

## SUBMISSION TO THE PRODUCTIVITY COMMISSION

This submission focuses upon the ACCC's analysis of airport market power in its *Airport Monitoring Report 2009/10*. In this context, its further focus is on the ACCC's analysis of Sydney Airport, which it believes might be exercising market power and earning monopoly rents. Sydney Airport, being the largest of Australia's airports, crystallizes the arguments regarding economic regulation and because of this and because of the important role of the ACCC in monitoring Australia's airports, its views regarding Sydney have a particular import. However in this brief note I wish to argue that the ACCC in reaching its conclusions on Sydney have neglected important considerations. The data analysed is also open to alternative interpretations.

The ACCC's Report states:

*Over several years, airlines have raised concerns about unsatisfactory levels of service at Sydney Airport. Over the same period, prices and profitability continue to increase. The monitoring results, when considered in this context of the airport's market power, as well as the incentives and ability to use that market power, point to Sydney Airport earning monopoly rents from services provided to airlines. (Summary, vii)*

I have two initial observations regarding this view. First, the ACCC in reaching this conclusion does not set out a theoretical reference point; it does not establish the behaviour one might expect from the owner of heavily used airport assets subject to constraints on expansion, nor does it set out clearly what assumptions it is making about the underlying cost function faced by the airport. Second, it is not apparent that this conclusion of the ACCC is firmly supported by the evidence put forward in its Report.

The basic characteristic of monopoly behaviour is that compared with a firm operating in a competitive industry the monopolist will charge higher prices and produce less, but higher prices alone are not necessarily indicative of the

exercise of market power. If the firm in question has increased capacity in parallel with an increase in prices charged, then rising prices could be indicative of the increasing costs of providing additional capacity. Thus, when drawing conclusions regarding the exercise of market power the behaviour of the firm with respect to its use of existing capacity, together with its strategy for adding capacity through investment, are both important considerations.

In this context, I can find no evidence in the ACCC's report that Sydney Airport is currently seeking to deliberately restrict its (quality adjusted) output. To the contrary, Sydney Airport appears to have been investing to increase capacity and the quality of this capacity. I understand that there has recently been expenditure in the order of A\$ 0.5 billion on the expansion of Terminal 1 and the 2009 Master Plan includes significant upgrades to Terminal 2 in excess of A\$ 100 million for the period 2011/2015. In addition, there has been recent significant expenditure on raising safety standards, particularly with respect to the cross-runway<sup>1</sup>. The ACCC Report points out that the value of Sydney Airport's aeronautical tangible non-current assets increased by A\$396m or 18 per cent over the recent 5 year reporting period. Examining the profile of the additions to asset values over the longer period shown in Chart 2.5.1, it is apparent that there was a substantial addition, exceeding 25 per cent of assets, at the beginning of the decade and then much smaller additions until the middle of the decade. Although I am the view that the investment indivisibility argument is over-egged in relation to airports, never the less, lumpiness is still a feature and the paucity of investment early in the decade possibly reflects the combination of substantial (lumpy) investment in 1999-00 providing adequate capacity for some time and a reaction to the impact of 9/11 on the aviation industry. Thereafter from the middle of the decade additions to aeronautical assets look reasonable<sup>2</sup>. Even though, contrary to popular perception, a full blooded monopolist will seek to expand output to some extent in a rising market, the extent of Sydney Airport's recent

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<sup>1</sup> In section 2.5.2 of its Report, the ACCC refers to its 2008-09 report having raised concerns as a consequence of Sydney airport having delayed investment. Apart from the fact that at the time of completing that report large scale investment must have commenced (see Chart 2.5.1), it has to be appreciated that because of some lumpiness, investment does not take place at a constant rate over time.

<sup>2</sup> The ACCC appears rather dismissive of some investment because it was spent on food and beverage facilities etc and not on check-in desks, baggage reclaim and the like (page 47). But this is perhaps to lose sight of the fact that the former is an equally valid component in the airports quality of service offering. The fact that it is geared to the passenger rather than the airline should not matter.

investments do not appear to support the view that the Airport is exercising market power by choosing to withhold supply from the market or by under-investing<sup>3</sup>.

