for an individual customer to completely cease operations without incurring any costs, while causing significant commercial harm to the supplier. Clearly, very few firms would be considered to have countervailing power using this measure. However, this belies the sophistication and complexity of relationships between airports and airlines which result in many shades of grey in terms of countervailing power.

The statement that airports and airlines rely equally on each other is an industry truism.

It is not credible for Qantas or Ansett or other international, domestic or regional airlines to argue that they would be powerless in a relationship with airports in a deregulated environment. Their countervailing power is in clear evidence in the current regulated environment, beyond the role they play in influencing the regulator and regulated outcomes.

Electricity, gas and telecommunications industries have a large number of relatively small customers. The ability and incentives for these customers to influence pricing outcomes may be limited, although vocal user groups and larger customers have a degree of political influence.

Airport revenues are generated from a relatively small number of very large customers (many times larger than airports by most measures), who are sophisticated, resourced and organised.

One of the courses of conduct open to the airlines (and which has been used by the airlines to date) is to exert commercial pressure on airports to give airlines a particular commercial outcome using litigation as a tool.

The discretion available to airlines to divert individual flights between airports can have a significant impact on airport profitability. While this may require airlines adopting a 'sub-optimal' route structure in the short-term, the commercial cost to airlines is likely to be modest. Airlines can choose to minimise operations to any major airport considered to be either expensive or otherwise unreasonable by avoiding any 'hubbing' activity at that airport.

The Domestic Terminal Lease arrangements at Sydney Airport enable airlines to direct Sydney origin or destination international passengers through either their domestic or international terminal by using another airport as the first or last point in Australia. The financial significance of this discretionary action could be very significant in the event it is used as commercial leverage.

Airlines can also remove or reduce tenancies for non-essential airport based activities. For example, aircraft maintenance, freight and additional office based activities.

A further level of countervailing power is the influence of airlines politically, commercially and in the media. Airport management and shareholders are likely to be sensitive to criticism and the influence of airlines will allow them to lobby for re-regulation. In a number of deregulated industries, including banking and fuel, customer concerns expressed through media and political avenues has resulted in the threat of re-regulation. No business wants to become a 'political football' and will likely consider the consequences of any actions that may be perceived to be unreasonable in this context.

1.6. Investment Incentives in Regulated and Deregulated Environments

Aeronautical facilities at Sydney Airport are scarce and valuable. For example, the airlines' note that slots are already 'full' for four hours during the peak period, and that it is their view that most of the available slots for peak periods will be exhausted by approximately 2002/03.[25] However, the government decision late last year also highlights that there is scope to make better use of existing aeronautical facilities in the short-term, including Sydney Airport. In the longer-term, significant investment to expand aeronautical capacity in the Sydney basin will be required, although the timing and size of that investment is not yet known – which will be driven by future demand for facilities.

SACL maintains that efficient pricing at Sydney Airport (and indeed other airports in Australia) is important in this process, in particular:

- to promote efficient use of runway slots, terminal facilities, aerobridges, and apron space – all of which are scarce at Sydney Airport;
- to promote efficient investment in additional aeronautical capacity (particularly with respect to the timing and the size of expansion), whether this be additional terminal or apron space at the existing site, or in runways and other facilities at an alternative site; and
- from the more general perspective of promoting competition in aviation, given the scarcity and importance of slots at Sydney Airport, as evidenced, for example, by the aggressive bidding by Qantas and Ansett for Hazelton.[26]

These aspects are discussed in turn below.

1.6.1 Efficient Pricing from a Demand Side Perspective

The Government announced on 13 December 2000 that it would be premature to build a second major airport. It instead decided to support the development of Bankstown Airport as an overflow facility capable of handling small jets (but not large B747s). Sydney Airport will continue to be subject to the same curfew and movement cap arrangements. The Government's announcement stated that it "is confident that the commercial decisions by the airlines and our policy measures will ensure that Sydney Airport will be able to cope with the increasing air traffic until the end of the decade." A further review of policy will take place in 2005. Subsequently, the Government announced on 28 March 2001 that Sydney

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[25] BARA submission to the ACCC, December 2000, p 8.

[26] Media commentary over the past few months draws attention to the high value derived by users from obtaining access to Sydney Airport. For example, an article in the Sydney Morning Herald quotes a Southern Sydney Regional Organisation of Councils' report that puts a value of a slot to an airline "carrying 100 passengers each way per flight" of $365,000 a year, with a capitalised value of $2.5 million. [Source: Wainwright, Robert, "Flights set to soar if slots fall to airlines", Sydney Morning Herald, p12.] This value will increase as Sydney Airport becomes more capacity constrained. Another media commentator suggests that: "[b]ased on Qantas's current performance, that [ie, a typical peak hour slot] is worth at least an extra $1.5 million net profit for just one extra one-way peak hour trip a day between Sydney and Melbourne. [Source: Sandilands, Ben, "Storm brewing over rural flights", Australian Financial Review, 19 December 2000, p28.]

Airport would be privatised by way of 100 per cent trade sale in the second half of 2001; with Bankstown and the subsidiary airport privatised separately in the second half of 2002.

The most important economic consequence of these decisions is that it establishes a very real cap on physical capacity for a substantial time. This focuses attention in the short to medium term on demand management, rather than the expansion of supply. For example, the ACCC recognises that:

> … [c]ongestion is an important issue for Sydney Airport, with a number of peak hours already fully occupied. The Commonwealth Government's decision not to proceed with a second airport at Badgery's Creek at this stage means that effectively managing congestion at Sydney Airport will become increasingly important over the next few years.[27]

The current administrative slot system allocates capacity at Sydney airport, but there is little reason to believe that this system promotes efficient allocation. SACL, throughout the process relating to its aeronautical pricing proposal, has argued that efficient prices are urgently required to address capacity constraints at Sydney Airport. However, several arguments have been made during Sydney Airport's pricing notification process to try to support the case that SACL's pricing proposal is not necessary or desirable for alleviating congestion at Sydney Airport. The arguments that have been made include:

- a slot auction (or pricing based on customer's valuations) is required to manage slot use; and
- airline demand is relatively inelastic to aeronautical prices.

We discuss these issues below.

1.6.1.1 Slot Auction

A slot auction system has been suggested as an efficient means of determining user valuations and allocating scarce capacity. The ACCC, for example, appears to argue in its draft decision on Sydney Airport that the only way to deal effectively with congestion is through slot auction or, at the least, through congestion pricing, which must be based on customer valuations.

SACL agrees that, theoretically, an auction of runway slots is a first-best approach to allocating slots efficiently, since it would allow a competitive market process to determine the value of slots, by reference to the opportunity cost for users (rather than the opportunity cost to the service provider as proposed by SACL). An auction could be designed consistent with Government policy objectives regarding regional access by simply excluding those slots.

However, a slot auction is unlikely to be a practical alternative at this stage. Since airlines fly to and from different airports around the world, there are complex interrelationships between timetables and landing slots at different airports. There are likely to be formidable practical difficulties in designing a formal auctioning framework that adequately addresses these complex interactions.

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[27] ACCC, *Draft Decision*, February 2001, p115.

Also, the strength of airline associations (such as the International Air Transport Association) may create a disrupted process with airlines reaching prior agreement not to participate competitively.

Moreover, it is not only slots which are scarce, and in need of 'rationing', at airports. In the case of Sydney Airport, it is also aprons, aerobridges and terminal space that are in scare supply. Efficient prices for these facilities are therefore urgently required.

Hence, on balance, SACL does not believe a slot auction is necessary to achieve efficient prices. A deregulated environment would allow regular alterations to price level to achieve prices that closely mimic the outcome of an auction. This would reduce the value of slots to a level at which they would be freely exchanged.

1.6.1.2 Price Elasticity of Demand

Several participants in Sydney Airport's pricing notification process, including the airlines, have argued that airline demand is inelastic to aeronautical prices and therefore they are unlikely to respond to price signals. For example, in its recent draft decision on Sydney Airport, the ACCC has argued that:

> In relation to the prices proposed by SACL, neither SACL nor any submissions to the Commission have presented any evidence to suggest that the new charges will lead to materially different scheduling decisions by airlines.[28]

In contrast to the apparent views of the ACCC, SACL has provided considerable detail on the price elasticity of demand and the scheduling behaviour of airlines. For example:

- sections 5.3.3.8 and 6.4 of the revised draft pricing notification provides details on why, from a demand perspective, prices are important for efficiency at Sydney Airport and outlines some of the changes that the airlines can make in response to a price change, such as use Canberra airport, altered fleet mix, seek an off-peak service discount, etc; and

- the paper by NERA entitled "Promoting Efficient Use of Sydney Airport" (January 2001), submitted confidentially to the ACCC and the Productivity Commission, provides an analysis of current airport use by the airlines and demonstrates that there is considerable scope to improve the use of facilities at Sydney Airport.

The information demonstrates that airlines can and will respond to price, to varying degrees, and as such efficient pricing is essential.

Indeed, the airlines themselves acknowledge that their demand is sensitive. For example, in a submission to the Prices Surveillance Authority's review in 1993, Ansett argued that:[29]

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[28] ACCC, *Draft Decision*, February 2001, p117.

[29] Ansett, Ansett Supplementary Submission to the Prices Surveillance Authority's Inquiry into the Aeronautical and Non-Aeronautical Charges of the FAC, 1993, p3, as quoted in Prices Surveillance Authority, Inquiry into the Aeronautical and Non-Aeronautical Charges of the FAC, 1993, p53.

> … "airport "costs are a substantial component of the costs covered by any airfare. If FAC (Federal Airports Commission) charges were to drop, the opportunities for considerable stimulus would be created. If they were to materially increase this would have the potential to significantly constrain an operator's pricing flexibility. The point would come where operations could not be sustained and must be downgraded or terminated."

Furthermore, other airport operators acknowledge the importance of pricing efficiently and, indeed, the capacity of the airlines to respond to pricing signals. For example, Tim Rothwell of Brisbane Airports Corporation stated at the ACCC's Public Forum last year:[30]

> … And the last thing is that efficient [airport] pricing throughout Australia might see us make a few sensible economic decisions. At the moment the airlines are focused on controlling slots in Sydney, and that is a massive issue for the airlines. They want to control the airport before it is privatised, not surprisingly.
>
> Maybe if they decide to pay an economic price for use of that airport we might see airlines looking seriously at their route structures around Australia. At the moment more than 50 per cent of the people in South East Queensland who want to fly internationally come through Sydney even though they don't want to. They have got no choice because that is the way the routes are structured. And that will always go on as long as prices are inefficient.
>
> With efficient prices they will look at Brisbane and, to a lesser extent, Melbourne. I am sure that having opportunities, and that might see a whole efficient airline industry. And my final message is that the second Sydney airport is not needed too soon, it is already there, it is in Brisbane, but people aren't using it yet.

Hence, SACL contends that efficient pricing at the airport is critical from the perspective of demand management. If prices are not set efficiently, it would send incorrect signals to the airlines regarding the seriousness of the capacity constraint problems at the airport, which is likely to result in appropriate or deferred fleet mix decisions, etc, exacerbating the capacity constraints. Indeed, it is likely to impact negatively on aviation competition (the reasons for which we discuss below).

1.6.2 Efficient Pricing from a Supply Side Perspective

In the short term, we now know that a new major airport will not be available for at least 8-10 years, so efficient (demand based) pricing has an important role to play in enhancing allocative efficiency. However, in the longer term, the Government will look at the demand characteristics of Sydney Airport in determining whether or when a major new airport is required. If prices at that point are below efficient levels, this will send signals that capacity is required more quickly than is efficient. This will lead to inefficiently early investment in new capacity.

As noted by Professor Alfred Kahn in his paper prepared on behalf of SACL: [31]

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30 Mr Tim Rothwell, Brisbane Airports Corporation, ACCC Public Forum, Transcript of Proceedings, 13 December 2000, p95.

31 Kahn, Professor Alfred, *Evidence on behalf of Sydney Airports Corporation*, 17 January 2001, p10-11.

> The fact that the Sydney Airport is already congested, that slots during four peak hours every weekday are already rationed administratively, and that most of the other available slots for peak periods will be exhausted by approximately 2002-03 (BARA's submission, p. 8), the recent announcement by the Australian government that it intends to expand capacity in the Sydney basin, initially by developing an existing small facility near the Sydney Airport (Bankstown) as an overflow airport, and that, as I am informed, it has declared its intention to investigate the possible need for a second airport in 2005 all have additional significance for the efficient pricing of services of the present airport today. …
>
> *If the decision of when and how much additional capacity is to be efficient, users should be confronted with prices reflecting either those short-run congestion costs—rising over time—or, once the expansion of capacity is clearly on the planning horizon, the long-run incremental cost of adding to capacity, as proposed by Sydney Airports Corporation*, (pp. 55-57 of its Proposal). And the investment decisions—including their timing—are unlikely to be efficient unless users are indeed confronted with prices reflecting those true incremental social costs, whether short-run or long-run. …

The significant costs of early investment will be borne by society in some form (which could be the travelling public through higher air fares or Australian taxpayers in the event of Government investment or subsidy). The efficiency loss of building a $4 billion facility, say, 3 years too early would be around $1 billion ($4 billion x 9% cost of capital x 3 years).

