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Submission to the Productivity Commission's inquiry into the economic regulation of airport services

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Executive Summary

The airports have market power

The Productivity Commission's (PC's) draft report finds that Brisbane, Melbourne, Perth and Sydney airports – and to a lesser extent Adelaide Airport – have 'sufficient market power to be of policy concern'. It recognises that efficiency losses may result if that power is exercised.

The exercise of market power can result in detriment to Australians in a number of ways. Firstly, high prices (and/or low quality) can result in inefficient under-utilisation of airport infrastructure and services, including by airlines, passengers and related markets such as those that rely on goods transported by air. Secondly, firms with market power may inefficiently under invest, so that demand for their services will exceed supply, leading to further potential for monopoly prices. This can also lead to underinvestment in related markets. Thirdly, an airport exercising its market power could operate inefficiently by allowing its costs to rise or by it not adopting cost-saving or innovative technologies. Finally, monopoly pricing is of concern to the community and consumers, especially as they will ultimately pay for any monopoly rents.

The monitoring regime has identified concerns about the exercise of market power

The ACCC has monitored the performance of airports in various forms since 1997-98. In recent airport monitoring reports, the ACCC has identified trends that raise concerns that some airports may have exercised their market power, particularly in the provision of aeronautical services (services provided to airlines) at Sydney Airport and landside services (such as car parking) at Melbourne Airport.

The PC's draft report has proposed that monitoring continue and that the airports' exercise of market power be constrained by the threat of sanction if, following concerns raised in monitoring reports, the ACCC conducts a 'show cause' process and Part VIIA price inquiry and finds that an airport has exercised its market power.

The ACCC submits that more monitoring and inquiries will not constrain the exercise of airports' market power and does not provide an effective ongoing solution. Although Part VIIA price inquiries could examine whether certain airports have exercised their market power, the potential for annual ex-post investigations will impose additional costs and uncertainty.

An effective permanent solution is needed.

Facilitation of commercial negotiations constrains the exercise of market power and provides an effective permanent solution

An effective solution would be one that encouraged bona fide market-based commercial outcomes; that is, normal commercial agreements arrived at absent the exercise of the airports' market power. Such agreements will promote efficiency and better outcomes for consumers and for businesses in related markets.

Such an effective permanent solution could be achieved by addressing the imbalance in bargaining power of the parties, so that the exercise of market power could be constrained.

The ACCC has proposed the use of deemed declaration for aeronautical services and mandatory undertakings for landside services under Part IIIA of the *Competition and Consumer Act 2010* (CCA). However, it recognises that others have argued for a fit-for-purpose airport regime, rather than use of Part IIIA. The ACCC agrees that the legal mechanism is less important than the substantive outcome of promoting competition and efficiency.

For aeronautical services, the existence of a credible ability to seek arbitration would balance the bargaining power of the parties. It would encourage, not inhibit the development of commercial relationships between the airports and their customers. Practical experience – including in the airport industry itself when Sydney Airport domestic services were declared – has shown that parties greatly prefer to reach commercial agreements rather than fall back on ACCC or any other arbitration.

Recognising that parties involved in seeking access to landside services may be smaller and less able to negotiate effectively, mandatory access undertakings would best facilitate commercial negotiations, limit transaction costs and give airports and their users greater certainty about the access conditions applying to the airports' infrastructure.

1. Introduction

The Productivity Commission's (PC's) draft report finds that the major Australian airports have 'sufficient market power to be of policy concern'. It recognises that efficiency losses may result if that market power is exercised.[1]

To control the exercise of market power, the PC's draft report proposes to rely on an 'ex post' regulatory regime where the ACCC, based on the information obtained through the monitoring program and after conducting a 'show cause' process, could ask the Minister to approve a Part VIIA inquiry.

This differs from the ACCC's suggested approach that the airports regulatory regime move to an 'ex ante' approach of deemed declaration and mandatory access undertakings under Part IIIA, where those airports with significant market power are identified and their ability to exercise market power is constrained by the threat of arbitration by the ACCC (for aeronautical services) or by a court-enforceable access undertaking (for landside services).

The use of Part IIIA does not represent a return to price caps. Rather, it provides parties with the fallback of arbitration through the use of Part IIIA. The existence of a credible ability to call on arbitration restrains the ability of the airports to exercise their market power. In this sense, the ACCC submits that Part IIIA can be considered as a relatively light-handed but fit-for-purpose form of regulation for Australian airports.