The ACCC places emphasis on the fact that Sydney Airport's prices have steadily increased over time and it suggests that this points to the exercise of market power. The Airport is, however, subject to certain statutory constraints on its ability to expand its capacity; the Airport is subject to a daily curfew and it is subject to a limit on its permitted maximum runway movements. Its general location also limits its scope for easy expansion. As the Airport has noted, "As demand increases, the scarcity of SACC's resources and limitations on SACC's ability to expand to meet increases in demand, is becoming increasingly apparent." The Airport is subject to periods of peak demand when it is operating at, or close to, peak capacity; (it is noted that the ACCC Report provides little information on capacity utilisation at Sydney). Furthermore, given the overall size of Sydney and the physical constraints that it faces, it is probable that Sydney Airport is subject to decreasing returns to scale and thus rising long-run average costs. In the light of these circumstances, we might expect the long-term profile of average prices charged by Sydney to increase in order to allocate existing capacity efficiently and to reflect the underlying profile of costs. These circumstances can, of course, lead to the increasing accrual of economic rent (by the airport), but these rents are a necessary feature of the efficient allocation of constrained supply to downstream users who may also abstract economic rent of a similar nature from their customers (reflected perhaps in the fares paid by passengers using peak period flights). These rents are in the nature of scarcity rents and not monopoly rents. The ACCC's Report does not discuss this issue in relation to aeronautical prices (although it does allude to such issues when discussing car parking charges)<sup>4</sup>.

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<sup>3</sup> I note also the comment of Peter Forsyth, (Airport Policy in Australia and New Zealand in C Winston and G deRus, *Aviation Infrastructure Performance*, Brookings 2008) that generally Australian airports have come under pressure from regional interests to make excessive investments (page 67).

<sup>4</sup> "It is unclear if *Sydney Airport* has reached capacity limits for car parking that is close to the airport terminals. If the airport cannot technically provide more spaces, the margins received by Sydney Airport for car parking may be more reflective of locational advantages." (page xii). More generally with respect to car parking there appears to be a degree of disconnect in the analysis with other airport revenue streams. Airports are multi-product industries, which has led to some discussion in the context of two-sided market theory. That apart,

The ACCC's Report also expresses concern regarding the quality of service delivery by the Airport (see, for example, the quotation at the beginning of this note) particularly to airlines where service quality is regarded as less than satisfactory<sup>5</sup>. But here again the signals are rather mixed. The report states (page 46): "... Sydney Airport's overall rating for quality of service improved more recently. In particular, it is noted that passengers rated the airport's service as satisfactory on average in 2009-10 and, indeed, over the whole reporting period." (emphasis in original text)<sup>6</sup>. However the ACCC appears to downplay this aspect and gives prominence to the views of the airlines (see again the initial quotation). It argues that "importantly" passenger's perceptions can be influenced by the concurrent services provided by airlines and border agencies (Page x). This might be true, but the ACCC can avoid this problem by careful questionnaire design and, in any case, the disaggregation of passenger responses to different components of service as evident in Chapter 8, does allow for a clearer view of the passengers' reactions to those services provided directly by the Airport. Moreover, the ACCC recognises the potential incentives for airlines to deliberately under-report quality, although it tries to do checks to adjust for this (page 16)<sup>7</sup>. Thus, it is not at all clear that the possibly biased views of the airlines are a more reasonable reflection of service quality than the views of passengers subject to wider influences. Apart from that, one has to question whether in some ways the ACCC has lost sight of the broader picture on the question of service quality<sup>8</sup>. The final consumer in this case is the passenger (together with shippers of freight, parcels and a few other sundry 'end-users') and it is, arguably, their views that are the more important. A view to the contrary carries the implication that relationships between firms in the aviation supply chain are better handled through regulation than by recourse to commercial negotiation and contract and that it

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one might expect airports to take into account the demand characteristics of different revenue streams when determining prices for any particular one. According to ACCC, parking prices at Melbourne Airport are of particular concern but it has the lowest aeronautical revenue per passenger. At Sydney the situation is broadly reversed but it is the latter airport that appears to be the focus of ACCC's market power concerns.

<sup>5</sup> However, over the period as a whole the service-to-airlines rating has oscillated around and close to satisfactory and for some components exceeded a score of 3.0 throughout.

<sup>6</sup> Although the passenger quality-of-service rating is referred to as "satisfactory" it was in fact 3.5 (out of 5.0) or between satisfactory and good.

<sup>7</sup> The average result for the airlines might also reflect the fact that different airlines have different requirements and priorities (which sometimes might conflict) and that it might be difficult to manage these different preferences.

<sup>8</sup> See also footnote 2

is the state of such inter-firm relationships rather than the experience of the passenger et al. that should drive airports policy.

In conclusion it is reasonable to point out that the ACCC do not claim that Sydney *is* exercising its market power and they do suggest that the monitoring results do not provide conclusive evidence as to whether or not the airports are earning monopoly power. But in the case of Sydney Airport there is a strong inference that this is the case with statements such as: “the results point to Sydney Airport earning monopoly rents from services provided to the airlines.” A more detailed examination of the evidence might indeed conclude that Sydney Airport is abusing its monopoly power but I am far from convinced that the evidence in the ACCC Monitoring Report shows this to be the case at the present time.