11 May 2000

Prices Surveillance Inquiry
Productivity Commission
Locked Bag 2
Collins Street East Post Office
MELBOURNE VIC 8003

Dear Sirs

Review of the Prices Surveillance Act 1983

Please find attached the Qantas submission in response to the invitation by the Productivity Commission to make an initial submission concerning the inquiry into the *Prices Surveillance Act 1983*.

Qantas is willing to expand on any of the points raised in this submission as required, or provide additional information or data to the Productivity Commission.

If you would like additional information or have any queries in relation to our submission, please call Sarah Collins on (02) 9691 4164.

Yours faithfully,

Brett Johnson
General Counsel & Company Secretary

QANTAS INITIAL SUBMISSION
PRODUCTIVITY COMMISSION INQUIRY
PRICES SURVEILLANCE ACT 1983

This submission responds to the invitation by the Productivity Commission to make an initial submission concerning the inquiry into the *Prices Surveillance Act 1983* ('**PS Act**').

Qantas is a substantial user of services provided by Australian airports. As noted in your issues paper, a variety of airport services have been declared for the purposes of prices surveillance or monitoring under the PS Act. Additionally, services provided by Airservices Australia are subject to prices surveillance by the ACCC under the Act.

Accordingly, Qantas has a direct interest in your inquiry. If recommendations are made to amend or repeal the PS Act, this will impact directly on Qantas. Specifically, the removal of price control over various airport services or services provided by Airservices Australia will detrimentally impact on Qantas.

It is unclear from the issues paper whether the Productivity Commission intends to investigate the economic conditions prevailing in each industry which is subject to regulation under the PS Act, and particularly the airport industry. As you will be aware, the Australian Competition & Consumer Commission ('**ACCC**') has been requested to review the prices oversight arrangements applying to Melbourne, Brisbane and Perth airports by the end of 2001. That review will commence in December 2000, although in November 1999 the ACCC published its proposed approach and guidelines in a document titled 'Airports Review'. Qantas will be making detailed submissions to the ACCC as part of that review.

This initial submission briefly outlines the relevance of your inquiry to Qantas by addressing 3 issues:

- the market power of airports in the provision of many of their services;
- the role and effectiveness of regulating prices of airport services under the PS Act; and
- alternative methods of regulating prices of airport services.

As this is an initial submission, the above points are discussed relatively briefly. We would be pleased to expand on any points, and provide additional information and data, if requested by the Productivity Commission.

Qantas would also be pleased to provide comments in relation to price regulation of Airservices Australia, which has not been specifically addressed in this initial submission. Many of the comments made in relation to airports are, however, relevant to Air Services Australia.

Market Power of Airports

Qantas generally supports the shift which has occurred in the focus of the PS Act to sectors of the economy where competition is weak or non-existent. Qantas also supports the corresponding reduction in the number of organisations and goods subject to surveillance under the PS Act. However, Qantas believes that price regulation, whether under the PS Act or other legislation, should apply to industries such as airports which have natural monopoly characteristics and very substantial market power.

It is widely accepted that the major Australian airports have substantial market power over a range of airport services. This market power arises from the natural monopoly characteristics possessed by those airports.

In its inquiry into the aeronautical and non-aeronautical charges of the Federal Airports Corporation (Report No 48, 1993), the Prices Surveillance Authority commented:

> *'Airport service markets are largely non-contestable: provision of airport services tends to be characterised by very large sunk costs and high barriers to entry. In addition, there appear to be economies of scale in the provision of airport services and significant economies of utilisation over a range of levels of airport activity, which ensure natural monopoly status. Airports, like other utilities, exhibit joint and common production cost characteristics in the production of multiple services. Airports generally can be considered to be local monopolies in the provision of aeronautical services. Finally, the characteristics of airports has led to regulation of airport charges in several countries, including the United Kingdom.'* (pp 47-48).

This conclusion did not depend on all airports being owned by the Federal Airports Corporation. In the same report, the Prices Surveillance Authority considered the extent of competition between airports. It concluded that:

> *'…. the major airports in Australia are not particularly good substitutes for each other. Apart from a few areas where there are effective alternative airports in close proximity, such as the New South Wales north coast, most destination regions offer only one airport. In the capital cities, only the major airports are capable of handling large jet aircraft used by RPT [Regular Passenger Transport] airlines.'* (p51).

