Australian Competition and Consumer Commission

Administration of airport price cap arrangements

January 1997

1. Introduction

In its *Pricing Policy Paper* the Department of Transport and Regional Development outlined pricing oversight arrangements for leased Federal airports. This paper provides additional information on the price cap and its administration, including:

? details on the price cap formula;

? the ACCC's administration of compliance with the cap;

? the ACCC's administration of individual price change notifications;

? information requirements for airport operators as part of administration of compliance and price notifications; and

? new investment and the price cap.

The arrangements outlined in this paper are consistent with the *Pricing Policy Paper*. Some of the arrangements are provisional only and subject to refinement following consultation with the airport operators.

2. The Price Cap

Aeronautical charges at leased phase one airports will be declared by the Treasurer under section 21 of the *Prices Surveillance Act 1983*. The declared services will be subject to a price cap.

The *Pricing Policy Paper* states that the "The CPI-X price cap will apply to that group of charges for aeronautical services covered by the definition in the *Federal Airports Corporation Act*". The paper also provides a list of the aeronautical facilities and services to be covered by the price cap (a copy is at attachment A) - the ACCC has been advised that this list will be included in the declaration notice.

The price cap will apply over a five year period commencing on the date the airport lease is granted.

The price cap is a CPI-X cap. The CPI measure used will be the underlying measure of national CPI, recorded in the year to the previous March quarter, as published by the Australian Bureau of Statistics.

The value of each airport's 'X' in the price cap reflects the expected productivity improvements that the Government considers can be made in the provision of aeronautical services at each airport. In this regard, the Government recently determined the following 'X' values:

4.0 per cent for Melbourne airport;

4.5 per cent for Brisbane airport; and

5.5 per cent for Perth airport.

The price cap formula

Concurrent with the declaration process it is expected that the Treasurer will issue a Ministerial direction to the ACCC under section 20 of the *Prices Surveillance Act 1983* specifying the price cap formula (including specification of the levels of X in the price cap and the form of the cap).

The price cap formula measures changes in the prices of airport services subject to the cap. The ACCC will use this to monitor compliance of actual aeronautical charges with the CPI-X price cap.

The price cap formula to be implemented is a modified version of the revenue-weighted average price form. It takes the percentage change in the price of each charging 'component' from one period to the next, weights this change by that component's revenue share in the previous period and then sums over all components. Here charging 'component' refers to a charge for a particular service, for example, a charge for landing or a charge for international terminal use.

The formula applies to all components, weighting the price changes of each component by its revenue share. This allows for changes in the pricing structure used by operators. Price increases on specific service components which exceed the CPI-X requirement may still comply with the price cap if there are compensating reductions in the price of other service components.

The price cap formula is specified in attachment B.

Calculation of the price of individual charging components in the price cap formula

The discrete nature of compliance assessment periods for the price cap means that it is possible that a particular service's price could change a number of times within a single period (year). In such circumstances the price of a particular service or charging component will be estimated by an average revenue, or revenue-yield, analysis. This involves deflating the revenue from a service or charging component by an 'output proxy', ie dividing total revenue from a service by the output proxy to obtain an average price.

The choice of output proxy would normally follow the charging basis used at the airport. Landed tonnes, passenger numbers and passenger movements are some examples of potential 'output proxies'.

This averaging approach will also be used if the airport operator uses a non-uniform pricing structure for a particular service, for example charges which vary according to the time of day of landing.

Cost pass-through provisions

In the administration of the price caps at the major leased Federal airports, the ACCC will allow a 100 per cent pass-through of those direct costs related to Government mandated airport security requirements.

In addition, congestion charges that are employed as part of a demand management scheme under the *Airports Act 1996* will be passed-through the price cap. It is important to note, however, that only congestion charges that are associated with current or future Government mandated demand management schemes will be passed-through and therefore excluded from the cap.

Under and over-recoveries

The pricing oversight arrangements are intended to ensure prices remain within the cap over the entire price cap period. As a consequence, any under-recoveries can be carried over between years within the five year duration of the price cap. In relation to over-recoveries, there will be a requirement for these to be passed back to customers within the following two years from the period of over-recovery (except in the case of year 4, where the over-recover is to be passed back in year 5).

Starting point prices

In the initial assessment of the cap, following the first year of private airport operation, prices will be compared to the FAC prices in place at the time the lease is granted, for example, for phase one airports the FAC prices introduced on 1 January 1997. The ACCC proposes that the initial previous period revenue shares be calculated for the period from 1 January 1997 to the date the lease is granted if that period is less than one year.