The issue raised by airlines in the Sydney Airport pricing context that the Commonwealth role in deciding the timing of new capacity negates the need for efficient pricing, is simply wrong. The intermediate capacity solution chosen by the government at this time confirms that the government does consider infrastructure projects in light of, amongst other things, investment criteria.

1.6.3 Impact on Airline Competition

Currently the incumbent airlines have a strong incentive to advocate inefficient (or relatively low) pricing of facilities. This is because, in advocating aeronautical charges be set at below their economic value, while at the same time shepherding their grand-fathered rights to existing landing slots, incumbent airlines are in fact seeking to use their monopoly rights in landing slots to create a barrier to entry for new airlines, and thereby distort competition in airline services.

In this regard, SACL is not suggesting airlines are behaving inappropriately. On the contrary, this is simply profit maximising behaviour within a framework that encourages behaviour that results in inefficient outcomes.

In particular, the grandfathering system whereby slots are held indefinitely by any party on the basis only of continued use creates significant potential for inefficient allocation. This includes "slot banking" by incumbents with an anti-competitive intent to restrict the access by or growth of competitors.

As noted by the Productivity Commission, in its inquiry into international air services:

> The current administrative system of allocating slots entrenches the position of incumbent airlines at airports. DTRD [Department of Transport and Regional Development] noted that:

> *The inability of the committee based slot allocation process to provide adequate provision for new entrants is a fundamental weakness of the system.*

'Grandfathering' provisions ensure that the peak time slots held by incumbents are generally not made available to new entrants. The issue of slot availability particularly concerns new entrant airlines. An executive from Virgin Atlantic argued that:

> *The costs for the travelling public of maintaining grandfather rights are huge. These costs represent a direct subsidy from consumers to those dominant airlines fortunate enough to have acquired slot holdings in the past as gifts from their government-owners. That should be unacceptable in a free market. (Humphreys, 1997, p3)"*[32]

Indeed, airline participants in the Productivity Commission inquiry identified constraints at Sydney Airport, particularly the availability of landing and takeoff slots at peak periods, as a significant operational constraint for their business.[33]

The current beneficiaries of low aeronautical charges are mainly the incumbent airlines and their owners. Final customers are unlikely to see any of the apparent benefit of artificially low aeronautical charges when there is excess demand for popular slots, and rights are conferred on the basis of existing use. In fact, it is not in the interests of the incumbent airlines to provide new capacity at a second airport, or to price the existing capacity at Sydney Airport at its opportunity cost. To do so would make it increasingly difficult for incumbent airlines to hold onto existing slots, thereby providing greater opportunities for competitors to secure landing slots and increase competition in airline services.

This is largely due to the fact that inter-airline competition on many routes is not sufficiently strong to ensure that the benefits of low input costs are passed on to passengers. Reducing the barriers to entry created by the shortage of airport capacity would mean that, in the longer term, air travellers could be expected to benefit from the increased effectiveness of airline competition. Indeed, the potential benefits of domestic airline competition are well recognised with the arrival of Compass in the early 1990s and the emergence of Impulse and Virgin Blue in more recent times.

The incumbent airlines also have an incentive to 'game' or hinder the expansion of aeronautical facilities. For example, the lack of access to airport infrastructure, primarily terminals, was widely discussed as a contributing factor to the downfall of Compass MKI and MKII. While terminal access has been provided for domestic new entrants at Sydney Airport, runway capacity may become a big issue for the growth of competition in both domestic and international markets.

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32 Productivity Commission, *International Air Services*, Inquiry Report, Report No.2, 11 September 1998, p194-5. Italics denote the Productivity Commission quoting DTRD ("*Administrative System of Slot Allocation*" Study Paper, Canberra, 1997, p4) and "an executive" from Virgin Atlantic (Humphreys, B. "*Slot Allocation: the need to dump grandfather*", Aviation Strategy, November, 1997, p2-3) respectively.

33 op cit, p185.

1.6.4 Conclusion

SACL has incentive to maximise the volume of passengers and aircraft movements to generate higher revenues at any given unit price. This is likely to correlate closely with allocative efficiency.

An unregulated environment would provide the maximum flexibility for SACL to "micro-manage" the price settings of various services and facilities to generate efficient outcomes. This could include time of day (peak/off-peak) pricing, the extension of the current system of off-peak discounts for new services and greater levels of facility specific pricing to manage excess demand at any choke points where expansion is either not possible or where the incremental cost of expansion exceeds current prices.

Where continued investment on the current site can alleviate choke points, a deregulated environment will provide the best incentives for SACL to develop and proceed with innovative investment solutions. Innovative solutions to capacity on a constrained site will often be at a higher unit cost than solutions on an unconstrained site. A regulated investment environment requires the regulator to "second guess" the airport operator in terms of the best investment solution, particularly when incumbent customers seek to delay investment or reduce the regulated price by arguing that innovative investments are "inefficient" due to higher average unit cost than selective benchmarks.

There would be understandable concern on the part of airlines about the ability of the operator of a capacity constrained airport to extract economic rents from airline customers. Empirical evidence suggests that airlines currently capture significant economic rents through pricing airfares from capacity constrained airports above efficient levels. As a result, high airport prices may only have a distributional impact which is a second-order issue in terms of efficiency. In the case of Sydney Airport, which remains Commonwealth-owned, the capture of any rents by the airport is likely to have social equity benefits as compared with their capture by airlines. Such rents could then be used for funding health, education, transport etc, rather than be distributed to the predominantly foreign owners of SACL's airline customers. Provided the environment is predictable on sale, the proceeds of any sale would include the present value of any rents.

1.7. Quality of Service, Consultation and Reporting

1.7.1 Quality of Service

Sydney Airport provides high levels of quality of service for passengers and airline customers, in line with increasingly high expectations. SACL reports to the ACCC annually on a range of quality of service indicators including the results of a passenger survey.

The recent completion of the major expansion and upgrade of the international terminal, along with other major improvements such as taxiway enhancements, have significantly increased the quality of services at Sydney Airport.

A June 2000 survey of more than 1100 passengers and visitors to the Airport found high levels of satisfaction with new facilities including check-in counters, baggage reclaim, car parking and taxi pick-up.

Compared with the same survey the previous year, the results show improvements in passenger satisfaction for almost all of the 34 categories tested.

Key outcomes of the survey were:

- a large proportion of survey respondents rated the baggage system favourably, with 76% rating waiting time at the baggage reclaim area as good or excellent;
- inbound baggage inspection was rated as good or excellent by 93% of respondents;
- outbound immigration (89% saying good or excellent) and passenger screening (83%) were also highly rated;
- 76% of passengers rated waiting times at check-ins as either good or excellent;
- 92% rated the availability of trolleys as good or excellent;
- 72% gave a positive rating (good or excellent) to the availability of carpark facilities, with 59% positive about the standard of parking facilities; and
- 92% rated taxi waiting times at the International Terminal as either good or excellent.

Sydney Airport was named "Major Airport of the Year" by the Australian Airports Association on 14 November 2000 and earlier in November 2000 the Airports Council International Board meeting in Chile passed a special commendation for Sydney Airport in recognition of its role in successfully delivering the Sydney 2000 Olympics and Paralympic Games.

Disappointingly, the results of an airline survey conducted by the ACCC resulted in mixed responses. In this context, the Productivity Commission should be alert to the strong commercial and legal incentives for a grouping of airlines to respond to ACCC quality surveys in ways that are influenced by factors strictly extraneous to quality performance alone. These incentives come from the ability to subsequently quote themselves in relation to regulatory processes and in the context of Federal Court action taken by certain airlines in a related area. There is prima facie evidence that regulatory 'gaming' is taking place in the responses to these surveys.

SACL believes quality outcomes would be strong in a deregulated environment. As discussed earlier, airport owners will have incentives to develop strong relationships with airlines customers and quality will generate stronger demand across the board for airports. High quality outcomes will also likely be seen to provide a defence against the threat of re-regulation.

1.7.2 Consultation

Airports in an unregulated environment will have strong incentives to consult with their customers on investments and quality outcomes to avoid wasteful investment (noting that price will not be directly linked to price) while facilitating an optimal level of demand. Prices and returns can be higher, all other things being neutral, in a commercial environment if quality and investment outcomes are optimal. Accordingly, there is no particular need to require consultation.

1.7.3 Reporting

Reporting is a fact of commercial life in countries like Australia. The current additional reporting requirements for airports under the Airports Act 1996 may not be necessary in a

deregulated environment, given the incentives discussed above. However, the resource costs of this additional level of transparency are modest for most major airports. Continuation of these reporting requirements would provide a sound basis for any future policy debates on the success or otherwise of deregulation and to address any calls for re-regulation.

1.8. Costs and Benefits of Regulation

The most significant cost to society of unnecessary airport regulation is the potential to blunt investment incentives and to result in sub-optimal investment decisions. Investment incentives are equally important in capacity constrained and unconstrained environments.

1.8.1 Recent International Examples of High Regulatory Costs

There are a number of sobering examples of the potential costs of imperfect regulation. The following is a very brief description of the current debates in the UK and US of, respectively, the regulation of Railtrack and the Californian electricity industry.

1.8.1.1 Railtrack (UK)

The Economist magazine sums up the situation of Railtrack as follows:

> Britain's model for privatising its railways has been a failure…. Railtrack's power over the operating companies meant it had to be tightly regulated, so 90% of its income from track access charges was fixed. It therefore had no incentive to invest in growth. The service has, as a consequence, deteriorated – a problem exacerbated by an economic boom and rocketing passenger numbers.[34]

The impact that the lack of investment in the maintenance, upgrade and expansion has had on Railtrack customers (the train operators) has been strongly negative. This is an example of a regulatory system designed to keep access costs low, resulting in very poor medium term outcomes. One can now only speculate about how the regulatory system could have been better designed, or the outcomes of a lighter handed or deregulated structure.

Pressure is now mounting from train operators to allow them to consolidate and to take over the operation of tracks in their areas. It remains to be seen whether this vertical re-integration will be accepted and whether it will deliver net benefits. The likely costs are a reduction of competition, new access issues, and track investment and maintenance split between a number of operators.

Railtrack's role has parallels with the role of airports. The lessons from this for Australian airports are that "micro-management" of a regulatory system in an attempt to be "all things to all people" is likely to fail. In particular, the attraction in the short term of low access prices can result large net medium to long term costs as a result of lack of appropriate investment incentives.

1.8.1.2 California Electricity

The problems in the California electricity industry include a severe shortage of investment in electricity generation and a consequent program of rolling black-outs. A state of emergency

[34] The Economist, *Britain off the rails*, 17 March 2001, p18

has been declared by the State's Governor, and the prospects of bankruptcy loom for some of the State's largest utilities.

Deregulation has been blamed in some of the popular media for the current problems, as California has long been considered to have one of the more progressive, light-handed regulatory systems for electricity.

However, a closer look at the situation shows that the problem is likely to be the result of the residual regulation. This residual regulation included rate freezes which required utilities to sell power at levels apparently below the incremental cost of new capacity. As a result, the utilities have not invested in new capacity.

Full deregulation was resisted by both utilities and consumer groups.

> The utilities rejected that because it would have left them with lots of uneconomic power-generating capacity acquired under the good old days of the previous regime; they wanted compensation for those "stranded assets". Organisations claiming to represent the interests of consumers rejected it as well because they wanted implicit subsidies to particular groups to continue (which meant keeping the costs hidden) and because they feared the untrammelled monopoly power of the liberated suppliers.[35]

The challenge this case poses for the Productivity Commission and Government is to have the courage to fully deregulate the airport industry in Australia, avoiding the temptation to compromise by retaining a residual degree of price control.

1.8.2 Less Dramatic Efficiency Costs

Most regulatory costs are not as dramatic as the failures discussed above in relation to Railtrack and Californian electricity. The other forms of less visible costs of regulation include:

- incremental investment not taking place;
- investment occurring too late or to a sub-optimal standard;
- sub-optimal funding or risk sharing outcomes;
- lack of incentives for innovation.

The interpretation of the benefits of regulation is often misguided. The concept of preventing a business from earning monopoly profits is, and should be, generally consistent with the goal of efficient price levels. As discussed in the section above on efficient pricing, the identification of true monopoly profits is not straight forward. As a result, regulators often take a simplified approach of looking at rates of return on a valuation of the company or assets.