These conclusions have been reaffirmed more recently by other bodies. In its draft guide to section 192 of the *Airports Act*, the ACCC commented:

> *'The combination of economies of scale and significant entry and exit costs means that most larger airports, including most if not all core regulated airports, could not be economically duplicated.'* (p vii).

In considering an appeal by Sydney Airports Corporation Limited ('**SACL**') against declaration of various services pursuant to section 44H of the *Trade Practices Act 1974 (Cth*) ('**TPA**'*)*, the Australian Competition Tribunal commented:

> *'The Tribunal heard that most major commercial airports around the world exhibit strong natural monopoly or bottleneck characteristics. Once the basic infrastructure (runways, taxiways, control tower) is in place, the owner of the facility faces sharply falling costs of servicing increments of demand (economies of scale). By contrast, a new entrant would have to replicate this basic infrastructure which is inherently capital intensive.*
>
> *'Such airports also typically provide a bundle of services, (for example, international and domestic passenger and freight services). In addition, many airports also benefit from economies of scale and scope generated by strong network effects associated with the geographic location and the absence of viable transport modes. Passengers typically travel to destinations, not airports, and airlines will prefer to locate at one airport so that they may gain commercial benefits from interconnecting with other services and airlines.*
>
> *'SIA [Sydney International Airport] exhibits very strong bottleneck characteristics:*
>
> - *not only is it Sydney's only international airport, it is Australia's major international airport, handling some 50% of international air freight leaving and entering Australia;*
> - *it handles the largest portion of total international passenger traffic entering and leaving Australia;*

- *it is a national and regional interconnector with domestic passengers travelling overseas, with the two domestic carriers (Qantas and Ansett) having invested very large sums in their passenger handling facilities.'*

The Tribunal identified a *'market controlled by SACL, for the provision of the complete suite of physical assets necessary to service international airlines flying into and out of the Sydney region - these assets exhibit very strong monopolistic (or bottleneck) characteristics because of pervasive economies of scale and scope and barriers to entry derived both from high sunk costs and the market size and location'*.

It is apparent from the foregoing that the possession of substantial market power by major Australian airports has been well recognised by a variety of economic regulatory bodies.

Additionally, Qantas has numerous examples of the use of that market power by airports to achieve monopoly prices in areas which are unregulated or inadequately regulated. There are also clear indications that monopoly prices would be charged for regulated services if they were not regulated. A recent example is SACL's proposal to increase aeronautical charges from $98 million to $212 million per annum commencing 1 November 2000.

Role and Effectiveness of Regulation under the PS Act

As discussed in the issues paper, the PS Act assigns three functions to the ACCC: prices surveillance, prices monitoring and holding price inquiries. Strictly speaking, the PS Act does not contain powers of price control or regulation.

Despite this, in the context of the airport industry, the PS Act is being used to control and regulate prices for airport services. Under instruments issued pursuant to the PS Act, all major Australian airports (other than Sydney Airport) are subject to a price cap of the CPI - X form. Although the ACCC does not have express legislative power to enforce the price cap, the conduct of all airports to date indicates that they accept the price cap as binding.

Whilst there is no CPI-X price cap applicable at Sydney Airport, its aeronautical services are declared under the PS Act and it is required to notify the ACCC of any price increases. Under an instrument issued pursuant to the PS Act, the ACCC has been directed to take into account certain matters in considering whether to approve any proposed price increase, including the starting point prices at the time of transfer of the airport assets from the Federal Airports Corporation to SACL.

The PS Act in its application to airports is still relatively new - Phase 1 airports were privatised in 1997 - and the effectiveness of the airports regulation is still being tested. For privatised airports, the PS Act together with the instruments issued under it have prevented price increases for declared services other than for new investment. However, the effectiveness of the PS Act in regulating or controlling prices at airports can be questioned in a number of areas.