On this point, the ACCC is concerned that the PC's draft report underestimates the costs, resources and time required to conduct Part VIIA inquiries. Importantly, the process under Part VIIA, which provides the potential for annual ex post investigations of conduct that can involve price freeze periods, can not be considered as a relatively light-handed form of regulation.

2. The major Australian airports have market power

The PC's draft report finds that Brisbane, Melbourne, Perth and Sydney airports – and to a lesser extent Adelaide Airport – have 'sufficient market power to be of policy concern'. It recognises that efficiency losses may result if that power is exercised.

The exercise of market power can result in detriment to Australians in a number of ways. Firstly, high prices (and/or low quality) can result in inefficient under-utilisation of airport infrastructure and services, including by airlines, passengers and related markets such as those that rely on goods transported by air. Secondly, firms with market power may also inefficiently under invest, so that demand for their services will exceed supply, leading to further potential for increased prices. This can also lead to underinvestment in related markets. Thirdly, an airport exercising its market power could operate inefficiently by allowing its costs to rise or by it not adopting cost-saving or innovative technologies. Finally, monopoly pricing is of concern to the

[1] For further information on the terminology used by the ACCC as opposed to the PC in relation to market power refer to Annexure 1.

community and consumers, especially as they will ultimately pay for any monopoly rents.

3. The ACCC's monitoring regime has identified concerns about the exercise of market power

The ACCC airport monitoring reports of 2008-09 and 2009-10 made a number of findings, key of which were that:

- the monitoring results, when considered with the airport's incentives and ability to exercise its significant market power, point to Sydney Airport earning monopoly rents from services provided to airlines;
- information provided to the ACCC as a part of the monitoring program indicates that car parking prices at Melbourne Airport are of particular concern
    - Melbourne Airport appears to have reduced the ability of off-airport parking and private bus operators to compete with its own car parking services by imposing excessive access levies and controlling the available space for those operators. This can lead to increased demand for on-airport parking, which brings about higher prices paid by consumers and allows Melbourne Airport to earn monopoly rents.[2]

However, the airport monitoring results do not in themselves provide conclusive evidence as to whether or not the airports are earning monopoly rents for aeronautical or landside services such as car parking. The airport monitoring results only provide for indirect indicators of economic efficiency.[3]

Nevertheless, in comparing the market characteristics and expected outcomes against the information provided to the ACCC, observations can be made that raise questions about the airports' performance. The ACCC concluded that a more detailed evaluation of the major airports' performance – which is beyond the scope of a monitoring exercise – would be required to make more definitive findings.

The Minister brought forward the PC's review so that the findings of the ACCC's airport monitoring reports could be examined further.[4]

4. Ongoing monitoring and price inquiries are not effective in constraining the exercise of market power

The ACCC considers that monitoring can provide information on trends in pricing and service delivery over a period of time, which provide indications about the airports'

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2 ACCC, *Airport Monitoring Report 2009-10: Price, financial performance and quality of service monitoring*, January 2011, p. vii.

3 ibid, p. 45, 72.

4 In the 2009 National Aviation Policy White Paper, the Government announced that it would continue with the existing regime including the price and quality of service monitoring conducted by the ACCC with a review to be conducted by the PC in 2012. The Government had reserved the right to conduct the review earlier.

performance and the need for further investigation. It can also assist in bringing about transparency where there is information asymmetry. However, price monitoring of itself is not effective in constraining the airports' exercise of market power.

Additionally, monitoring represents an unnecessary burden on airport businesses. Price monitoring is not a costless activity, with both airports (through compliance costs under the *Airports Act 1996*), and the ACCC (through the costs of publishing the airports monitoring reports annually) bearing some costs.

The ACCC notes that further monitoring and inquiries, whether Part VIIA inquiries or any other, are no more likely to constrain the use of market power by major airports. In its draft report, the PC states that it has '…not conducted a forensic examination of the prices at each monitored airport', and that while it 'is suited to system wide reviews from an economy-wide perspective, it is less suited to undertaking forensic evaluations into individual airports' conduct.'[5] The ACCC agrees that a Part VIIA inquiry by the ACCC or another body might be able to do that. However, it will impose additional costs and uncertainty and will not provide an effective ongoing solution to constrain the ability of the airports to exercise their market power. Furthermore, the potential for annual ex-post investigations of conduct that can involve price freeze periods can not be regarded as a relatively light-handed form of regulation.