1.8.3 Benefits of Regulation

The benefits of regulation are the prevention of capacity being inefficiently constrained with the intention of allowing prices to rise above efficient levels, and/or quality of service falling

[35] The Economist, *When the lights go out*, 18 Jan 2001

below the desirable level. Quality can largely be considered simply an integrated part of an efficient price, as a lower quality of service has the same impact as a higher price and vice versa.

The actual economic benefit of preventing prices exceeding efficient levels will depend on the elasticity of demand for the particular service. In highly elastic markets, the production will reduce below the efficient level rapidly if prices are too high. This will result in significant net losses of welfare to society.

In an airport context, loss of production relates to reductions in aircraft and passenger movements at airport prices above efficient levels. The social benefit of regulation then depends upon:

- the likelihood of prices in an unregulated environment being set above efficient levels; and
- the elasticity of demand, to determine the extent of lost production.

This submission has demonstrated that:

- there are a number of strong reasons why an airport in a deregulated environment would not necessarily raise prices in an extreme way; and
- current airport charges are likely to be well below efficient levels.

As a result, the risks of prices being set above efficient levels is low.

In terms of elasticity of demand, the Sydney Airport aeronautical pricing process has revealed a degree of consensus between airlines and the ACCC that elasticities are low.[36] However, as discussed in Section 1.6.1.2 above, SACL argues that elasticities exist sufficiently to enable material price differentials to be used to maximise allocative efficiency.

The combined effect of a low risk of inefficiently high prices and the relatively low elasticity of demand results in very low potential benefits of price regulation.

1.8.4 Net Cost/Benefits

In theory, a perfect regulatory system could be designed that sets prices at efficient levels, that provides the regulated business with all the incentives it requires to provide the right facilities and services, at the right time. All this requires is perfect information, instantaneously updated, and no other influences on a perfectly predictable regulator. Of course, this is a dream and cannot be converted into reality. Accordingly, Government's must accept that regulation will have costs and risks and need to balance them with the expected benefits to determine whether regulation is likely to deliver net benefits.

The analysis of NECG in the context of its submission on the National Access Regime provides a stylised analysis of the likely benefits and costs of regulation.[37] SACL believes

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36 ACCC, *Draft Decision*, February 2001, p65

37 NECG, *Submission to the Productivity Commission Inquiry into Part IIIA*, 18 January 2001, p20

this analysis is relevant to airports, but is likely to be a very conservative interpretation of the airport situation where the risks of high prices are low and, accordingly, the costs of regulation are likely to far outweigh the benefits.

This section demonstrates convincingly that deregulation is likely to deliver net costs, rather than benefits. As a result, airports should be deregulated.

1.9. What is Deregulation? – Threat of Re-regulation?

All businesses are regulated, in the sense that they must comply with various pieces of Federal and State legislation, including in relation to taxation, reporting and trade practices. In an airport context, regulation also covers many areas of airport operations through the *Air Navigation Act 1920* and *Airports Act 1986*, as well as curfew, slots and regional access requirements.

Economic deregulation in the context of this submission means:

- no Declaration or Directions in relation to any airport services under the Prices Surveillance Act 1983;

- either the abolition or amendment of section 192 of the Airports Act so that airports are not automatically declared for the purposes of Part IIIA of the Trade Practices Act 12 months after privatisation unless access undertakings are in place; and

- unless the same effect is achieved through amendment of section 192 of the Airports Act, amendments to Part IIIA of the Trade Practices Act to exclude its application to airports.

Sovereign Government's retain the ability to legislate to change arrangements where problems arise. This power to re-regulate provides Government with comfort in regard to taking an acceptable degree of risk in de-regulating airports. However, the existence of this sovereign risk provides investors with a strong incentive to conduct their affairs in a manner that remains demonstrably reasonable.

The threat of re-regulation is enhanced in the case of airports due to the influence of airlines at a commercial, political and media level.

1.10. Conclusion

No regulation of Australia's major airports is required. The Government envisaged, at the time airports were privatised, a highly implemented regulatory regime that encouraged commercial outcomes. This has not eventuated due to issues of legal framework, design, implementation and the 'gaming' incentives created. As a result, the development of strong commercial relationships has been hindered, rather than promoted.

As discussed, the risks of deregulation are small. SACL believes deregulation is certainly worth pursuing, as the costs of continued regulation are likely to rise sharply as investment requirements at airports increase, and participants become more aware of the pitfalls.

SECTION 2. AN ALTERNATIVE "LIGHT-HANDED" REGULATORY ACCESS AND PRICING REGIME FOR MAJOR AUSTRALIAN AIRPORTS

2.1 Introduction

In SACL's view, Section 1 of this Submission makes a strong case for the Productivity Commission to recommend that no price controls or access arrangements are required for major Australian airports.

If for any reason the Productivity Commission still wishes to consider some form of regulation in relation to some airport services, SACL has developed a framework of "light-handed" regulation that avoids a number of the problems with the current system.

The heart of this light handed arrangement is a "Prices and Quality Undertaking" that emulates the type of commercial arrangement that an airport may enter into on a one-to-one basis with individual airlines if this were practicable[38].

2.2 Objectives of a "Light Handed" Regulatory Structure

In view of the potential difficulties of the existing intrusive regulatory arrangements (outlined throughout Section 1 of this submission), an improved regulatory structure should:

- encourage innovative operating and investment solutions;
- appropriately reward behaviour that generates growth;
- incentivise an efficient operating environment;
- ensure that the quality of services and facilities appropriately meets customer requirements;
- ensure that any broader community and/or aviation policy objectives can be met in a transparent, commercially sustainable manner; and
- discourage sustained prices above efficient levels.

2.3 Framework Structure

Airports already have an industry specific regulatory structure under the Airports Act 1996. The Airports Act currently deals with a number of planning, environmental and reporting arrangements, as well as access arrangements with links to Part IIIA of the Trade Practices Act 1974.

SACL understands that the Airports Act was not used for price control for a number of reasons, including the intended short-term nature of price control. While arguably

[38] In SACL's view, one-on-one agreements are not practicable in the short term due to the number of individual customers, and the incentives for customers to 'hold out' for increasingly preferential terms as a form of regulatory gaming (particularly if there is an expectation that the airport will deliver these agreements in 'exchange' for less direct regulation). An evolution of a genuinely light-handed regulatory system may be tailored individual agreements based around the 'standard' terms and conditions.

deregulation of airport pricing is the course most consistent with this policy intent, if the Productivity Commission and/or Government intends to implement on-going price control, the Airports Act would provide a sensible base.

2.3.1 Use of Section 192

Section 192 of the Airports Act 1996 in its current form deals with access arrangements, including the automatic application of Part IIIA of the Trade Practices Act 1974. This is a logical section to be amended to incorporate the concept of a Prices and Quality Undertaking.

It is envisaged that the revised section would provide for a process of Ministerial approval similar to the Master Planning approval process currently covered by the Airports Act (further details of consultation and review processes are discussed below). The section would then provide for exemption from actions under Part IIIA with respect to the services and facilities covered by an approved Prices and Quality Undertaking.

The fallback regulatory instrument in the event a Prices and Quality Undertaking is not agreed would be the standard provisions of Part IIIA. For reasons discussed elsewhere in this submission, it is not proposed that this application would be automatic.

As the application of Part IIIA is considered regulatory "overkill" for airports, it is envisaged that most major airports would choose to have a Prices and Access Undertaking approved. As discussed below, this assumes that the process of approval is significantly less onerous that the current Access Undertaking requirements under Part IIIA.

2.4 Prices and Quality Undertaking

A Prices and Quality Undertaking under a revised section 192 of the Airports Act 1996 could meet the objectives of a sound regulatory system described above.

2.4.1 Contents

A Prices and Quality undertaking would be expected to contain:

- a statement of the services covered by the undertaking and its term;
- the price path that will be maintained over the period covered by the undertaking;
- any arrangements that provide for movements away from the price path in the case of specified investment requirements;
- objectively determinable service levels that would be achieved or maintained throughout the period, including any penalty and/or bonus arrangements;
- any statements necessary to ensure compliance with agreed Government aviation policy goals, international obligations, or agreed social policy goals; and
- other terms and conditions of use for the airport for the users of aeronautical facilities.

2.4.1.1 Services Covered and Term of the Undertaking

It is envisaged that most airports would seek to cover most services and facilities in which there are potential market power concerns. The proposed definition of an airport service as set out in section 4 may provide a starting point.

In order to retain maximum flexibility, it would be possible for an airport to submit a Prices and Quality Undertaking in respect of any number of services and facilities, and could have a number of separate Undertakings in order to keep the processes in manageable size pieces.

Naturally, the exemption from the provisions of Part IIIA would apply only to the services for which there are Undertakings in place.

The term should also be kept flexible to provide for individual circumstances. Longer terms provide greater certainty for all parties, but can increase risks if market factors drift away from expectations. Five years would perhaps be seen as a mid-range benchmark and is consistent with other Airports Act terms and many regulatory periods in other industries.

2.4.1.2 The Price Path

Fundamentally, a CPI-X style incentive based regulatory arrangement is a sound place to start for a light handed regulatory framework. However, any pre-determined unit price path has the same incentives for efficiency.

While a smooth price path may be most likely, there does not appear to be any prima facie reason why individual airports cannot propose different approaches that vary with circumstances. For example, an airport may wish to propose increases or decreases in price points during the cycle to correspond with anticipated investments (if applicable, see next sub-section).

It would be incumbent on each airport to propose and justify its own price path. Guidelines should be developed, however, to guide both preparation and assessment by advisers to the Minister. A fundamental concept should be that the price path would be forward looking, target efficient price levels and be designed to provide appropriate investment incentives. SACL's recent experience suggests that a full "building blocks" style assessment would be excessively onerous and not necessarily address the key points.

2.4.1.3 Any Arrangements for Specified Investment Requirements

There appear to be very good reasons for the basic price path to incorporate most investment requirements. The investment program could be estimated in the development of a price path, but the actual investments would be determined by the airport's ability to meet the predetermined quality indicators (see below).

There are at least two reasons why it would be difficult to incorporate all new investment in an underlying preset price path. First, there may be potential major investments that cannot be accurately estimated at the time of the Undertaking. One such example at present is the investment that may be required to accommodate new large aircraft such as the Airbus A380. Currently the scope of investment required is impossible to predict.

Secondly, where existing prices are well below incremental costs, a smooth price path may initially be insufficient to sensibly provide incentives for substantial capacity enhancements.

These circumstances could be addressed in a number of ways. One may be to link additional price increments to particular events. For example, "an additional 5% unit price increment for each new aerobridged gate up to maximum of five new gates". In this example, a 5% increment would be expected to provide sufficient incentive to add new gates as required, noting that as volumes grow, so does the revenue incentive.

Another possibility may be to set a formula for determining the increment by specifying as many parameters as possible (such as WACC parameters, depreciation rates or amortisation period, operating cost assumptions etc), with actual cost being the objective final parameter to a "building blocks" style automatic increment.

In theory, an airport could propose to retain a form of the existing NNI arrangements by nominating an appropriate arbitrator or decision-maker. In practice, SACL believes this is unlikely to be favoured due to the costs, timing concerns and uncertainty.

2.4.1.4 Service Levels

A number of key service standards could be developed to assess the appropriateness of the airport over the period and address any concern about incentives to under-invest. It would be of primary importance that the indicators are objective, and are within the direct control of the airport operator.

A number of static indicators may be appropriate. A few examples of these could include specified standards in relation to:

- the availability of runways and taxiways (other than for reasons of weather) during peak and off-peak times (potentially different standards);
- percentage of passengers embarking and disembarking using aerobridges; and
- the number of passengers per check-in counter (noting that queuing times are influenced by airline staffing levels).

Passenger based surveys of sufficient sample-size would also provide a statistically relevant measure of quality issues. A few examples of these could include specified standards in relation to:

- the cleanliness of toilets, other amenities, public areas etc;
- the availability and quality of public seating;
- the standard of signage to guide passengers to departure/arrival gates; and
- assistance available and received from terminal staff if required.

The current quality of service monitoring program under the Airports Act would provide a starting point for consideration of appropriate indicators. It would be ideal for a standard set of indicators to be agreed between a number of airports to allow comparison across and between airports, although this should not be mandatory.

To provide for full coverage of quality standards, indicators that rely on third party performance (or subjective judgement) should also be established. In these cases,

however, the remedial action would be directed towards joint consultation and not any ultimate penalty clauses for the airport.

In the event an airport does not achieve any objective quality standard in a given period, the Undertaking should describe steps for remedial action, which may involve policy changes, additional investment or higher levels of operating resources. The initial emphasis should be on remediation within a reasonable timeframe.

In the event of on-going failure to meet quality standards, the Undertaking could either provide for automatic penalties, or a reassessment by the Minister.

If penalties are provided for, airports should also be able to include bonus provisions in the form of temporary price increments for continued over-performance of standards.