(i) Scope of declared services

First, the ***scope*** of services subject to price regulation is unsatisfactory. Not only is the definition of 'aeronautical services' unclear, but the policy basis for distinguishing between aeronautical, aeronautical-related and non-aeronautical services is not stated expressly in the regulatory instruments. The 'Pricing Policy Paper' issued by the Department of Transport and Regional Development in November 1996 states that in connection with the privatisation of airports the Federal Government sought to maintain the scope of price regulation previously contained in the *Federal Airports Corporation Act*. However, this approach failed to take account of criticisms previously made by the Prices Surveillance Authority about the scope of regulation under the *Federal Airports Corporation Act*. In Report No 48, the Prices Surveillance Authority commented:

'The PSA considers the basis of prices surveillance in this case should be the existence of market power in the supply of services, rather than an apparently arbitrary definition of charges.' (p59).

Qantas believes that the existing scope of services subject to price regulation should be broadened. There may be an advantage in a body such as the ACCC having power to determine that additional services provided by airports should be regulated, and to regulate those services accordingly. Indeed, Qantas considers that there are good economic reasons for regulating the entire business of an airport operator, an approach which has been adopted at many airports around the world.

The difficulties of the existing definitions of aeronautical and aeronautical-related services under the existing PS Act regulation of airports is illustrated in the ACCC's report concerning Fuel Throughput Levies (December 1998), which is discussed further below.

One of the questions asked in the Productivity Commission's issues paper is 'has implementing the PS Act succeeded in limiting the use of market power by declared organisations? Are there instances where the intended objectives of the Act have not been achieved through its application?' Qantas' view is that there are numerous instances where airports have been able to use their market power to charge monopoly prices. This has occurred in relation to services that are not declared as aeronautical services under the PS Act. It would also occur in relation to declared services if SACL is successful in its current pricing proposal.

We would be willing to provide further information concerning these issues if required by the Productivity Commission.

(ii) ACCC's lack of regulatory powers

The second area in which regulation under the PS Act is deficient is the ***regulatory powers*** given to the ACCC under that Act. As noted already, the PS Act does not empower the ACCC to enforce a price cap, but instead relies on voluntary compliance. Qantas considers that the PS Act should be strengthened to ensure that prices for services which are declared under the Act are not increased without ACCC approval.

Additionally, the ACCC's prices surveillance role is confined to assessing compliance with a price cap (for privatised airports) or proposed price increases (for Sydney Airport). The ACCC cannot perform a proper regulatory role. For example, if an airport ceases to supply a range of aeronautical services, the ACCC is not empowered to lower the price cap. Accordingly, airport operators have considerable freedom to exercise market power by reducing the quantity or quality of services free from regulatory oversight.

The powers of the ACCC in relation to price monitoring are also deficient. In its report concerning Fuel Throughput Levies in December 1998, the ACCC determined that there was a strong case that by introducing fuel throughput fees the airports were taking advantage of market power and that the introduction of the fees together with a number of other factors *'could erode some, or all, of the intended benefits of the price cap and potentially compromise the effectiveness of the present prices oversight arrangements'*. The ACCC's report recommended to the Treasurer that aircraft refuelling services be included within a CPI-X price cap. Approximately 18 months later, those services are still not subject to a cap and the fuel companies have passed the charges through to Qantas. As discussed above, if the ACCC were to be given the power to determine that additional services provided by airports should be regulated, and to regulate those services, situations as have occurred in relation to fuel throughput might be avoided.

It would also be helpful if the ACCC could initiate inquiries in relation to airport pricing without needing the Minister's approval.

(iii) Regulatory criteria

The third area in which PS Act regulation is deficient is in the ***regulatory criteria*** to be applied by the ACCC in making price decisions. As outlined in the issues paper, the primary statutory criteria which must be taken into account by the ACCC are contained in section 17(3), being the need to:

- maintain investment and employment, including the influence of profitability on investment and employment;
- discourage an organisation with market power from taking advantage of that power when setting prices; and
- discourage cost increases which stem from wage increases or changes in employment conditions that are inconsistent with the principles established by relevant industrial tribunals.

The Minister may also direct the ACCC to give special consideration to additional matters. In the context of the airport industry, specific directions have been given to the ACCC. For all airports other than Sydney Airport, those directions include compliance with the price cap. In addition, for all airports the ACCC has been directed to consider specific criteria when assessing proposed price increases resulting from new investment.