The ACCC considers that there are more appropriate regulatory tools (such as deemed declaration and mandatory access undertakings, discussed below) available to achieve competitive market outcomes and effective access.

Part VIIA of the CCA was derived from equivalent provisions in the *Prices Surveillance Act 1983* (PSA). Under the PSA, inquiries were used for a number of purposes, including:

- to determine whether pricing outcomes reflected competitive market forces;
- to advise the Minister on what types of prices oversight, if any, should be applied to the company or companies under inquiry;
- to assess price notifications in greater depth and to encourage compliance with determinations about notified price increases;
- to play an educative role by bringing information into the public domain, thereby facilitating public understanding of the pricing matters at issue.[6]

These roles remain today. In recent times, the ACCC has conducted thorough evaluations of industry structure and conduct through Part VIIA price inquiries, such as those for unleaded petrol[7] and groceries.[8] There are a number of issues to consider before undertaking a price inquiry. Regardless of their type, price inquiries are costly, resource- and time-intensive processes and are not designed to be an effective form of

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5 Productivity Commission, *Draft Report: Economic Regulation of Airport Services*, August 2011, p. 112, 241.

6 Productivity Commission, *Inquiry Report: Review of the Prices Surveillance Act 1983*, 14 August 2001, p. 4.

7 ACCC, *Petrol prices and Australian consumers: report of the ACCC inquiry into the price of unleaded petrol*, December 2007.

8 ACCC, *Report of the ACCC inquiry into the competitiveness of retail prices for standard groceries*, July 2008.

utility regulation.[9] Both the petrol and grocery inquiries took approximately six months[10] to complete and both involved:

- submissions;
- information and document requests (with penalties for failure to produce the information or documents);
- public hearings (often involving summonses under the CCA);
- data requests; and
- the taking of evidence on oath or affirmation, subpoenas.

However, while price inquiries investigate market situations to determine the nature, significance and causes of alleged pricing problems, a price inquiry will not in and of itself resolve those pricing problems or restrain the exercise of market power any more than price monitoring under Part VIIA would.

The PC's draft report proposal for Part VIIA price inquiries will not resolve the industry's market power concerns. It will simply result in the possibility of more inquiries, more costs and further delay to achieving an effective regulatory outcome. The costs of price monitoring to the airports and the ACCC are not trivial. Price inquiries are even more costly and time-intensive, and are not designed to be an effective form of utility regulation. Indeed, significant costs are likely to lie in the uncertainty and annual risk that an ACCC inquiry and consequent price regulation represents for incentives to invest in airports.

5. Having arbitration as a fallback encourages bona fide commercial negotiation

The PC has recommended that an airport specific arbitration regime of deemed declaration of airports under Part IIIA should not be introduced, because 'expedited access to arbitration at the contract formation stage could fundamentally undermine light-handed regulation' and risk a return to 'institutionalised determination of charges and conditions.'[11]

The ACCC considers that deemed declaration would not undermine the principle of light-handed regulation. Arbitration under Part IIIA is not a given. Having arbitration as a fallback is intended to ensure efficient access to essential services, by addressing the imbalance in bargaining power between monopoly service providers and access seekers.

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[9] Price inquiries also judge the performance of an industry ex post when the ex ante rules of regulation are not clear or not yet in place. In other regulated industries, such as gas, the ACCC has observed that the design and ex ante application of regulation has substantially mitigated theoretical concerns regarding incentives for investment.

[10] The Minister for Competition Policy and Consumer Affairs requested that the grocery inquiry be commenced on 22 January 2008. The ACCC provided its report to the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs on 31 July 2008. The former Treasurer agreed to the holding of an inquiry into the price of unleaded petrol on 15 June 2007. The inquiry was initially to be completed and a report submitted to the Treasurer by 15 October 2007. This date was subsequently extended to 15 December 2007.

[11] Productivity Commission, *Draft Report*, August 2011, p. 249.

The ability of either side to seek arbitration makes it more difficult for any party to exercise market power. If an airport attempted to set prices substantially above those likely to be determined by the ACCC, airlines could credibly threaten to raise a dispute through arbitration. In so doing, it would provide airlines with countervailing power where necessary. By putting the commercial negotiation on a more neutral footing, it encourages bona fide commercial negotiation and promotes efficient market-based outcomes that do not reflect the inefficiencies and loss of national welfare that arise from the exercise of market power.