2.4.1.5 Compliance with Agreed Government Policy Goals

One of the advantages of industry specific regulation is the ability to incorporate industry specific objectives. It is important that any additional requirements on airports be a process of agreement and not imposition by the Government.

Issues that this could cover would include any international obligations arising from the Australian Government's membership of the International Civil Aviation Organisation. In addition, specific objectives in relation to access for particular user groups (such as the existing policy in relation to regional airline access to Sydney Airport) could be agreed and included.

2.4.1.6 Other Terms and Conditions of Use

It would be sensible for the Undertaking to also cover general terms and conditions of use such as credit and payment terms, warranties and indemnities etc. This would replace (or replicate) the Conditions of Use currently in place at a number of airports.

2.4.2 Consultation and Review Prior to Approval

It is envisaged that the development of any Undertaking would be best achieved in consultation with customers and other interested parties. It would be consistent with the Master Planning provisions of the Airports Act for there to also be a compulsory consultation period and requirement for comments to be considered.

The Minister would also be likely to require specialist advice on pricing matters more generally. This could potentially be provided by the ACCC or NCC, who could recommend acceptance of, or alterations to, the proposed pricing arrangements, in light of the investment and quality plans.

As discussed above, it is not envisaged that this would be a detailed cost-based exercise, but rather a forward looking efficiency based approach, with an emphasis on ensuring appropriate incentives for investment. This will require the reviewing party to be provided with guidance as to the approach to be adopted.

It would ultimately be a decision for the Minister to balance the benefits of the Undertaking against any outstanding concerns of customers and advisers such as the ACCC or NCC.

2.4.3 Dispute Resolution

A dispute resolution mechanism could be included. It is likely that this would mirror standard contractual resolution models, rather than defaulting to a regulatory body or courts.

2.5 Access Undertakings under Part IIIA

Arguably, similar provisions already exist under section 192 and Part IIIA for airports to have an access undertaking approved to put them beyond further Part IIIA coverage.

The proposed Prices and Quality Undertaking differs from an Access Undertaking under Part IIIA in its scope. Access issues, per se, are far more important in vertically integrated businesses where non-price terms can potentially be used for anti-competitive purposes. Airports do not have these incentives and, therefore, the onerous requirements of access undertakings in this regard are not necessary.

The experiences of Melbourne and Perth airports in (unsuccessfully) pursuing access undertakings resulted in no Phase 2 airports even attempting this route. The costs, uncertainty and ultimate lack of flexibility have been factors in the deterrent. SACL has similarly investigated the resources required to complete a successful Part IIIA Undertaking and decided it is too onerous and uncertain to warrant pursuit.

2.6 Further Development

This submission does not attempt to describe in detail the coverage of a Prices and Quality Undertaking or the changes that would be required to individual legislative instruments to give effect to the recommended position. These steps could presumably be explored at a later stage of the inquiry process, or during the implementation phase following the inquiry and Government consideration.

In this regard, SACL notes that it considers this an unnecessary "second best" approach in comparison to the deregulation advocated in Section 1.

SECTION 3. APPLICATION OF *PRICES SURVEILLANCE ACT 1983* AT SYDNEY AIRPORT

SACL supports and endorses the submission made by the Australian Airports Association to the Commission's inquiry into the PSA.

SACL strongly believes that the overwhelming experience of all airports in the operation of pricing oversight at core regulated airports by the ACCC under the PSA is that this form of price regulation has been largely detrimental. It considers that there is no continuing need for operation of the PSA, whether in its current form or even as it might otherwise be amended following the Commission's PSA inquiry.

In particular:

- continued application of the PSA would be totally unnecessary if SACL's proposals for regulatory reform as outlined in Section 1 or 2 of this submission were adopted; and

- such application would also be quite unnecessary if, alternatively, Part IIIA of the TPA continued to apply at core regulated airports, especially if Part IIIA were amended as recommended in Section 5 of this submission.

In this latter regard, and assuming that a complete new regime along the lines suggested in Section 1 or 2 of this submission is not adopted, SACL believes that use of the Part IIIA mechanism to constrain any abuse of airport pricing would have a number of very significant advantages over the present PSA regime:

- where airport and customer were able to agree on price, there would be no need to approach the regulator - accordingly, costs for all parties, including the regulator and thereby the taxpayer, would be minimised. More importantly, there would be no delay in allowing the construction of new infrastructure necessary for the commencement or expansion of airline services by new entrant airlines, thus promoting competition in that industry;

- the ACCC has the capacity to force the parties to negotiate their differences as far as is possible so that its intervention can be limited to that absolutely necessary - for example, it can decline to accept a dispute notification as valid where it is not satisfied that the parties have in fact reached the point where they are "unable to agree" as required by section 44S(1) of the TPA; and

- this reliance on mutual negotiation as the first resort to achieving price settlement would greatly reduce the scope to "game the regulator" and, over time, would force through its emphasis on negotiation and mutual agreement the development of normal commercial relationships between airports and their customers - a desirable feature that is sadly and totally lacking in the current PSA regulatory model.

SACL notes that BARA, Qantas and Ansett argue, in their submissions to the Commission in relation to the PSA inquiry, that reliance on Part IIIA of the TPA would be an unacceptable alternative to PSA regulation or some other form of price regulation. Notably, however, their arguments in support of that proposition are not enunciated. The BARA suggestion that "there is clear evidence that Part IIIA is not an appropriate method of regulating prices in an industry with strong natural monopoly characteristics" is not only unsubstantiated but seeks to deny entirely the very purpose and effect of Part IIIA. BARA and Qantas each suggest

that, because telecommunications, electricity and gas each have regulatory regimes that extend beyond Part IIIA, airports should similarly have an additional form of price regulation. This argument is, however, neither substantiated nor logical.

Their suggestion that reliance on Part IIIA without the PSA would potentially require every airport user to seek ACCC arbitration is alarmist and contrary to experience. That is not what currently happens under Part XIC of the TPA, where exactly the same potential could be said to exist.

Emerging experience and common sense, together with a rigorous ACCC approach to the conduct of arbitrations only when bilateral negotiations have intractably failed, suggests that:

- in the absence of PSA regulation, airports and airlines would seek to negotiate price and other terms and conditions as far as they are able;
- they would seek to arbitrate only intractable differences; and
- arbitral outcomes with one customer would be readily extended by airports to other customers in comparable circumstances.

BARA, Qantas and Ansett also suggest that continued PSA price regulation is necessary to ensure appropriate price reductions if airport operators chose to reduce the level of service provided while seeking to maintain existing charges. That argument is flawed. In the unlikely event that an airport operator did adopt that approach, Part IIIA would provide an avenue for resolution of any intractable dispute about residual charges. Continued PSA regulation is not necessary for this purpose.

In SACL's view, none of the arguments advanced by BARA, Qantas or Ansett is sufficient to negate the proposition that reliance on Part IIIA would adequately protect the interests of airport customers and users in the absence of PSA regulation and its attendant detrimental effects. While SACL would clearly prefer that a new regime should be introduced along the lines set out in Section 1 of thus submission, SACL nevertheless is convinced that continued application of the PSA completely unnecessary if Part IIIA has a continuing application.

The above comments apply to price control of aeronautical services. So far as price monitoring of aeronautical-related services is concerned, SACL's view is that monitoring to date has not disclosed any substantiated concern about airport pricing of the services to which it has applied. Accordingly, SACL sees no need for continued application of prices monitoring of those services. While the impact of prices monitoring is far less troublesome when compared to the price approval process, it nevertheless does entail compliance costs for both airport operators and the ACCC and experience to date suggests that such cost has generated no net public benefit.

It might be questioned, if PSA price regulation were no longer to apply to aeronautical charges as urged in this submission, whether price monitoring of those charges should replace it either indefinitely or for a transitional period. The view of SACL is that this would be unnecessary. The residual role of the ACCC under Parts IV and IIIA of the TPA would in our view provide adequate opportunity for scrutiny of such charges.

The following is an extract from the submission of the Australian Airports Association to the Commission in connection with its PSA inquiry. SACL endorses and supports the views set out in this extract:

In this submission, the AAA argues that:

- if PSA price regulation of Australian Airports was ever appropriate, it has now outlived its usefulness;

- indeed, the operation of the PSA regime is fostering highly undesirable outcomes - particularly by impeding new investment at Australian airports to the detriment of increased competition between airports and amongst airlines, and by promoting a culture of "gaming the regulator" that is completely counter-productive to the development of the sound commercial relationships between airports and their airline customers that it was the intention of the Government to foster and that should be the medium to long-term aim of any regulatory structure;

- while they are generally monopoly or near monopoly providers of airport services, the countervailing power of their customers means that Australian airports either do not have or are not able to take advantage of the degree of market power necessary for them to extract unreasonable or monopolistic prices for those services;

- there is no continuing need for reliance on the PSA as a regulatory tool within the Australian airports regulatory regime.

This is not to suggest, however, that the present airports regulatory regime apart from the PSA operates in an optimal way. It does not, and there are other issues that require attention. The AAA will address those issues in later submissions to the other relevant Inquiries being conducted by the Commission - the National Access Regime Inquiry and the Price Regulation of Airport Services Inquiry.

Pricing Regulation at Australian Airports - Experience Reviewed

The history of prices regulation at Australian airports falls into two quite separate and distinct phases:

- the previous regulation of aeronautical charges imposed by the former Federal Airports Corporation (**"the FAC"**); and

- the present regulation of the aeronautical charges sought by current lessees of Australian airports.

These phases are each marked by quite distinct and fundamental differences:

- the FAC undoubtedly had significant market power - it controlled all major Australian airports and had clear and unambiguous statutory powers that truly enabled it to impose, with legislative force, its view as to the terms and conditions on which the facilities and services of those airports should be made available to all airlines and other airport users;

- in contrast, the current airport lessees have little or no prevailing market power - they are a diverse group who generally control only one regulated airport; in doing so they have no statutory power to impose terms and conditions; effectively they can only ensure a desired financial return either by securing customer agreement to their proposed terms and conditions or by winning approval from the Australian Competition and Consumer Commission (**"the ACCC"**) over opposition from those customers.

The first phase is now a matter of history. There would be little to be gained from now considering whether or not, in retrospect, it was appropriate for the PSA to be used to regulate the prices charged by the FAC. While tending to the view that PSA intervention was

justified in the particular context of the FAC, the AAA does not now seek to debate that issue at any length.

Rather, the AAA simply notes that, if the use of PSA regulation of the FAC was ever justified, that justification would have no necessary application to the present situation in which each of the major Australian airports has been (or, in the case of Sydney Airport, is about to be) privatised. If the FAC ever possessed the degree of market power that would justify regulatory intervention through the PSA, the privatised airports do not. That the present situation in relation to market power is fundamentally different from that of the FAC is apparent from the points made above.

Over the past 3 years, AAA members have had frequent and detailed experience of the present airports regulatory regime and particularly of that regime insofar as it involves PSA price regulation. In their view, the overall outcome of PSA regulation has not only been most unsatisfactory from the airport perspective but has also been contrary to the public interest.

This summary view needs to be seen in context lest it is too lightly dismissed as mere self-interest.

It might be immediately thought that any price regulated business will always regard a regulated price as unsatisfactory, and would always prefer a price set at its own discretion and without the need for any third party endorsement. Of course, Australian airports would not reject such an outcome.

However, the criticisms made by AAA members of the present PSA regulation of airport pricing are based more soundly in public policy than in mere self-interest.

In the view of the AAA there are three fundamental reasons why continued application of PSA price regulation at Australian airports is inappropriate:

- first, privatised airports simply do not have the degree of market power of which they could take advantage in order to charge unjustified prices;

- second, the need for prior ACCC approval for aeronautical price increases has positively worked to preclude the development of the normal and desirable commercial relationships between airports and their customers that should be the eventual aim of any regulatory system; and

- third, the PSA processes and their consequences have substantially hindered the development of effective competition in Australian air transport.

We expand on each of these issues in the following sections of this submission.

The PSA and Market Power of the Privatised Airports

There is no doubt that the major capital city airports have significant attributes of a monopoly:

- in each case, the privatised airport is either the only airport in its particular city, or the only airport readily able to offer facilities with the capability sought by major international, national and regional carriers. Notably, however, airports do compete with one another for significant sections of their business - for example, for the location of international and regional headquarters, hubbing and maintenance facilities;

- the barriers to entry are extremely high - airports capable of meeting the needs of those international, national and regional carriers are extremely capital intensive and

other regulatory regimes (particularly environmental) may inhibit their construction in any truly competitive location; and

- there is only limited substitutability between air transport and other modes of transport - rail, road and sea are each competitive forms of transport for some travellers, but not for the majority of air travellers.