New charges

New charges on aeronautical services - whether they are replacing existing charges or in addition to them - will be factored into the price cap. If new charges on aeronautical services are introduced then compensating reductions in other charges will generally be required to comply with the price cap.

The following points provide an indication of the ACCC’s likely approach to new charges. Note that the approaches suggested are preliminary only and that the ACCC will refine them after consultation with airport operators.

? If a new charge replaces an existing charge (for example introduction of a landing charge based on number of passengers to replace a charge on landed tonnes), then in the transition year an average price based on the original output proxy (in this example landed tonnes) will be calculated and used to determine compliance with the cap.

? A similar approach will be used if a new charge is introduced to supplement an existing charge (for example a charge on each aircraft landed in addition to an existing charge based on landed tonnes). In this case an average price covering both

services will be calculated for the transition year based on the original output proxy (in this example, landed tonnes).

? If a new charge is introduced for a new service or a service on which no charge was previously levied, then for the transition year revenue from the new charge will be allocated to other charging components in proportion to their previous period revenue share (notionally increasing the average price on the other components).

Note that if a new charge is introduced on a new service then the ACCC will first make an assessment of whether the new service is an aeronautical charge and therefore subject to the price cap.

New investment and the price cap

The cost of new infrastructure investment into aeronautical services *may* be recouped outside the price cap under some circumstances. As stated in the Department of Transport and Regional Development's Pricing Policy Paper this would arise when: "the prices are required to fund the new investment; and those users with a significant interest in the new investment support the investment, including the associated charges". The ACCC will examine proposals on a case by case basis. In assessing proposals, the ACCC will follow the guidelines on new investment specified by the Government which are outlined in Attachment B of the Pricing Policy Paper. A copy is at Attachment C.

The precise treatment of increased charges attributable to new investment in terms of the cap will be determined in consultation with airport operators. Examples of possible approaches include the following:

? Permit the introduction of a new aeronautical charge or an increase in an existing aeronautical charge as a once off increase to a level agreed to by the ACCC. The price cap would subsequently apply to the new set of charges.

? Treat the charge as a separate charge outside the cap.

? Introduce a 'K' factor in conjunction with the cap so that the cap effectively takes the form CPI-X+K.

3. Proposed Procedures for Administration of Price Cap Compliance

The ACCC will administer the price cap using the prices surveillance powers under sections 21 and 22 of the *Prices Surveillance Act 1983,* as well as the information

gathering powers under section 32. In addition, separate provisions under Part 7 of the *Airports Act 1996* (the Act) require airport operators to supply prescribed reports and accounts to the ACCC as part of its broad prices oversight role.

Administration of the cap will involve two main dimensions - processing individual price change notifications and monitoring compliance with the price cap.

Airport operators will be required to provide the ACCC with specified information on a regular basis so that the ACCC can assess compliance with the price cap.

Annual monitoring of price cap compliance

The ACCC proposes to carry out a formal assessment of price cap compliance on an annual basis to determine compliance with the cap. It will apply the price cap formula outlined in appendix B to actual aeronautical charges and compare it to the relevant CPI-X cap taking account of any previous carry-over credits or debits.

Airport operators will need to provide the ACCC with sufficient information to allow the derivation of the price cap formula. As a minimum this is likely to include:

? revenue from each of the charging components subject to the cap over both the year being assessed and the previous year; and

? volume or output achieved for each of the components, such as total landings, movements, tonnes landed and passengers for the airport concerned - which are relevant inputs into the determination of the price cap formula. This information must be provided for both the year being assessed and the previous year.

This and other information as specified by the ACCC must be provided on an annual basis immediately following the end of the relevant period.

Assessment period for the cap

There appear to be advantages to carrying out the yearly assessments of compliance with the cap on a financial year (July-June) basis. The previous period revenue shares, which both the ACCC and the airport operator should know at the beginning of each assessment period, could then be based on the data underlying an audited set of accounts.

If airports leases do not commence at the beginning of a financial year, one possible approach is to set the first assessment period from the date of privatisation until the end

of that financial year. An alternative is to have the first assessment period as longer than a year and run it until the end of the following financial year. The appropriateness of these options will vary depending on the date of commencement of the airport lease. The ACCC will consult with operators to develop a mutually acceptable approach.