It is the mere existence of a credible ability to resort to arbitration that encourages the development of bona fide market-based commercial relationships between the airports and their customers.

The Hilmer Committee addressed the issue of access to essential services and found that while there is usually no legal duty for one company to do business with another:

> The law has long recognised that this freedom may require qualification on public interest grounds in some circumstances, particularly where a form of monopoly is involved.
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> …
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> … there are some industries where there is a strong public interest in ensuring that effective competition can take place…Where such a clear public interest exists, but not otherwise, the Committee supports the establishment of a legislated right of access, coupled with other provisions to ensure that efficient competitive activity can occur with minimal uncertainty and delay arising from concern over access issues.[12]

The PC has expressed concern that arbitration would be viewed by airlines as the default option. The ACCC reiterates the view from its March 2011 submission, that for vertically-separated businesses such as airports, it is more likely the threat of arbitration would create an incentive for parties to enter into constructive negotiations. Negotiated terms and conditions for access have some obvious benefits over an outcome determined by arbitration due to greater certainty and speed of outcomes, and transaction cost savings.[13] In *Virgin Blue Airlines*, The Australian Competition Tribunal found that:

> …declaration need not result in arbitration. The parties are free to reach commercial agreements and will have a clear commercial and financial incentive to do so.
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> …
>
> We consider that the availability of a binding dispute resolution process provides an incentive for parties to negotiate in a realistic, practical and positive manner in an attempt to resolve differences which affect, and have a real impact on, their daily commercial activities. Indeed, we consider that the availability of a binding dispute resolution process will bring about a more efficient outcome than a situation where no such process is available….[14]

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[12] *National Competition Policy Report by the Independent Committee of Inquiry* (25 August 1993) (Hilmer Report), p. 242 and 248.

[13] Australian Competition and Consumer Commission, *Submission in response to the Productivity Commission's issues paper on the 'Economic Regulation of Airport Services'*, 21 March 2011, p. 23.

[14] *Virgin Blue Airlines Pty Ltd* [2005] ACompT 5, para 594; para 604.

The Tribunal's findings are consistent with the Hilmer Committee, which noted that once a declaration has been made 'the parties are then free to negotiate their own agreements…if the parties cannot agree either party may seek binding arbitration by or under the auspices of the Australian Competition Commission'.[15] This view is supported by the commercial resolution of the access dispute between Virgin Blue and Sydney Airport in 2007 and by the relatively small number of disputes that do arise when a declaration is in place. The PC argues that this lack of use is noteworthy, however the ACCC would argue that the relatively small number of disputes is indicative of the success of arbitration under Part IIIA as a credible threat, rather than a failure.

The National Competition Council (NCC) has found the declaration process and the possibility for arbitration to be a non-intrusive form of regulation:

> This 'light handed' regulatory approach is intended to encourage the commercial resolution of access issues, with minimal regulatory intervention. By incorporating protections for the legitimate interests of service providers, the process maintains incentives for efficient investment by service providers and facility owners.[16]

The ACCC agrees with the NCC that the role of declaration is to encourage, not replace commercial negotiation. Once invoked, Part IIIA provides parties with the degree of certainty provided by the Part IIIA statutory criteria and objectives. In this sense, Part IIIA is light-handed but fit-for-purpose regulation.

Finally, the ACCC notes that access regulation is not just about the curtailing of market power, but is also about providing for effective competition in related markets. Notably, the rationale for a generic access regime given in the Hilmer Report was that:

- access to 'essential facilities' is necessary to promote competition in related markets;
- where the essential facility owner is vertically integrated into the related market, it may have an ability and incentive to foreclose competition in that market; and
- where the facility owner is not integrated, it may nonetheless possess market/monopoly power, and price inefficiently, hence impeding competition in the related market.[17]

The airports are vertically integrated in the market for landside services, such as car parking, and their market power in aeronautical services also provides them with the ability to affect competition in related markets such as air services. Therefore, it is important that effective regulation is in place to constrain the exercise of the airports' market power and allow for effective competition in those related markets. The ACCC proposes that deemed declaration of aeronautical services and mandatory access undertakings for landside services is an appropriate form of access regulation.

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15 Hilmer Report, p. 261.

16 National Competition Council, *Submission in response to the Productivity Commission's issues paper on the 'Economic Regulation of Airport Services'*, 8 April 2011, p. 4.