But possession of these attributes does not bring with it the degree of market power that would allow an airport to unilaterally impose its view as to price or other terms and conditions. This is because:

- major customers at the privatised airports have enormous, and greater, countervailing power;

- while theoretically an airport may preclude entry by an airline unwilling to pay its stipulated price, this is not achievable in any realistic sense- from a practical perspective, it cannot preclude an aircraft's arrival and, from a financial perspective, it has limited or no capacity to replace the lost revenue stream because of leasehold conditions which require continued use of aeronautical facilities for airport purposes;

- the limited but nevertheless real competition that does exist between individually operated airports acts as a pricing inhibitor; and

- pricing disputes can be independently arbitrated by the ACCC under Part IIIA of the TPA.

At some privatised airports, by far the largest proportion of the airport's aeronautical revenue derives the domestic duopsony of Qantas and Ansett. Increasingly at domestic airports, the desire to attract new carriers such as Impulse and Virgin Blue means that price restraint must be exhibited in order to promote additional traffic and to limit exposure to that duopsony and this restraint acts as a significant pricing inhibitor. At international airports, in addition to each of the preceding factors, the collective representation of major international carriers through the BARA, together with the ubiquitous influence of Qantas and Ansett, acts as a powerful pricing brake.

Active competition between airports is amply demonstrated by the efforts made by various airport operators to attract the operational and maintenance headquarters of Impulse and Virgin Blue, and to be accepted as the initial Australian destination of new international carriers such as Gulf Air.

At privatised airports, general aviation air operators undoubtedly have less pricing influence than major domestic and international airlines. But, nevertheless, some of these same factors still operate to inhibit overpricing by airports.

None of these factors were of influence in the days of the FAC. They are each a new feature of the industry as it has evolved since the advent of the privatised airports.

In addition, of course, Australian airports like any other monopoly or near monopoly provider are subject to the active scrutiny of the ACCC through Part IV of the TPA generally, and section 46 in particular.

The submissions of BARA and Qantas argue that Australian airports are freely able to exercise substantial market power. Those submissions are, however, fundamentally flawed. They do not countenance the countervailing market power of airlines themselves. And they rely for support on selective quotations from past decisions of the Prices Surveillance Authority in respect of the Federal Airports Corporation which was, as noted above, in a markedly different and more powerful position than any current Australian airport operator.

The additional reliance by Qantas on the Part IIIA decision of the Australian Competition Tribunal in support of the proposition that Sydney Airport has substantial market power is equally flawed. In its proper context, that decision goes not to exercise of market power, but to the criteria for declaration under Part IIIA of the TPA. The ownership of a facility declared under Part IIIA, whatever else it may entail, certainly does not provide evidence of abuse of market power, or of the ability to effectively abuse such power.

Moreover, the BARA and Qantas assertion that Sydney Airport has sought to achieve "monopoly prices" in lodging a valid and substantiated notification with the ACCC is overtly unsustainable. Sydney Airport has simply developed a rational case for increased aeronautical charges, supported by appropriate expert and technical evidence. To suggest that it is abusing its market power in seeking to implement those proposals in accordance with the law is, simply, incredible.

Having regard to all of the above, the AAA submits that the prime rationale for invoking PSA pricing regulation at Australian airports does not exist - the privatised airports do not have the either the degree of market power or the effective capacity to exercise such power that would warrant such intervention. Whatever market power airports may have, it is not sufficient to allow them to abuse that power without constraint through the imposition of unjustifiable prices or terms and conditions.

Effect of the PSA on Commercial Relationships between Airports and their Customers

As a matter of public policy, regulatory intervention into commercial affairs should be limited to, and no greater than, that the extent necessary to redress market failure.

In the view of the AAA, the present intervention through PSA price regulation is actually producing rather than redressing market failure.

The ultimate aim of airports regulation should be to allow a situation to develop where, because the market power of airports is balanced by the countervailing power of their customers, aeronautical charges are routinely agreed between provider and customer without the need for third party regulatory intervention. Until that outcome is achieved, there will be a need for a mechanism to resolve intractable pricing disputes, but this should be a true avenue of last resort.

The reality is that the prohibition on charging more than an ACCC-approved price means that there is no incentive at all for airport customers to ever agree to any price increase sought by an airport. Indeed, there is a positive disincentive to reach an agreement of the nature that would be required in an ordinary dealing between two commercially balanced parties.

The (understandable and quite rational but nevertheless economically inefficient) incentives for airlines under PSA price regulation are to delay the introduction of higher airport charges for as long as possible and to seek to minimise the magnitude of any increase eventually imposed. In this context, the present PSA price regulation distorts market economics in favour of "gaming the regulator". Even where an airline might otherwise accept a proposed airport price increase as reasonable, commercial advantage lies in forcing the airport to justify its proposal in every aspect through a protracted and disputed ACCC inquiry.

The Commission's own interim finding is that "prices oversight should be used as a remedy of last resort". At present, however, PSA price regulation of Australian airports is an avenue of first resort.

Because the ACCC's role is not limited to those likely few cases of intractable disagreement between provider and customer, there is no incentive whatsoever for airlines to form and build constructive and normal commercial relationships with airports. The promotion of such relationships was a stated intention of the Government in establishing the airports regulatory regime. However, the fact is that the legislative necessity for routine ACCC intervention in

the airport industry as required by the PSA is instead serving as a positive inducement to continued market failure.

As a proper remedy of last resort, regulatory intervention should be limited to that necessary to resolve disagreements as to price that cannot be resolved by properly conducted negotiation between the parties themselves, and should be structured in a way to discourage rather than promote the recurrence of future disagreements of the same nature.

PSA price regulation, in the context of Australian airports, dismally fails each of these tests. It positively discourages the development of normal commercial relationships between airports and their customers and, if it remains, risks making the need for continued regulatory intervention a self-fulfilling promise. It does not promote optimal market based outcomes for either airports or users. It is completely contrary to the stated Government intention of encouraging commercial negotiation between airports and airlines, and it encourages continued "regulatory gaming".

The Effect of the PSA on Competition

The PSA processes are lengthy, inefficient and expensive for both those regulated under it and the regulator itself (and thereby the Australian taxpayer). There appears to be general support for these propositions from many of those who have made submissions to the Commission including, from within the aviation industry, Ansett.

However, simply seeking to amend the PSA to deal with these issues of regulatory efficiency and compliance cost, as urged by Ansett and some others, ignores the more fundamental impacts of PSA regulation which go far wider. To limit reform to such measures, at least in relation to airports regulation, would be short-sighted in terms of both economic efficiency and public policy. Fundamental problems would undoubtedly remain

An inherent problem with PSA regulation, in requiring regulatory rather than negotiated approval for any aeronautical price increase, is that it not only delays the introduction of revised charges necessary to ensure that airport operators are assured of a reasonable return on their pre-existing investment but also,. more importantly, it deters and delays new investment.

This not only inhibits increased competition between airports and fails to promote the efficient operation of airports; it also adversely affects competition between airlines. PSA regulation thereby positively favours incumbent airlines and operates to the detriment of new entrant airlines and, ultimately, the travelling public.

If the PSA regime has not already impeded competition between airlines, it is clear that its continued operation will do so. A very practical example of these adverse effects on investment and competition between airlines can be found in the 26 October 2000 submission to the Commission by Australia Pacific Airports Corporation, the operator of Melbourne Airport. Its experience with the PSA regime means that, in the future, it will no longer accept the regulatory risk of proceeding with pro-competitive investment before a final ACCC decision is known. Had it adopted that position in relation to the recent establishment of the Domestic Express multi-user terminal at Melbourne Airport, the commencement of Impulse and Virgin Blue services at that airport would have been delayed by some 4-5 months.

The absence of any merits appeal process from ACCC decisions under the PSA means that there is little prospect of an operator assuming regulatory risk by proceeding with investment ahead of approval in the knowledge that an unfavourable ACCC ruling might be overturned on appeal to the Australian Competition Tribunal or the Administrative Appeals Tribunal.

To the extent that airports were prepared to assume regulatory risk and undertake new investment ahead of regulatory approval, their mounting and generally very negative

experience of PSA regulation is increasingly meaning that new investment will not be undertaken when required unless ACCC approval is in place. It is clear that even customer agreement to new charges cannot guarantee that the price eventually approved by the ACCC will guarantee a reasonable return.

Moreover, there is no evidence that the PSA regime has protected small users and new entrants from pricing discrimination compared to larger incumbent airlines. Because the PSA allows the setting of maximum prices, it is incapable of achieving that effect. But this weakness is not an argument for strengthening the PSA to give the ACCC power to set minimum as well as maximum prices. Experience shows that competition between airports, and the desire to achieve optimal facility usage, means that airport operators do price to attract new entrants and small operators, as evidenced by the discounts offered in Sydney Airport's published Conditions of Use. Moreover, while airlines themselves remain unconstrained by price regulation, there can be no guarantee that any reduction in airport aeronautical charges will be passed on by airlines to passengers.

It needs to be said that AAA members disagree with many of the decisions that have been made by the ACCC in exercise of its powers under the PSA insofar as they affect airports. But the concerns of AAA members go far beyond disagreements about whether or not particular decisions were right or wrong, favourable or unfavourable, optimal or sub-optimal. The AAA recognises, and wishes to state publicly, that not all its concerns and disagreements flow from error on the part of the ACCC. While this may be the case in some instances, the AAA recognises that the ACCC is being asked to implement a fundamentally flawed regime.

Rather, the AAA is concerned that pricing regulation through a PSA model, however administered, will always inherently have adverse implications for competition between airports and amongst airlines.

If the PSA were to remain as a regulatory tool in the airport industry, there are many changes that airports would wish to see. These would involve a major re-writing of the PSA itself to remove present ambiguities and to better state the underlying objectives; a re-casting of declarations and directions made under the Act to better reflect the representations made by the Commonwealth at the time of its sale of airport leases and to remove ambiguity and give greater certainty; and a reform of administrative procedures to expedite decision-making and to allow merit reviews of ACCC decisions.

But, so far as airports are concerned, the AAA believes that these measures would not resolve the present problems. The fact is that there is no need for, and considerable harm done by, the very fact that prices are regulated through the PSA at all.

PSA Intervention at Australian Airports is No Longer Necessary

Different views may be held as to whether or not it was necessary or appropriate to declare aeronautical services at the privatised airports at the time of privatisation. Those views may turn on one's views about issues such as market power, and may extend to other issues such as the legal validity of the directions given and the capability and legal efficacy of the PSA as a regulatory tool for the implementation of a CPI-X price cap. Whatever those views, it is also the case that compliance with the price cap was a contractual requirement of the leases between the Commonwealth and PSA price regulation was not necessary to ensure its implementation.

In the AAA view there is little point in a retrospective debate of this nature. Rather, the far more important point is whether or not airports should be subject to PSA price regulation in the future. It is the AAA's submission that, if there ever was any need for PSA regulation at Australian airports, that need has passed.

The CPI-X price cap imposed on the privatised airports was intend to apply only for the first 5 years of privatisation. That this remains the policy of the Government is reinforced by the terms of reference given to the Commission on 21 December 2000.

Accordingly, any justification for PSA price regulation that may previously have been based upon ensuring compliance with such a cap can have no continuing validity.

For the reasons outlined above, airports simply do not have significant market power to impose their pricing wishes on their principal customers. Accordingly, any justification for PSA price regulation based on market power, if it has any validity at all, can only operate in respect of small general aviation customers.

And, for the reasons outlined above, the need to gain ACCC approval for any price increase means that the regulator is involved too intimately and too early in what should desirably be a normal commercial bilateral relationship based on mutual goodwill and rational negotiation.

Accordingly, the AAA believes that there is no longer any need for PSA price regulation at Australian airports.

This view of the AAA of course stands in stark contrast to that of BARA and Qantas, and apparently Ansett, who argue not only for a continuation of the present PSA regime but for an expansion of it. It is apparent that this approach is simply a bid for greater power on their part to frustrate the legitimate commercial interests of airport operators.

This is clearly shown by their argument that PSA regulation should be extended to the entire business of an airport operator, despite the fact that the non-aeronautical business of airports is already subject to the ordinary discipline of a fully competitive market. In putting ambit propositions of this nature, the airlines not only defy Government policy but also good economic and policy sense.

Again, the BARA suggestion that Sydney Airport's expression of its view on the application of the ministerial directions under section 20 of the PSA in relation to necessary new investment justifies some expansion of the ACCC's enforcement powers under the PSA is irrational and unjustifiable.

Similarly, the BARA and Qantas argument that the ACCC's powers are somehow deficient because the Treasurer has not accepted the ACCC's recommendation that Fuel Throughput Levies be brought within the CPI-X price cap is fundamentally flawed. The fact is that the ACCC recommendation in that matter was itself unsound. What the airports in question had there done was to exercise a pre-existing agreed contractual right, negotiated and secured by the FAC, to introduce such a levy. The exercise of that right could never be properly construed as an exercise of market power by the airports who purchased that right from the Commonwealth for proper consideration, and cannot be legitimately argued as a basis for expanding the ACCC's powers under the PSA.