Assessment of individual notifications under the price cap

Airport operators are required to notify the ACCC of price increases in advance under section 22 of the *Prices Surveillance Act 1983.* The ACCC's assessment of a notification will focus on whether the proposed prices are likely to comply with the cap. However, the main emphasis in monitoring compliance with the cap will be on the annual assessment rather than at the time of price notifications.

The ACCC will streamline its assessment process and anticipates a fast response to notifications given by airport operators. As a maximum period of time the ACCC is required to advise that it objects or does not object to a notified price increase within 21 days of notification (though an extension of time is possible if the party who has given the notice agrees to the extension).

The airport operator will need to supply the information necessary for the ACCC to make an assessment of the notification. This will include information on the original and new prices, the previous period (years) revenue share of the relevant component and the implementation date of the price change.

Attachment A

AERONAUTICAL SERVICES

The facilities and services for which aeronautical charges under a CPI - X cap are levied or can be levied are:

Aircraft movement areas

(a) grounds, runways, taxiways, aprons
(b) airfield lighting, airside roads/lighting
(c) airside safety
(d) nose-in guidance
(e) aircraft parking areas
(f) visual navigation aids

Passenger processing areas

(a) forward airline support area services
(b) aerobridges, airside buses
(c) departure lounges and holding lounges (excluding commercially-important-persons lounges)
(d) immigration and custom service areas
(e) public address systems, closed circuit surveillance systems, security systems
(f) baggage make-up/handling/reclaim
(g) public areas in terminals, public amenities, lifts/escalators/moving walkways
(h) flight information display systems
(i) landside road and lighting, covered walkways

Notes:

1. Charging for 'aeronautical related' services are excluded from the cap.
2. Charges associated with current or future Government-mandated demand management (eg peak period pricing at Sydney Airport) are excluded from the cap.

Source: Department of Transport and Regional Development, '*Pricing Policy Paper*', October 1996.

Attachment B

THE PRICE CAP FORMULA

The price cap formula is a modified weighted average price (MWP) and in its general form for period t is:

$$MWP^t = \sum_i S_i^{t-1} \Delta P_i^t \quad ;$$

where

$$S_i^{t-1} = \frac{R_i^{t-1}}{\sum_j R_j^{t-1}} = \frac{P_i^{t-1} Q_i^{t-1}}{\sum_j P_j^{t-1} Q_j^{t-1}} \quad ;$$

and

$$\Delta P_i^t = \frac{P_i^t - P_i^{t-1}}{P_i^{t-1}} \quad .$$

The main variables in the price equation are:

- revenue shares (S), which represents component i's share of total aeronautical revenue;
- prices (P), which are average prices over the relevant time period;
- the percentage change in price from period to period, ΔP;
- quantities (Q); and
- revenue (R).

Superscripts denote the time or period reference, while subscripts denote the service or charging component. Thus:

- t denotes the current year (the year under consideration);
- t-1 denotes the previous year (the year prior to that under consideration); and
- i and j denote particular services (charging components)

Attachment C

ASSESSMENT OF PROPOSALS FOR CHARGING INCREASES RELATED TO NECESSARY NEW INVESTMENT - GUIDELINES FOR THE ACCC

These criteria will, where relevant for its purposes, guide the ACCC in its assessment of proposals related to necessary new investment to increase aeronautical charges at a rate in excess of the CPI - X cap:

(a) the operator's plans for new investment or service innovation and the associated costs;

(b) the relationship between the proposed increases in aeronautical charges and the costs (including the level of rate of return) of the new investment or service;

(c) support from airport users with a significant interest in the investment for the operator's proposal, including in relation to charging changes;

(d) contribution of the new investment/service to productivity improvements at the airport;

(e) overall efficiency of the airport's operation;

(f) the particular demand management characteristics of individual airports, including any demand management schemes in place, capacity constraints and any under-utilisation of airport infrastructure;

(g) airport performance against quality of service measures, including services under the control of the airport operator;

(h) airport performance vis a vis other Australian airports and any comparable international airports; and

(i) the extent to which the proposed investment will facilitate the operations of new entrants to domestic or international aviation.

While the ACCC must take the above into account in deciding whether to approve a proposal to increase charges outside the cap, each proposal will be considered on its merits having regard to the information available to the ACCC. The weight provided by the ACCC to each of the criteria (a) to (i) may vary on a case by case basis.

Consistent with the provisions of the *Prices Surveillance Act 1983*, where the ACCC does not approve a proposal to increase charges outside the price cap, it will provide a statement of reasons for its determination.

Source: Attachment B of the Department of Transport and Regional Development's *'Pricing Policy Paper'*.