Qantas believes that the specific directions to the ACCC applicable at privatised airports, particularly the price cap, have played an important role. However, section 17(3) probably requires re-consideration. Whilst the second criterion in section 17(3) is very relevant to organisations with market power, the first and last criteria are now somewhat dated and have not been amended since the enactment of the PS Act in 1983. Although probably relevant to the original policy objectives of the PS Act, the criteria in section 17(3) are insufficient to guide the regulation of prices in an industry which exhibits natural monopoly characteristics. By way of contrast, in performing its price regulatory function under the National Electricity Code, the ACCC must seek to achieve the following outcomes:

(a) an efficient and cost effective regulatory environment;

(b) an incentive based regulatory regime which:

  (i) provides an equitable allocation between asset users and asset owners of efficiency gains reasonably expected to be achievable by the asset owner; and

  (ii) provides for a sustainable commercial revenue stream which includes a fair and reasonable rate of return to the asset owner on efficient investment, given efficient operating and maintenance practices;

(c) prevention of monopoly rent extraction by the asset owner;

(d) an environment which fosters an efficient level of investment;

(e) an environment which fosters efficient operating and maintenance practices;

(f) an environment which fosters efficient use of existing infrastructure;

(g) reasonable recognition of pre-existing policies of government regarding asset values, revenue paths and prices;

(h) promotion of competition in upstream and downstream markets;

(i) reasonable regulatory accountability through transparency and public disclosure of regulatory processes and the basis of regulatory decisions;

(j) reasonable certainty and consistency over time of the outcomes of regulatory processes;

(k) reasonable and well defined regulatory discretion which permits an acceptable balancing of the interests of asset owners and asset users,

(Clause 6.2.2 of the National Electricity Code).

Qantas considers that the approach to be followed by the ACCC in assessing proposed price increases should be clearly specified in the legislation and any specific Ministerial directions.

Alternative Methods of Price Regulation

Both before and after the Hilmer Report in 1993, the need for price regulation in a number of industries has been recognised. These are industries which exhibit natural monopoly characteristics and include telecommunications, electricity transmission and distribution, gas transmission and distribution, rail networks, ports and airports.

Generally, price regulation has been implemented on an industry by industry basis. In one sense, price regulation in each of these industries has been based around the principle of access. Each of these industries are characterised by a bottleneck facility; open and efficient access to the bottleneck facility is required to facilitate competition in upstream or downstream markets. Nevertheless, the access regime contained in Part IIIA of the TPA has not been regarded as a sufficient instrument to regulate access and prices in these industries. In all cases, additional legislative regimes have been created.

The issues paper specifically asks the question whether Part IIIA is a sufficient substitute for price regulation under the PS Act. Qantas believes there is clear evidence that Part IIIA is not an appropriate method of regulating prices in an industry with strong natural monopoly characteristics. Qantas also believes that airports are quite different to other regulated monopoly industries because of the range of services at and users of airports. As a result, it is imperative that there is some form of price regulation in addition to Part IIIA as discussed further below .

There are a number of significant deficiencies in the access regime created by Part IIIA.

First, the process for having bottleneck facilities declared for the purposes of Part IIIA is slow and complex. The recent decision by the Australian Competition Tribunal in March 2000 to declare specific services at Sydney International Airport was made approximately three and a half years after an application for access to the services was first made to the National Competition Council.

This deficiency has been overcome within the regulatory regimes governing other industries. In industries such as electricity, the services to which access is permitted are defined within the regulatory regime. The regulator's role is to determine the price for, and quality of, the services provided.

In the airport industry, section 192 of the *Airports Act* is intended in part to overcome this deficiency of Part IIIA. However, it is an imperfect solution. It requires the ACCC, before arbitrating a dispute, to form a judgement about the economic duplication of facilities, a similar test which exists within Part IIIA, and about the necessity of the service for civil aviation. The first determination made by the ACCC under section 192 took approximately 12 months to conclude (Delta Car Rentals 1999). Additionally, section 192 does not apply to Sydney Airport.