In closing this Section, SACL particularly wishes to reinforce the comments made above by the Association in relation to the claims made by various airlines in relation to SACL's recent notification of price increases given to the ACCC under the PSA.

There can be no doubt that those claims by the airlines are clearly erroneous and extravagant. In SACL's view they warrant no further comment.

SECTION 4. SECTION 192 OF THE AIRPORTS ACT 1996

Section 192 of the Airports Act plays a potentially pivotal role in the present regulatory pricing and access regime. It acts as a "trigger" leading to automatic declaration of a range of "airport services" for the purposes of Part IIIA of the TPA. As such, it renders the standard NCC recommendation and Ministerial declaration processes in Part IIIA inapplicable.

In SACL's view, section 192 should be repealed.

SACL considers that a case has not been made out for such automatic declaration. In our view there is no reason why the ordinary Part IIIA processes of NCC recommendation and Ministerial declaration should be by-passed.

Section 192 would be totally unnecessary if SACL's regulatory reform proposals in Section 1 were adopted.

However, if section 192 is to remain, SACL believes that it should be amended so that it operates with greater transparency and certainty. Its present operation is slow, expensive and inefficient.

Section 192 applies only in respect of an "airport service" which is defined to mean:

> "a service provided at a core regulated service, where the service:
>
> (a) is necessary for the purposes of operating and/or maintaining civil aviation services at the airport; and
>
> (b) is provided by means of significant facilities at the airport, being facilities that cannot be economically duplicated;
>
> and includes the use of those facilities for those purposes".

The Delta Car Rental at Melbourne Airport case provides a graphic illustration of the inadequacies of this formulation.

Delta sought access to a particular spot on the landside roadway kerb at Melbourne Airport to enable it to collect and drop clients of its off-airport car rental service. Melbourne Airport was happy to grant Delta access to an alternative site but considered that it required control of the roadside kerb in order to ensure efficient traffic flow through the airport generally. It thus denied Delta's request for the identified site and Delta complained to the ACCC.

Over a period of some months, the Commission sought and received submissions from the parties and the industry more generally. It eventually decided that the particular kerbside site was an "airport service". It then became a matter for Melbourne Airport and Delta to enter into negotiations as to terms and conditions for access, or to move for ACCC arbitration of such.

SACL understands that the ACCC's decision is widely regarded as wrong; further, even if correct, it is widely regarded as producing a highly unsatisfactory outcome that does not promote the most efficient use of infrastructure; and, still further, it is viewed as providing no useful precedent or guidance for the future.

If time and cost of this magnitude were to be required every time such an issue arose, the judgment would have to be that section 192 in its present form fails any reasonable test of efficient and cost effective regulation.

Accordingly, SACL believes that, if section 192 is to continue to apply, the definition of "airport service" needs to be replaced with an exhaustive listing of those services and facilities that are to be declared.

The current Declarations of "aeronautical" and "aeronautical-related" services under the PSA provide an example of this approach. However, neither of those listings is sufficiently clear and unambiguous and they have generated considerable disagreement (and indeed litigation) between airports and the ACCC.

Nevertheless, SACL considers that a refined version of those listings along the following lines would be appropriate:

"airport service" means a service provided by means of:

(a) aircraft movement facilities and activities, being:

(i) grounds, runways, taxiways, aprons

(ii) airfield lighting, airside roads, airside lighting

(iii) airside safety

(iv) nose-in guidance

(v) aircraft parking

(vi) visual navigation aids

(b) passenger processing facilities and activities, being:

(i) forward airline support area services

(ii) aerobridges, airside buses

(iii) departure lounges and holding lounges

(iv) immigration and customs service areas

(v) public address systems, closed circuit surveillance systems, security systems

(vi) baggage make-up, baggage handling, baggage reclaim

(vii) public areas in terminals, public amenities, public lifts, escalators and moving walkways

(viii) flight information display systems

(ix) terminal access roads, landside lighting and covered walkways. Terminal access roads are roads that provide access to the terminals

from the off-airport public road network. They do not include subsidiary roads running off, or separate from, those roads and providing access to non-terminal buildings or facilities such as hotels, service stations, etc.

(c) other aviation facilities and activities, being:

(i) aircraft refuelling;

(ii) aircraft maintenance sites and buildings;

(iii) freight equipment storage sites;

(iv) freight facility sites and buildings;

(v) ground support equipment sites;

(vi) check-in counters and related facilities

but does not include:

(d) areas within terminal buildings that are not departure lounges, holding lounges, check-in counters or public areas such as arrivals lounges, public amenities, etc - these areas include:

(i) frequent flier and VIP lounges

(ii) office space for any user, including airlines, protective security, police, immigration and customs

(iii) retail outlets, including car rental desks, departure tax booths, etc

(iv) advertising areas (whether on walls or, eg, in display booths)

(v) floor space for vending machines, ATMs, etc

(vi) luggage trolley dispensing machines

(e) landside areas of land outside the terminal that are not terminal access roads or car-parks - these areas include:

(i) areas leased for use as hotels, motels, service stations, take-away food outlets, car-rental repair and maintenance facilities and other similar establishments

(ii) areas leased for industrial (including in-flight catering) or office use

(iii) roads connecting such areas to terminal access roads

(iv) land leased for issue and return areas for luggage trolleys

(v) land leased for advertising hoardings

(vi) land leased for valet parking

(vii) car parks;

(viii) landside roads other than terminal access roads. These roads are subsidiary roads running off, or separate from, terminal access roads (which provide access to the terminals from the off-airport public road network) and providing access to non-terminal buildings or facilities such as hotels, service stations, etc.

(ix) landside facilities for use by commercial vehicles and their operators (including such facilities located on or immediately adjacent to landside roads), regardless of the place at which, and the manner in which, fees and charges are imposed or collected in respect of those facilities. These facilities include, for example, non-public holding, parking, feeder and queuing areas for taxis, hire cars, rental cars, courtesy vehicles, limousines, tourist and public buses and coaches, delivery vans and commercial vehicles and facilities included within these areas for use by their operators such as rest areas, toilets, refreshment facilities and flight information displays;

(f) operator owned buildings and facilities or services on landside areas of land outside the terminal that are not terminal access roads or car-parks - these include:

(i) hotels, motels, service stations, take-away food outlets, car-rental repair and maintenance facilities and other similar establishments

(ii) industrial or commercial establishments and office premises

(iii) luggage trolley rental and return facilities

(iv) advertising hoardings

(v) valet parking facilities

(g) provision of support services by operators to authorised users of airside and landside facilities - eg, electricity, gas, cleaning, maintenance

In addition to amendments of this nature designed to clarify and give greater certainty to the reach of section 192, SACL also suggests that the section needs to be narrowed to apply to some only of the airports to which it currently applies.

SACL considers that it is clear that not all the airports currently covered by section 192 would meet the national significance test for declaration set out in Part IIIA of the TPA. Automatic declaration under section 192 thus extends far further than Part IIIA could extend in the ordinary course.

Moreover, the present reach of section 192 creates anomalies. For example, Launceston Airport is automatically declared but Devonport Airport is not. Similarly, Townsville Airport is automatically declared but Cairns Airport is not. SACL suggests that, at most, automatic declaration under section 192 should be confined to the principal airport in each State and Territory and that other airports should only be subject to Part IIIA if declared after rigorous assessment by the NCC and Ministerial decision under Part IIIA.

SECTION 5. PART IIIA OF THE TRADE PRACTICES ACT

5.1 Introduction

Part IIIA of the TPA was introduced to provide a regime to deal with situations where an infrastructure owner was motivated to deny access to its nationally significant infrastructure in circumstances where the access seeker could not reasonably replicate that infrastructure. It was never intended to provide a mechanism for price control where access was readily provided.

SACL submits that Part IIIA should not apply to Australian airports at all. Airport operators with available capacity have no economic incentive to deny access to airport users.

The only Australian airport with any present or imminent capacity constraint is Sydney Airport. The Commonwealth has already legislated to put in place a specifically tailored slot management scheme designed to ensure equitable access to otherwise constrained capacity at Sydney Airport.

Part IIIA thus has no role to play in relation to denial of airline access to Australian airports.

Properly characterised, disputes between airport operators and airport users are not about denial of access. Part IIIA stems from a paradigm that is inappropriate for dealing with those disputes.

Instead, such disputes are essentially about the terms and conditions, both price and non-price, on which access will readily be provided by the airport operator.

To the extent that they may arise commercially, such disputes should be resolved commercially with regulatory intervention available only as a matter of last resort.

To the extent that such disputes are instead fostered, as they are at present, by a distorted regulatory regime that rewards airport users who choose to "game the regulator", the present price and access regimes are fundamentally misdirected.

In this regard, SACL notes and supports the following statements in the ACCC's submission to the Commission in respect of its National Access Regime inquiry:

> When a service provider is vertically separated, it will usually have little incentive to deny access. While the service provider may exploit its market power by setting high prices it is unlikely to manipulate other terms and conditions to limit access. Nevertheless the negotiate-arbitrate provisions allow an access seeker to seek arbitration over non-price terms and conditions. This could result in unnecessarily intrusive arbitration over detailed operational matters.
>
> Price specification, for example tariff-setting or price caps, seems to have a number of advantages over the negotiate-arbitrate model, especially where the service provider is vertically separated.

While SACL does not support the ACCC's recommendations for a more intrusive role for itself in these circumstances for the reasons detailed below, and prefers the implementation of an airport-specific regime as outlined in Section 1 or 2 of this submission, it is nevertheless very telling that the ACCC itself acknowledges the inappropriateness of an negotiate-arbitrate model in the vertically separated environment in which airports and airlines co-exist.

SACL's primary submission is thus that Part IIIA of the TPA should not apply to Australian airports.

Rather, SACL considers that major airports should be subject to a more specific regulatory regime specially designed to deal with the unique regulatory and efficiency issues that arise in the airports context. An outline for such an airport-specific regulatory regime is set out in Section 1 or 2 of this submission.

However, against the possibility that such a regime may not be implemented, SACL sets out in this Section its views on how Part IIIA should be amended if it is to continue to apply to Australian airports. While this Section is written from the particular perspective of an airport operator, its recommendations may nevertheless be of broader relevance to all industries potentially affected by Part IIIA.

In the *Sydney International Airport* case, SACL had direct experience of the declaration process currently embodied in Part IIIA. That case is widely, and generally critically, referred to in many of the submissions lodged with the Commission in connection with its National Access Regime inquiry. There can be no doubt but that this case highlights deficiencies and confusion in the declaration criteria. Moreover, that case amply demonstrates the ponderously slow pace at which the declaration process can proceed. SACL certainly endorses the recommendation by the NCC itself that an extendable time limit of four months be imposed on both it and, on review, the Australian Competition Tribunal ("the ACT").

Despite that experience, SACL does not intend to dwell on those problems in this submission.

Sydney Airport is currently subject to the ordinary application of Part IIIA - that is, access rights only accrue when an NCC declaration recommendation has been accepted by the Minister. However, as already mentioned, following privatisation Sydney Airport will become subject to "automatic declaration" effect under section 192 of the Airports Act.

Accordingly, SACL's prime concern for the future is not with Division 2 of Part IIIA but with the interaction between the scope and effect of section 192 (dealt with in Section 4 above) and the remaining provisions (predominantly Divisions 3 and 6) of Part IIIA.

5.2 "Slow, Difficult and Costly"

A frequent complaint made in the submissions to the Commission is that the various Part IIIA processes have proved to be slow, difficult and costly in their implementation.

SACL agrees with this assessment, and would support amendments to Part IIIA that ameliorated those problems as far as that can properly be achieved.

At the same time, however, SACL does wish to stress that amendments designed to overcome those problems and to achieve fast, easy and cheap outcomes would, almost certainly, be quite inappropriate.

Part IIIA is intended to deal with matters in which the preservation of fundamental private property rights and questions of national economic significance converge.

It can never be expected that the processes for resolution of this Constitutional, legal, economic and private convergence should be fast, easy and cheap. The issues are simply

too fundamental. The problem is to achieve an appropriate balance between significant competing interests in a way that generates a demonstrable public benefit.

Accordingly, the challenge confronting the Commission is to identify those recommendations for change that avoid unjustifiable problems of delay, complexity and cost while at the same time recognising the justification for unavoidable delay, inherent complexity and reasonable cost.

5.3 Statement of Objectives

Part IIIA does not contain a statement of the objectives sought to be achieved through its application. In this regard it stands in stark contrast to Part XIC of the TPA.

SACL considers that it essential that Part IIIA should have an objects clause and that this be particularly carefully crafted. While not a substantive operative provision in its own right, this clause would provide a clear Parliamentary indication of the manner in which the inherently very significant discretions conferred in Part IIIA are to be exercised by the NCC, the Minister and the ACCC.