17 Hilmer Report, pp. 240-241.

Deemed declaration is a way to provide arbitration as a fallback for aeronautical services

In line with Hilmer, the ACCC considers there is a 'strong public interest' in ensuring that airports engage in bona fide commercial negotiations. As stated above, it is the credible ability to resort to arbitration that fosters bona fide market-based commercial agreements where one side would otherwise have market power. The ACCC considers that declaration is appropriate for aeronautical services as there is a history of airlines negotiating with airports, relatively small numbers of airlines, and vertical separation of the airport and airline businesses.

However, the effectiveness of the threat of declaration under Part IIIA as a constraint on the airports' market power is limited by the considerable costs, time and uncertainty associated with seeking declaration. Furthermore, effectiveness of the threat is hindered due to:

- the potential free-rider problem that exists with airlines gaining benefit from the declaration of an airport without contributing to the cost of an application for declaration; and
- the potential for an individual airline electing not to risk straining its relationship with an airport by seeking declaration and potentially creating a competitive disadvantage for itself.[18]

Therefore, the ACCC favours deemed declaration over the formal declaration process under Part IIIA. Importantly, deemed declaration of aeronautical services would address the imbalance of bargaining power between airports and airlines, and facilitate the development of commercial relationships while avoiding the difficulties associated with seeking declaration. This approach would encourage the airports to behave as if their activities were carried out in a competitive marketplace and recognises that each of the major airports operates in a different market, enabling a targeted regulatory response.

It remains the ACCC's view that a deeming provision, as was included in now repealed section 192 of the Airports Act 1996, would best assist in moving away from a regime that is based primarily on monitoring.

Mandatory access undertakings are appropriate for regulating access to landside services

The ACCC supports the PC's draft recommendation 11.8 that price monitored airports be required to publish on their websites the general prices and terms and conditions of access for transport operators. However this proposal alone would not constrain the airports' ability to exercise their market power.

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[18] ACCC, March 2011 submission, p. 20.

In its March 2011 submission, the ACCC considered that requiring the airports to submit Part IIIA access undertakings (that is, mandatory access undertakings)[19] for landside vehicle access services (airport car parking) would:

- best facilitate commercial negotiations and limit transaction costs;
- assist the alternative transport modes to on-airport parking in negotiating with the airports (as without the same experience, expertise and resources as the airlines in negotiating with the airports, deemed declaration would be less effective for these operators); and
- give the airports the opportunity to remove uncertainty as to what access conditions will apply to landside vehicle access services.[20]

The ACCC maintains that mandatory access undertakings are the most appropriate regulatory response in terms of landside access. Access undertakings set out the terms and conditions on which the access provider is prepared to allow access to its facilities. As an alternative to declaration under Part IIIA, access undertakings give infrastructure owners and operators greater certainty about the access conditions applying to their infrastructure.

While an access undertaking would need to specify pricing arrangements, this does not imply that an undertaking cannot provide scope for negotiation. To cater to the specific requirements of potential third-party users, undertakings could allow for negotiation of terms and conditions by establishing procedures for negotiations and clearly defined boundaries to the negotiations.

In terms of access pricing arrangements, prices can take the form of reference prices, or airports could specify maximum and minimum prices between which negotiation can take place. Irrespective of the approach used, the airport would be required to explain the basis for setting access prices and how they relate to costs.

While the ACCC has proposed the use of deemed declaration and mandatory undertakings, it recognises that others have argued for a fit-for-purpose airport regime, rather than use of Part IIIA. The ACCC agrees that the legal mechanism is less important than the substantive outcome of promoting competition and efficiency.

6. Appropriate regulation supports investment outcomes

With regard to the impact of regulatory risk on investment, the ACCC notes that normal profit-maximising behaviour for an unregulated monopoly business is to restrict output and create shortages, so as to be able to raise prices and maximise profits. A lack of effective regulation of monopoly infrastructure could therefore lead to a situation of inefficient overcharging, held up or delayed investment, or underinvestment. The ACCC reiterates that there is evidence that suggests access regulation supports investment in a number of regulated industries.[21]

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[19] Under Part IIIA, the giving of an access undertaking by an access provider is a voluntary process. The mandatory element of an access undertaking would need to be achieved through additional industry-specific legislation.

[20] ACCC, March 2011 submission, p. 36.

[21] ibid., pp. 14-16.

In particular, a mechanism that encourages commercial contracts negotiated in the absence of the major airports' market power will encourage commercial investment outcomes. Such agreements will promote efficiency and better outcomes for consumers and for businesses in related markets (such as airlines, tourism and those sectors relying on goods that require transportation by air).