Any delay is clearly to the advantage of the monopoly service provider. The consequence for access seekers is that the airport's proposed monopoly prices must be accepted if the user requires the service for its business. Qantas has had this experience both with services covered by section 192 and services which the ACCC does not consider to be covered but which could be declared under Part IIIA (for example, space for airport lounges).

Secondly, the TPA does not protect users who obtain services from other airport users which are themselves monopolies. For example with fuel throughput levies, charges are levied by airports on the Joint User Hydrant Installation and passed onto oil companies and then Qantas. Qantas is unable to take action itself in relation to the airports' charges as Qantas is seeking its service from the oil companies and not from the airport. The oil companies have little incentive to fight the charges as they can be passed on to the airlines.

The third deficiency of the access regime contained in Part IIIA is that price decisions are made individually for each service user. For example, if Part IIIA were the only regulatory instrument controlling prices for airport services, each airport user would need to negotiate directly with airports and, in the event of disputes, notify the disputes to the ACCC. The ACCC would then be required to arbitrate each individual dispute. Not only would such an approach be costly, time consuming and inefficient, it would also be extraordinarily complex and prone to error. In making individual pricing decisions, the ACCC would be required to allocate common costs between a range of different airport users. The ACCC would seek to avoid 'double dipping', whereby the airport operator recovers the same costs from different users. However, this task would have to be done on an individual basis as each dispute was notified.

Commercial activity at airports is characterised by a large number of users (comprising both airlines and other commercial entities providing services such as ground handling and catering services) acquiring a large range of services from the airport operator. Accordingly, there are a large number of commercial transactions which occur at the airport. In these circumstances, the transaction costs of requiring each user to negotiate terms and conditions of access to services within the framework of Part IIIA of the TPA will be substantial. Qantas submits that such a regulatory approach would place enormous burdens on Australia's aviation industry, reducing its efficiency.

In contrast, in other industries (eg electricity transmission) the government or a regulator sets a revenue or price cap applicable to the commercial activities undertaken by the monopoly provider. The maximum revenue is then allocated between services and users. Such an approach is desirable because it ensures that all costs are properly allocated to users and allocated only once. The pricing is efficient and fair. The PS Act together with the Ministerial directions for privatised airports go some way to achieving this, since the declared services are subject to a price cap. However we note that while the PS Act establishes an overall price cap applicable to a range of airport services, it does not:

- apply to all services provided by the airport (and therefore there is potential for recovering costs more than once); or

- set in place any mechanisms to prevent price discrimination between users, or excessive prices being charged for certain services.

Although the PS Act suffers from the deficiencies outlined above and earlier in this letter, it is preferable to relying solely on Part IIIA.

While Part IIIA is an inadequate replacement for price regulation of airports, it is nevertheless an important component in the regulation of airports. Part IIIA can be used to address instances of monopoly pricing in respect of individual services (even though the airport may remain within the price cap). Also, disputes between airport operators and users may also arise in respect of terms and conditions of access to airport services and facilities. These issues are not addressed under the PS Act. Accordingly, Part IIIA is an important supplement to the PS Act regulation of airports.

Conclusion

In conclusion, Qantas is a substantial user of airport services and Airservices Australia's services. A variety of these services are currently subject to regulation under the PS Act. The amendment or repeal of the PS Act will have a detrimental impact on Qantas, unless a new and improved form of regulation is implemented.

Qantas believes that price regulation of airport services under the PS Act has a number of deficiencies. In that context, Qantas is interested in exploring improvements to the PS Act or alternative regulatory frameworks for airport services. We also note that the ACCC is required to review the regulatory framework for airport services and report by the end of 2001.

Qantas believes that the access regime under Part IIIA of the TPA is not an adequate or appropriate framework for price regulation of airport services. Most importantly, the use of such a regime would create substantial transaction costs for the large number of users of airport services. These costs would create substantial inefficiencies for Australia's aviation industry. Additionally, the delay in determination of any access applications under such a regime may often result in the scheme not being used and the monopoly prices of airports having to be accepted.

As indicated earlier, Qantas would be willing to expand on any of the points raised in this submission as required, or provide additional information or data to the Productivity Commission.