From SACL's perspective, foremost in this regard is the balance which the ACCC is to achieve in determining access terms and conditions, particularly price. Given that Part IIIA is focused on infrastructure of national significance, it is essential that short-term pursuit of price reduction not be achieved at the expense of promoting investment in new and enhanced infrastructure that is essential to the longer term.

SACL is concerned that, in the absence of a strong lead from the Parliament on matters of this nature, the ACCC may not itself achieve the correct balance on matters of this nature. Indeed, SACL considers that the ACCC has demonstrated an undesirable propensity to pursue short-term cost cutting at the expense of longer-term strategic considerations of national importance in its February 2001 draft decision on SACL's PSA notification. It is a matter of concern that this has occurred notwithstanding the provisions of section 17(3) of the PSA that require the ACCC to have "particular regard" to "the need to maintain investment and employment, including the influence of profitability on investment and employment".

5.4 Interaction Between Part IIIA and Other Access Regimes

It is anomalous that State and Territory regimes may be accepted as "effective access regimes", and apply in lieu of Part IIIA, only where they meet the principles set out in clause 6(3) of the Competition Principles Agreement and yet the Commonwealth may impose its own alternative industry-specific access regime regardless of whether or not that regime meets those same principles.

Section 192 of the Airports Act operates to automatically apply Part IIIA to a wide and indeterminate variety of facilities and services which would not themselves meet those principles and does so at a number of airports that, viewed as a whole, would similarly not meet those principles. Moreover, it does so inconsistently. While Launceston Airport is caught by section 192, Devonport Airport is not. Similarly, Townsville Airport is regulated but Cairns Airport is not.

As a matter of principle, SACL believes that Commonwealth access regimes should be required to meet the same tests and embody the same principles as those required to be faced by State and Territory regimes. We note that the NCC also supports this proposition.

5.5 Application to Vertically Integrated Firms

A number of the submissions lodged with the Commission argue that Part IIIA should only apply to facilities and services where the access provider is vertically integrated.

Under the Airports Act, there are complex but effective controls over the ability for an airline to control an airport, and for an airport to control an airline. Vertical integration of airports with the primary users of their facilities therefore is not, and cannot be, a feature of the operation of major Australian airports. It would thus be convenient for SACL to support these calls for Part IIIA to be limited in its application to vertically integrated firms.

However, SACL does not subscribe to this view as a matter of necessary principle.

Rather, it supports the view that, in the absence of an appropriate industry-specific regime, Part IIIA should properly have the capacity to apply to "bottleneck" facilities, whether or not owned by vertically integrated firms, provided that there is either an established history or a reasonable apprehension of market failure through denial of access. In these circumstances, Part IIIA should deal with the situation where an upstream firm provides an essential input for downstream and where that input cannot be efficiently replicated. This situation can arise whether or not the firm which owns the bottleneck facility is vertically integrated.

However, SACL also considers that these circumstances will be rare. In a non-vertically integrated firm, the motivation to deny access will generally be non-existent. Rather, the motivation will be to grant access and the true concern will be with the terms and conditions, particularly as to price, on which that will be done. In such cases, a comprehensive industry-specific regulatory regime of the nature of that outlined in Section 2 of this submission will generally be preferable.

5.6 When Access Regulation Should Apply

The most important consideration, however, is to impose Part IIIA or any other industry-specific form of access regulation:

- only in respect of bottleneck facilities;
- only in respect of bottleneck facilities of national significance that cannot be efficiently replicated;
- only in respect of such bottleneck facilities where there is a demonstrated history or reasonable apprehension of market failure;
- only to the extent necessary to address these problems; and
- only for as long as market failure persists.

The *Sydney International Airport* case highlights that these tests are not necessarily met by Division 2 of Part IIIA. While Sydney Airport viewed as a whole may properly be viewed as a bottleneck facility of national significance, the same cannot be said of the facilities and services that were in fact declared in that case.

5.7 Which Australian Airports Should Be Regulated

It is inherent in what is said above that the only airports that should be regulated under Part IIIA (or indeed under the airport-specific regime proposed in Section 2) are those that are of national significance and that cannot be efficiently replicated. As noted in Section 4, section 192 casts a wider net and, in SACL's view, too wide a net.

In SACL's view, the only airports that are likely to meet this test would not be any more than the major airports in each State and Territory capital.

5.8 Market Failure at Australian Airports

The present airports access regime is predicated on an untested assumption that there will be market failure at Australian airports in the absence of some form of price and access regulation.

SACL accepts that, in many cases, an airport can be characterised as a "natural monopoly". It may be the sole provider of airport services in the region and it may not be economically feasible to replicate the facilities it offers.

But that is not, by itself, sufficient to presume market failure through the extraction of monopoly rents.

The submission lodged by BARA with the Commission in connection with its National Access Regime inquiry asserts that:

> … airlines (even major airlines) accessing the services of airport operators have little, if any, countervailing power in respect of the use of airport services. Countervailing power can only arise if the buyer has choices available to it. However, if a buyer has no choices other than to purchase goods or services from a particular seller, no countervailing power will arise, no matter how large the buyer is relative to the market. Airlines have no choice but to use the services of the major Australian airports. From a demand perspective, air transportation to a capital city is not substitutable for an alternate city. Even a major airline is not in a position to bypass or otherwise facilitate new entry into the provision of airport services for the major Australian airports. Airports have no choice but to use the services offered by those airports.

This view, however, represents only half the picture and ignores other salient features of the airport/airline dynamic.

True it may be that an airline may have no option but to use a particular airport for services to and from a particular location. But that does not mean that it has no countervailing power.

First, major Australian airports have no option but to provide airport services. Under both the Airports Act and the terms of their Commonwealth leases, they cannot use their airport premises for any purpose other than an airport. Denying access, while theoretically possible, is simply not a commercial alternative. Just as airlines may have no choice but to use the services of particular airports, those airports have no choice but to offer terms and conditions that make it economically viable to attract the custom of those airlines.

Second, because there is a significant degree of effective competition between geographically disparate airports for other significant airport services, an airline has a broader negotiating base than simply access rights for particular services. Such access rights can be readily "bundled" with other purchases an airline makes. For example, in recent times there

has been significant competition for the location of Virgin Blue's national headquarters, of Impulse Airlines' heavy maintenance facilities, and for Qantas' Boeing 767 maintenance facilities.

Third, because there is competition between air transportation and, variously, rail, road and sea transportation for both passengers and freight, airports recognise that their capacity to attract long-term traffic volume is inherently tied to airline profitability. Forcing monopoly rents that unreasonably exceed underlying cost, and failing to achieve operating efficiencies leading to lower prices, would be a counter-productive short-term tactic and recognition of it confers significant bargaining power on airlines.

And finally, this last mentioned competition between air and other transport modes means that convenient sharing of monopoly rents between airport and airline, to the disadvantage of consumers, is simply not an option.

Despite these factors, SACL accepts that the undoubted possession of countervailing power by airlines does not, at least at this time, provide adequate justification for the removal of all airport price and non-price control. It is for this reason that it recommends the airport-specific regime outlined in Section 2 of this submission. That regime would, in SACL's view, be far preferable to the continued application of Part IIIA which is not well suited to infrastructure in which the natural inclination is to grant rather than refuse access, and in respect of which there are numerous other restraints on operation (such as quality of service, environmental, etc).

5.9 Promoting Commercial Resolution

But, whether that regime or Part IIIA applies, regulatory intervention should continue for no longer than is necessary. An aim of any sound regulatory regime should be to promote efficient and effective commercial resolution so that intervention occurs only as a matter of last resort and, hopefully, is ultimately unnecessary altogether.

As noted in Section 3 above, the present PSA regime operates in a way that is completely counterproductive to the development of the mature commercial relationships that would allow resolution by mutual agreement of price and non-price disputes without unnecessary intervention by the regulator. Instead, it confers significant advantage on those airlines who decide to "game the regulator" and force even the most straightforward issue through the regulator.

This tendency would be equally encouraged by Part IIIA as it currently stands. In the amendments recommended later in this Section, SACL proposes changes designed to foster commercial resolution of all but the most intractable disputes.

Additionally, however, in recognition of the desirability that such issues be resolved by mutual agreement rather than regulatory involvement, SACL considers that "sunset" arrangements should apply to any access regime. In this way, as a matter of discipline, continued regulatory intervention would only be sustained where, industry by industry, it was clear that there was an ongoing need. Significant infrastructure owners would thereby be provided with still further positive incentive to grant access responsibly on agreeable terms and conditions, knowing that a sustained record of doing so would see an otherwise significant regulatory burden and cost lifted and not later reimposed.

5.10 Multi-Stage Access Regulation

A number of the submissions lodged with the Commission suggest that it would be more efficient to merge, or partially merge, the declaration and negotiate/arbitrate phases of the present Part IIIA processes.

SACL does not support those proposals.

Whether declaration is by the Minister under Division 2 of Part IIIA or equivalently by the ACCC under section 192 of the Airports Act, SACL considers that it would be both inefficient and inappropriate for such declaration to be accompanied by any indicative or binding statement of the terms and conditions on which access is to be granted.

Such a statement would be inappropriate because terms and conditions should, so far as possible, be negotiated commercially by access seeker and access provider. For the regulator to intervene ahead of those negotiations is unnecessary and would promote continued regulation when the aim should be to promote commercial settlement.

Such a statement would also be inefficient. It could not properly be made without the regulator engaging in protracted consultation not only with the access provider and the immediate access seeker but also with all other potential future access seekers. To lock other that the immediate parties to a dispute into pre-determined access terms and conditions would simply complicate issues and create future problems of potentially major significance.

In SACL's view, the declaration/certification and negotiate/arbitrate stages should remain quite separate.

5.11 Access Pricing Principles

For the same reasons as those mentioned in the preceding section, SACL does not support implementation of the original Hilmer recommendation that access declarations be accompanied by a statement of Access Pricing Principles.

SACL considers that the development of pricing principles should occur only after detailed consultation with all potentially affected parties and then only in light of actual experience in the negotiate/arbitrate stage. SACL notes that the ACCC has adopted this position in a number of instances under Part XIC of the TPA. This process has a higher chance of successful development of appropriate principles, and operates in a context in which determination of terms and conditions implementing such principles can be speedily challenged in the Australian Competition Tribunal.

Nevertheless, SACL would support a reserved capacity for the Government to give directions in relation to Access Pricing Principles to the ACCC in certain limited circumstances. This would require amendment of section 29 of the TPA which currently precludes the giving of directions to the ACCC relating to Part IIIA.

SACL suggests this reserved capacity to guard against the possibility that the ACCC may seek to implement pricing principles that the Government assesses to be contrary to its perception of the public interest.

The fact is that the ACCC exercises immense discretion under Part IIIA and related regimes and that none of these provide definite guidance to the ACCC on how it is to balance what are often diametrically opposed public interest considerations.

It would, for example, be only too easy for the ACCC to take individual decisions or settle upon a set of generally applicable pricing principles that the Government considered to be unduly focused on price reduction at the expense of investment promotion. In these circumstances SACL considers that the Government should have the capacity to redress the imbalance thereby perceived. The publication and parliamentary oversight provisions of section 29(2) and (3) of the TPA provide appropriate safeguard against the inappropriate use of such a power of direction.

In this regard, SACL notes that section 152CH in Part XIC of the TPA allows the Minister to make a determination "setting out principles dealing with price-related terms and conditions" and section 152CQ(6) precludes the ACCC from making a determination in an access dispute arbitration that is contrary to such a ministerial pricing determination. SACL believes that there is no reason why similar provisions should not be included in Part IIIA.

5.12 Access Undertakings

SACL agrees with the ACCC recommendation to the Commission that undertakings should be able to be lodged at any time and not just prior to the declaration of a service or facility. In SACL's view there is no reason why, following declaration, an access undertaking should not be formulated by the access provider and accepted by the ACCC and thereby obviate the need for its involvement in potentially numerous later dispute arbitrations.

However, SACL does not support the ACCC's recommendations that it be able to require the presentation of draft undertakings, or that it be empowered to impose undertakings where an access provider has failed to submit an undertaking or have an undertaking accepted. In SACL's view, the intrusion on private property rights that such a regime would entail is simply too great. SACL considers that property owners should be entitled to have individual access disputes dealt with individually if they so wish, subject to the ACCC's powers to terminate vexatious or trivial arbitrations. It is a fundamental principle, embodied in clause 6 of the Competition Principles Agreement (albeit only in respect of State and Territories specifically) that "access to a service for persons seeking access need not be on exactly the same terms and conditions". SACL suggests that it would be contrary to that principle for the ACCC to be empowered to mandate access undertakings of its own derivation without regard to the differing circumstances that may present themselves for decision in individual arbitrations.