In its draft report, the PC refers to the findings of its 2002 review, that regulation (in this case the price cap regime):

> … at best encouraged strategic behaviour by all parties, increased compliance costs and discouraged commercial negotiation, and at worst, discouraged efficient investment by sending poor price signals both to airport operators and users about the costs of providing aeronautical services. [22]

The PC states that a particular risk is that regulation focused on limiting aeronautical prices may, if it overshoots, significantly curtail investment and have negative long-term dynamic efficiency consequences.[23] The PC is concerned that while lighter regulation allows income transfers from the customer to the airport, regulation that is too restrictive can distort production, 'chill' investments and deter risk taking and innovation, working against the long run interests of Australian consumers and airlines.[24]

The ACCC has not proposed a return to price caps. Indeed, the submissions from both airlines and airports show that there is no desire to return to the regime that applied under price caps. Under the price caps that were in place following the privatisation of Australian airports that began in 1997, the ACCC was required to form a view on any increase in prices that airports identified as arising from necessary new investment.

By contrast, under Part IIIA the ACCC will not have a role unless a party to a dispute requests it. Rather, the existence of a credible ability to seek arbitration would balance the bargaining power of the parties. It would encourage, not inhibit, the development of commercial relationships between the airports and their customers. Practical experience – including in the airport industry itself when Sydney Airport domestic services were declared – has shown that parties greatly prefer to reach commercial agreements rather than fall back on ACCC or any other arbitration.

7. Welfare effects

As discussed in previous sections, the ACCC's view is that, under the existing monitoring regime, the airports have the ability to exercise their market power and there are indicators to suggest that some airports may have done so. Furthermore, the PC's proposed approach is unlikely to provide the necessary constraint on the airports' market power either. In the ACCC's view, the exercise of market power by airports has negative welfare effects that are potentially significant.

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[22] Productivity Commission, *Draft Report*, August 2011, p. xxv.
[23] ibid., p. 68.
[24] ibid., p. 236.

The exercise of market power can result in detriment to Australians in a number of ways. For example, high prices (and/or low quality) can result in inefficient under-utilisation of airport infrastructure and services by airlines, passengers and air freight providers, which can have consequential impacts on related markets such as tourism and those sectors relying on goods that require transportation by air. Firms with market power may also inefficiently delay investment so that demand for their services will exceed supply, leading to further potential for monopoly prices. This can also lead to underinvestment in related markets such as air services. Additionally, an airport exercising its market power could operate inefficiently by allowing its costs to rise or by it not adopting cost-saving or innovative technologies.

The PC's draft view is that monopoly pricing by airports is unlikely to result in significant welfare losses, and will largely represent a transfer of resources (or 'distribution') between airlines and airports. In forming this view, the PC submits that 'price discrimination by airlines may ameliorate some of the welfare effects caused by any inefficiently high airport charges'. Further, the PC submits that 'airport charges are a low (and stable) proportion of airfares, further reducing the likelihood that increased prices will reduce passenger numbers.'[25]

However, it is not clear from the PC's analysis that the negative welfare effects are not significant. Firstly, while the demand for airport services might be relatively inelastic in aggregate, it is not perfectly inelastic. Therefore, monopoly pricing will lead to negative welfare effects. Secondly, the proportion of airport charges in the price of air services may be higher than the PC has estimated. This will result in negative welfare effects that are higher than has been assumed by the PC. In particular, there has been an increase in the number of budget travellers, which are more price sensitive and for which monopoly prices would have a greater effect on demand. The ACCC's view is that the PC needs to undertake further empirical work to establish the likely welfare effects as a result of the exercise of the airports' market power. This is outlined in further detail in the following paragraphs.

The demand for airport services is derived from the demand for air services. The elasticity of demand for airport services will therefore depend on both the elasticity of demand for airline services and the proportion of airport charges in the price of air services.[26] Therefore, the greater the elasticity of demand for air services and the higher the proportion of airport charges in the price of air services, the higher the elasticity of demand for airport services will be.

The ACCC notes the PC's view that airport charges are a small proportion of airfares and, therefore, the demand for airport services will be relatively inelastic in aggregate. However, the ACCC further notes that the demand for airports services is not perfectly inelastic. Therefore, monopoly prices by airports will result in negative welfare effects.

