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*23 February, 2001*

*Dr. Neil Byron*
*Commissioner*
*Productivity Commission*
*Locked Bag 2*
*Collins Street East*
*MELBOURNE VIC. 8003*

*Dear Dr. Byron,*

*REVIEW OF PRICES SURVEILLANCE ACT (PSA)*

*Please find enclosed the Australian Airports Association submission with regard to the above subject heading. Should there be any further or immediate queries I can be contacted at any time on the above telephone number.*

*The Association would welcome the opportunity, at any future hearing, to discuss in more detail the issues raised in our submission.*

*In the meantime we thank you and your fellow Commissioners for the opportunity to make a formal written submission.*

*Yours sincerely,*

*Ken Keech*
*Chief Executive*

# AUSTRALIAN AIRPORTS ASSOCIATION

# SUBMISSION TO THE PRODUCTIVITY COMMISSION

# Review of the *Prices Surveillance Act 1983*

## Introduction

The Australian Airports Association (**"the AAA"**) comprises 235 airport members, and thus includes almost every airport within Australia. Included in its membership are all the airports which are subject to price regulation under the *Prices Surveillance Act 1983* (**"the PSA"**). This submission is made on behalf of the AAA itself and, while it represents a commonality of view amongst affected airport operators, does not purport to necessarily reflect in detail the individual view of each affected operator.

Collectively, AAA members account for the majority of companies currently declared under the PSA, and all of the airport operators declared under the PSA. They are thus well placed to provide the Productivity Commission with an important insight into the effectiveness of, and problems caused by, the present operation of the PSA as a price control measure.

The AAA has noted with interest, and agrees with, the interim findings set out in the Commission's Interim Report of October 2000. In summary, those findings were that:

- Australian prices oversight is no longer an instrument aimed at moderating inflation but should now be seen as part of competition policy with its primary focus on pricing by firms with substantial market power;

- prices oversight should be used as a remedy of last resort because of its limitations and potential costs (not only for those regulated and thereby their customers, but also for the regulator and thereby the taxpayer);

- the PSA has significant deficiencies and fails to meet best practice principles for legislation and prices oversight; and

- the PSA has the potential to inhibit and retard the development of pro-competitive options, particularly in industries which historically have been considered to have market power.

The AAA notes that, prior to forming its final recommendations to Government, the Commission intends to produce a draft report in the first quarter of 2001 as a basis for further consultation with interested parties.

However, the AAA considers it appropriate to make this submission ahead of the production of that draft report in order to assist the Commission in developing its consideration of how those interim findings should be reflected in the Commission's draft report and recommendations for future action. This is particularly so given that various submissions to the Commission from Qantas, Ansett and the Board of Airline Representatives in Australia (**"BARA"**) present what the AAA regards as a significantly deficient and inaccurate view of the operation of the PSA so far as it relates to Australian airports and as short-sighted in terms of economic efficiency and public policy.

The AAA believes that recommendations focussed simply on rewriting of the PSA to better state its objectives and to refine the associated administrative processes would be wholly inadequate and fall well short of the remedial action that should now be taken, at least in relation to the airport industry. In the view of the AAA, far more fundamental reforms are required insofar as pricing at Australian airports is concerned.

## Summary of This Submission

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.

## Relationship with other Commission Inquiries

The AAA notes that, separately from its PSA Inquiry, the Commission is undertaking a review of Part IIIA of the TPA as part of its National Access Regime Inquiry. The AAA intends to lodge a submission with the Commission in the course of that Inquiry in which it will review the experience of AAA members in Part IIIA matters.

The AAA also notes that the Commission has been directed by the Assistant Treasurer to conduct the scheduled 5-year review of airport pricing. The AAA will provide a separate submission to the Commission in response to the specific terms of reference for the Price Regulation of Airport Services Inquiry. However, it considers that the proposals in this submission are fully consistent with the aims that should desirably be sought to be achieved by the Commission in the course of that Inquiry.