SACL understands the ACCC's desire to avoid the need for multiple arbitrations on the same issues, but believes that access providers will quickly realise that it is inefficient for them to persist with arbitrations that raise only issues that have already been dealt with by the ACCC in earlier arbitrations.

In SACL's view it is a matter of concern that no access undertaking has been successfully negotiated by any Australian airport.

The history of the operation of this process under Part IIIA is most unsatisfactory. Only two airports, Melbourne and Perth, embarked down the undertaking path. SACL understands that each found the approach of the ACCC too intimidating because the ACCC:

- was not prepared to accept undertakings that were limited to only those services that are automatically declared under section 192; and

- was also not prepared to accept an undertaking that was limited to some only of the services that were offered by an airport.

In SACL's view the ACCC's stance on this first score is a clear example of the "regulatory creep" referred to by the Australian Council for Infrastructure Development in its submission to the Commission in relation to its National Access Regime. As the Association there noted, regulatory creep of this nature runs the severe risk that new investment will be deferred or diverted contrary to the public interest. This is not the only example of regulatory creep that the ACCC has exhibited in its administration of the current airports regulatory regime. Its intention, in its February 2001 draft decision in relation to SACL's aeronautical pricing notification under the PSA, to include within a single till not only price regulated services but other non-regulated services, stands as a yet more alarming example which heightens regulatory risk for potential new investors or investments.

In SACL's view the ACCC's stance on the second score is simply counterproductive. The ACCC should accept any undertaking that puts forward reasonable terms and conditions for any declared service under section 192 without insisting that an undertaking be all encompassing. To reject such a limited undertaking unnecessarily risks placing all matters in contention in a later access dispute.

SACL urges the Commission to recommend amendments to Part IIIA to oblige the ACCC to accept any undertaking that proposes otherwise reasonable terms and conditions, notwithstanding that it may not apply to all declared services under section 192, and to preclude the ACCC from insisting that services that are not declared be included within an access undertaking as a condition of its approval.

Moreover, Part IIIA should require, as does section 152BU in Part XIC, that the ACCC must give reasons for any decision to reject a provision of an access undertaking.

5.13 The Negotiate/Arbitrate Process

Consistent with SACL's view that regulatory intervention should be framed so as to encourage voluntary resolution of disputes by mutual agreement, SACL recommends that a number of detailed amendments be made to Part IIIA of the TPA to encourage that end.

Part IIIA should include a provision along the lines of sections 152BBA, 152BBB and 152BBC of the telecommunications access regime set out in Part XIC of the TPA. Those provisions give the Commission a power to issue enforceable directions to the parties to a dispute to facilitate the conduct of negotiations between them, and allow the ACCC to assume a mediation role in such negotiations at the request of the parties.

SACL considers that provisions of such a nature should be included in Part IIIA, and drafted in terms which encourage and reinforce their use by the ACCC to require the parties to negotiate their issues in dispute between them to the point where the only outstanding issues really are matters of intractable dispute.

In this way the ACCC could serve a most valuable role in actually forcing the development of mature commercial relationships between the parties that, over time, would come to form the preferred basis for dispute resolution. As things stand at present, it is simply too easy for the parties to notify an access dispute and to leave it to the ACCC to do what they

should do for themselves. Provisions of this nature would work against the trend to "game the regulator" which is so obviously encouraged by the present airport regulatory regime.

Part IIIA should also be amended to allow the ACCC to make interim determinations in an access dispute notified to it. Such provisions exist in Part XIC of the TPA and SACL considers that there is no sound reason why they should not similarly exist in Part IIIA. In the absence of a power to issue an interim determination, those resisting the terms and conditions sought by an access provider have a positive incentive to prolong the negotiation process and thereby defer the implementation of revised terms and conditions. Such provisions exist in section 152CPA of Part XIC and SACL considers that there is no sound reason why they should not similarly exist in Part IIIA.

Similarly, Part XIC includes, in section 152DNA, a power for the ACCC to backdate a determination to the date of lodgment of the dispute notification. Again, to avoid providing an incentive for delaying the conclusion of an arbitration, such a provision should equally exist in Part IIIA.

The fact that these provisions do not currently exist in Part IIIA would seem to be based on a presumption that the negotiation of terms and conditions will arise only in circumstances where access has not previously or yet been provided. That of course will not always be the case and, in relation to airports specifically, will seldom if ever be the case because, as noted elsewhere, airports almost never have any economic incentive to deny access to their facilities.

However, SACL also believes that amendments of this nature are not necessarily sufficient to ensure that parties do not use the arbitration process for essentially delaying or anti-competitive purposes.

SACL thus suggests two further amendments to Part IIIA.

First, section 44ZN permits the making of regulations to allow the ACCC to charge the parties to an arbitration for the ACCC's costs in conducting that arbitration, and to apportion that charge between the parties.

SACL suggests that this provision be amended to require that, where the ACCC terminates an arbitration under section 44Y(1)(a)-(c) (ie, on the basis that the dispute notification was vexatious, that the subject matter was trivial, misconceived or lacking in substance, or that the person notifying the dispute had not engaged in good faith negotiations), the regulations shall require that the ACCC charge its costs and apportion all such costs to the party whose dispute notification was vexatious, trivial, misconceived or lacking in substance, or who failed to negotiate in good faith.

Second, SACL believes that there needs to be a more pointed deterrent to conduct which causes delay in the introduction of new competition into the relevant market. For example, an airline facing imminent competition from a new entrant airline could notify a dispute concerning the terms and conditions under which terminal alterations necessary to allow that new entrant to commence operations were to be shared amongst all terminal users. By protracting the negotiations associated with an access dispute notified by them, the airline might achieve substantially greater profit than it would otherwise have achieved had the new entrant been able to commence operations on a timely basis.

In these circumstances we believe that, where it considers that a person who has notified a dispute has failed to participate in an arbitration in good faith, the ACCC should be empowered to apply to the Court for:

- an order requiring that person to pay to the Commonwealth an amount up to the amount of any financial benefit that the person has obtained directly or indirectly and that is reasonably attributable to its conduct in the arbitration; and

- an order requiring that person to pay to any other person who has suffered loss or damage as a result of that conduct an amount that the Court considers appropriate to compensate that person; and

- such other order as the Court considers appropriate.

Section 87B of the TPA, relating to the enforcement of voluntary undertakings given to the ACCC, provides a precedent for an analogous provision. In SACL's view, there should effectively be implied into the lodgment of every dispute notification an obligation on, and undertaking by, the party notifying that dispute to conduct the arbitration in good faith.

SACL notes that some submissions, and notably the ACCC and NCC submissions, argue for amendments designed to remove any incentive for the access provider to delay resolution of an access dispute. SACL would not oppose such amendments. While it expects that they would seldom if ever be applicable to an airport, because airports have an economic interest to resolve disputes and thereby implement new terms and conditions for agreed access rather than delay the grant of disputed access, it realises that the contrary may be the situation in other circumstances and particularly where the access provider is vertically integrated.

5.14 Rights of Appeal

Any access regime should allow intrusion by the regulator to detract from the fundamental property rights of an infrastructure owner only in very limited circumstances. But even then such regime will confer very significant discretion on the regulator. The conferral of that discretion should be accompanied by appropriate checks and balances. Important amongst these are the existence of appropriate rights of appeal through merits review. The availability of judicial review, whether under the *Administrative Decisions (Judicial Review) Act* or otherwise, is not sufficient.

Part IIIA of the TPA and section 192 of the Airports Act are both unsatisfactory in this regard.

SACL believes that there should be rights of appeal to the ACT against:

- an ACCC decision that a particular service is an "airport service" for the purposes of section 192 of the Airports Act - such a decision is equivalent in effect to a Ministerial declaration under section 44K of the TPA and that latter declaration is able to be appealed to the ACT - it is anomalous that an ACCC determination under section 192 is a disallowable instrument rather than an appellable decision; and

- a decision by the ACCC in relation to an access undertaking - it is anomalous that a decision to accept or reject an access undertaking or a variation to an access undertaking under Part XIC of the TPA is appellable to the ACT but the same decision under Part IIIA is not.

It is obvious from the above that SACL rejects the ACCC recommendation that rights of review of its Part IIIA decisions be limited to matters of law.

5.15 Other Submissions

SACL wishes to place on record that it is generally supportive of the thrust of three particular submissions, which have been lodged with the Commission in its National Access inquiry. These are the submissions lodged by:

- the Australian Council for Infrastructure Development; and
- the Law Council of Australia.

To the limited extent that SACL's view deviates from the position put in each of those submissions, these matters are specifically dealt with in the preceding parts of this Section.

ATTACHMENTS

A Letter from the Hon John Anderson MP, Minister for Transport and Regional Services to Australian Competition and Consumer Commission *(12 January 2001)*

The Hon John Anderson MP
Deputy Prime Minister
Minister for Transport and Regional Services
Leader National Party of Australia

12 JAN 2001

Professor Alan Fels
Chairman
Australian Competition and Consumer Commission
GPO Box 520J
Melbourne VICTORIA 3001

Dear Professor Fels

I understand the Australian Competition and Consumer Commission is currently considering the aeronautical pricing proposal lodged by the Sydney Airports Corporation Limited (SACL) on 3 October 2000.

As you are aware, in selling long term leases to the Federal airports the Government was concerned to improve the efficiency and flexibility in the way those airports were being managed and to foster a more commercial approach in their operation. In that context, the pricing oversight framework was designed to complement those objectives and to provide, inter alia:

- airport operators with sufficient incentive to invest in new infrastructure and to use airport infrastructure efficiently;
- encouragement to airport operators and their customers to negotiate directly on infrastructure provision, service standards and requirements and charges; and
- comfort to airport users that protection mechanisms were available should there be any abuse of market power.

Implicit in the framework was that regulatory intervention would only occur where it was apparent that airport behaviour was adversely impacting on consumers or competition between airlines through the exercise of a real or perceived monopoly power. In general this approach reflected a Government policy preference of not interfering in commercial operations unless the weight of evidence suggested that not only did a market failure exist but also that it was being exploited.

The pricing policy framework clearly states that the Government would not mandate the use of a single till approach to aeronautical pricing and it does not expect that approach to be mandated by regulatory control. To do so would clearly be at odds with the Government's objectives in privatising the airports.

As you would be aware, the current aeronautical pricing structure at Sydney Airport is a legacy of the network pricing structure of the Federal Airports Corporation that, in

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1999/2000, provided a negative return on aeronautical assets of 0.4 per cent. Without the proposed price increases SACL are expecting this to be repeated for 2000/2001.

Moreover, the fact that Sydney is not subject to a price cap on aeronautical charges is an important difference in approach to the other major leased airports. It reflects, in part, a view that the pricing framework for Sydney Airport was not an appropriate pricing structure on which to build efficiency gains at an airport subject to congestion.

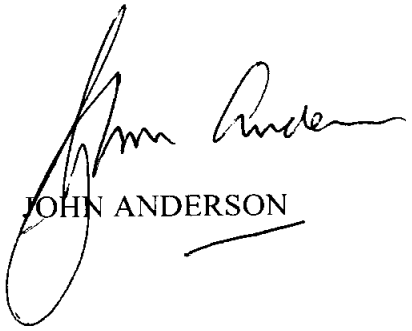
It was due to the effects of congestion at Sydney Airport that the Government committed to facilitating regional access to the Airport in 1998 but to the extent that slots have been 'ring fenced' (from potentially higher value alternative use by interstate or international services), it is recognised that SACL (and the shareholder) carries a community service obligation. Since the consequential efficiency implications and income redistribution effects between stakeholders result from the Government's decision as shareholder and transport policy regulator, this should not influence the Commission's consideration of SACL's proposal to obtain otherwise available efficiency improvements.

To accommodate new entrants and growth in international and domestic passenger numbers through Sydney, better use of existing slots by major carriers is urgently required. International and domestic regular public transport services utilise around 70 per cent of slots at Sydney Airport and considerable efficiency improvements are available from using improved fleet mixes. It is, therefore, appropriate that the major regular public transport operations should be a focus for pricing measures designed to encourage the use of larger aircraft into Sydney.

Accordingly, I am of the view that the principles underlying SACL's pricing proposal are appropriate and represent a reasonable approach on which to move forward. The longer-term efficient use of the Airport is critically dependent on SACL having flexibility to structure its aeronautical pricing arrangements to drive the potential efficiency gains. It is appropriate that they should be accompanied by an improved return on aeronautical assets to provide correct signals for making future investments in aeronautical assets. The proposal is also consistent with the Government's policy decision to retain the existing pricing arrangements for regional carriers at Sydney Airport.

It is important that the Commission recognise the Government's policy objectives in its consideration of the draft proposal. In that context, should the Commission consider that the current Declarations and Directions present a legal obstacle to giving effect to the Government's policy objectives, I would appreciate your advice.

Yours sincerely



JOHN ANDERSON