Importantly, the ACCC is concerned that the PC may have underestimated the proportion that airport charges make up of airfares in submitting that airport charges are unlikely to have a significant impact on the airfares paid. Notably, according to figure

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[25] Productivity Commission, *Draft Report*, August 2011, p. 39.
[26] Productivity Commission, *Price regulation of airport services; Inquiry report*, January 2002, p. 107.

4.2 on page 67 of the PC's draft report, airport charges account for approximately 8 per cent of the lowest available restricted economy airfare for a Melbourne-Sydney return trip. If this were the case, then using the average aeronautical revenue per passenger (used as a proxy for prices) from the ACCC's most recent airport monitoring report, the lowest available full economy airfare for a Melbourne-Sydney return trip would be approximately $552.[27] However, this analysis is based on BITRE data that appears to exclude Low Cost Carriers (LCCs), such as Tiger, as well as the cheapest airfares offered by Qantas and Virgin Australia. Based on a sample of airfares available online, the ACCC notes that a return trip of $552 seems high. Indeed, the proportion of airport charges on the cheapest airfares offered by Qantas and Virgin Australia could, in fact, be as high as between 10 per cent and 20 per cent. The proportion of LCCs' airfares will be even higher.

Whilst the ACCC acknowledges that this is only an estimate, it does raise questions about whether or not airport charges are truly unlikely to have a significant impact on the prices for air services and whether or not monopoly prices are unlikely to result in significant negative welfare effects.

Furthermore, the ACCC notes that, since the previous inquiries, there has been growth in the number of 'budget travellers' as a result of the growth in LCCs. These budget travellers also travel on the cheapest airfares offered by Qantas and Virgin Australia. Importantly, budget travellers are more sensitive to price and the proportion of airport charges in their airfares will be higher. As such, monopoly prices by airports that are passed on in airfares are likely to have a greater impact on the budget traveller's decision to travel than for the main market segments, which are traditionally less sensitive to price.[28] Therefore, as noted above, any given impact on final prices for budget travellers will have a relatively greater effect on the number of passengers travelling and associated negative welfare effects.

The PC accepts that the major Australian airports have significant market power. Without effective regulation, these airports would be expected to price at monopoly profit maximising levels. Furthermore, there is a concern that the welfare effects resulting from the exercise of that market power could be more significant than the PC's analysis has assumed. The ACCC's view is that the PC needs to undertake further empirical work to better establish the likely welfare effects as a result of the exercise of the airports' market power before coming to a conclusion about what the appropriate regulatory response is.

8. Distributional effects

As noted above, the PC's draft view is that monopoly pricing by airports will largely represent a transfer of resources (or 'distribution') between airlines and airports. Of

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[27] The ACCC has used the average aeronautical revenue per passenger (AARPP) for both Melbourne ($8.06) and Sydney ($14.03) airports, taken from the 2009-10 airport monitoring report. In calculating the lowest available full economy airfare for a return trip, the ACCC has assumed that both take off and landing charges apply and that the AARPP figures would therefore apply twice. Taking the figure of $44.18 as being approximately 8 per cent of the total of the lowest available restricted economy airfare provides a figure for the airfare of approximately $552.

[28] ACCC, March 2011 submission, pp. 13-14.

course, any policy or regulatory reform should be guided by its overall expected economic welfare gains. That said, the distributional effects are relevant to the community and consumers as they may ultimately pay for any monopoly rents. It is important that the potential 'winners' and 'losers' can be identified, in addition to the likely magnitude of the impacts of a change on those groups.

As noted above and in its March 2011 submission, the ACCC has concerns that under the current arrangements the airports' monopoly behaviour is unconstrained. Furthermore, the ACCC believes that it is unlikely that the ongoing monitoring and inquiry regime proposed in the PC's draft report will provide the necessary constraint on the airports' monopoly behaviour either.

In its draft report, the PC has identified that airports have "sufficient market power to be of policy concern". However, the PC draft report suggests that an exercise of that market power, resulting in monopoly prices, is unlikely to have a significant impact on demand and, therefore, on pure efficiency grounds there is no concern.

Whether or not the PC's efficiency conclusion is correct (noting the questions raised about this finding in the previous section), any monopoly rents imposed by airports on the cost base of airlines will ultimately be paid for by users, including consumers. This is of concern to the community and consumers.

The ACCC reiterates that, if regulatory arrangements were put in place to balance market power between airports and airlines, airports would find it difficult to charge monopoly prices. Airports would be the 'losers' in this scenario, however any excess profits would move into the more competitive environment (the airline market) where they have a greater likelihood of being competed away, and where there is a greater likelihood of consumers not paying monopoly prices. The ACCC submits that effective regulation can produce more efficient prices, which not only have a welfare enhancing effect but also have the distributional effect of consumers not paying monopoly prices.

9. Conclusion

As found by the PC, the major Australian airports have sufficient market power to be of policy concern. The exercise of market power can result in detriment to Australians in a number of ways, including through higher prices (and/or lower quality) than would be expected in a competitive market.

The ACCC submits that more monitoring and inquiries will not constrain the exercise of market power and does not provide an effective permanent solution. The ACCC is concerned that, without effective regulation, the airports would be expected to price at monopoly profit maximising levels, which can lead to potentially significant negative welfare effects. In any case, any monopoly rents imposed by airports on the cost base of airlines will ultimately have to be paid for by users, including consumers. This is of concern to the community and consumers.

The ACCC's proposal is the use of deemed declaration for aeronautical services and mandatory undertakings for landside services under Part IIIA of the CCA as a form of effective regulation to constrain the exercise of the airports' market power. The ACCC

submits that this would encourage true commercial negotiations absent the exercise of the airports' market power, which will also support commercial investment outcomes. Such agreements will promote efficiency and better outcomes for consumers and for business in related markets (such as air services and car parking).

Annexure 1: Misuse of market power

The PC refers to the 'misuse' and the 'abuse' of market power a number of times throughout its draft report. In its March 2011 submission, the ACCC applied the terms 'use' or 'exercise' of market power when describing the potential for airports to extract monopoly rents and constraint of that market power more generally. An exercise of market power refers to the ability of a firm to profitably raise its prices above efficient long-run costs for a sustained period.

The ACCC's analysis in its March 2011 submission and in the airports monitoring reports was not undertaken to assess conduct against the prohibition on 'misuse of market power' under section 46 of the *Competition and Consumer Act 2010* (Cth). As a result, the PC's characterisation of market power in terms of abuse or misuse is different to that defined for the purposes of section 46.

Section 46 prohibits a firm from taking advantage of its market power (in that or any other market) for the purpose of eliminating or substantially damaging a competitor, preventing entry, and deterring or preventing competitive conduct.

The limited parameters of the ACCC's monitoring task do not enable the ACCC to determine whether airports are misusing their market power for the purposes of section 46. Rather, they allow the ACCC to indicate that airports may have significant market power and that the evidence suggests that they exercise that power. The exercise of that market power is not illegal, but is of concern because it results in inefficient market outcomes.

Annexure 2: The Aeronautical Pricing Principles

The pricing principles relating to prices for aeronautical services and facilities (as defined in Part 7 of the *Airports Regulations 1997*) provided by airports are:

a) that prices should:

(i) be set so as to generate expected revenue for a service or services that is at least sufficient to meet the efficient costs of providing the service or services; and

(ii) include a return on investment in tangible (non-current) aeronautical assets, commensurate with the regulatory and commercial risks involved and in accordance with these Pricing Principles;

b) that pricing regimes should provide incentives to reduce costs or otherwise improve productivity;

c) that prices (including service level specifications and any associated terms and conditions of access to aeronautical services) should:

(i) be established through commercial negotiations undertaken in good faith, with open and transparent information exchange between the airports and their customers and utilising processes for resolving disputes in a commercial manner (for example, independent commercial mediation/binding arbitration); and

(ii) reflect a reasonable sharing of risks and returns, as agreed between airports and their customers (including risks and returns relating to changes in passenger traffic or productivity improvements resulting in over or under recovery of agreed allowable aeronautical revenue);

d) that price structures should:

(i) allow multi-part pricing and price discrimination when it aids efficiency (including the efficient development of aeronautical services); and

(ii) notwithstanding the cross-ownership restrictions in the *Airports Act 1996*, not allow a vertically integrated service provider to set terms and conditions that discriminate in favour of its downstream operations, except to the extent that the cost of providing access to other operators is higher;

e) that service-level outcomes for aeronautical services provided by the airport operators should be consistent with users' reasonable expectations;

f) that aeronautical asset revaluations by airports should not generally provide a basis for higher aeronautical prices, unless customers agree; and

g) that at airports with significant capacity constraints, peak period pricing is allowed where necessary to efficiently manage demand and promote efficient investment in and use of airport infrastructure, consistent with all of the above Principles.