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ACCC Airports and Aviation - Regulatory and Competition Issues

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Introduction

Since the last Australian Airports Association (AAA) conference the Australian aviation industry has experienced one of the most extraordinary periods in its history. The optimism connected with new domestic entrants Impulse and Virgin Blue received a jolt with the financial crisis of Impulse, leading to its acquisition by Qantas and then more recently the well publicised problems with Ansett. The events of September 11 have compounded the impact of Ansett's failure with the industry now experiencing a downturn in international as well as domestic traffic.

On the airports front the Commission and the industry dealt with complex aeronautical pricing issues at Sydney Airport and the Federal court ruled on taxi charges. At the moment the industry and the Government are grappling with questions about the future regulation of airports following the recent release of the Productivity Commission's (PC's) report on that subject.

Today I would like to discuss each of these issues. First I will focus on airports with an overview of the year's events and then future airport regulatory arrangements. I will then turn to airlines and possible measures to promote effective competition in the industry.

Airports - the year in review

The implications for airport operators of Ansett's failure

Turning first to Ansett's failure, the implications for airport operators are substantial. Immediately after Ansett collapsed domestic traffic volumes fell by some 20 to 30 per cent. Almost all airports were affected. While Qantas, Virgin Blue and Ansett Mark II have added capacity since then traffic volumes are still down.

Given the sunk nature of airport assets, airport operators have little scope to reduce costs. Recognising this the Government responded by lifting the price cap at a number of smaller airports. This position is supported by the Commission, and is consistent with its proposals for future regulation. In its submission to the PC the Commission argued for deregulation of smaller airports.

The Government also introduced changes that will allow once-off price increases of between 6.2 and 7.2 per cent at Melbourne, Brisbane and Perth airports subject to Commission approval. The Commission has already approved increases at Brisbane and Perth Airports.

The changes are favourable for airport operators. They should cushion them from the impact of Ansett’s failure by allowing the operators to increase prices in response to the traffic downturn currently being experienced. This relief stands in marked contrast to other sectors affected by the downturn, such as hotel operators and others in the tourism industry.

Sydney Airport

Earlier this year the Commission issued its decision on proposals by Sydney Airports Corporation Limited (SACL) to increase aeronautical charges at Kingsford Smith Airport. Sydney Airport’s proposals and the Commission’s decision provoked considerable interest. This is not suprising given the major role played by Sydney Airport for both domestic and international traffic.

The Commission did not object to an increase in aeronautical charges of 97 per cent. By comparison SACL sought a 130 per cent increase. The increases translate to around $3 to a domestic return flight and around $14 to an international return flight. Charges for international services now total around $35 per passenger.

The decision followed an extensive public consultation process.

The decision approved a substantial part of the increases sought by SACL. The Commission considered that the increases were required to give SACL a reasonable return on its investments and to compensate SACL for major new investments undertaken in the lead up to the Olympics. Nevertheless the draft decision did not approve all of the increases sought.

Two issues were particularly contentious, namely the “dual till” and land valuation.

The Commission’s decision adopted a “dual till” methodology as distinct from the “single till” methodology proposed by airport users. The Commission considers that the methodology has considerable merit. It focuses regulation on areas where the airport has market power and is more likely to promote efficient pricing outcomes than the single till. Those services which are relatively contestable, such as duty free, are not subject to prices oversight.

However, the Commission had reservations about SACL’s *application* of the dual till methodology. In its *draft* decision the Commission took SACL’s financial performance in providing “aeronautical-related” services into account. This was because the Commission considered the resulting aeronautical prices would yield better economic efficiency outcomes and more effectively constrain market power than SACL’s proposals. The aeronautical-related services taken into account included aircraft refuelling, check-in counters and car parks. They were already subject to monitoring under the existing regulatory framework.

The Commission conducted its review of Sydney Airport’s proposals pursuant to detailed directions made by the Minister for Financial Services and Regulation pursuant to section 20 of the *Prices Surveillance Act 1983*. After the Commission released its draft decision the Minister issued a new direction (Direction no. 22). Until then the Government had not clearly stated its position on the dual till or the boundary of the till. The new direction clarified the Government’s policy intent in relation to this issue. It stated that “the Commission should not take into account the revenue generated, or costs incurred, in the provision of services other than aeronautical services”. The

Commission accommodated the new direction in its *final* decision by not taking Sydney Airport's financial performance in aeronautical related services into account.

In effect the Government's policy intent was to apply the dual till approach on a narrower basis than proposed by the Commission in its draft decision. Implementation of the policy intent has resulted in higher prices – around an extra $2 per international passenger and 50 cents per domestic passenger.

It should be noted that the PC's draft report points to significant market power in the provision of some of the aeronautical-related services the Commission had proposed to take into account in its draft report, in particular aircraft refuelling. The Commission considers that such services should be included in the price cap.

In relation to land, SACL claimed to use an opportunity cost valuation based on an estimate of the site's market value in its best alternative use.

The Commission's decision supported the opportunity cost principles proposed by SACL in valuing land but questioned their application. The challenge in using an opportunity cost methodology is to apply it in practice.

One thing is clear: Sydney Airport did not use an opportunity cost valuation. Instead Sydney Airport adopted a DORC (depreciated optimised replacement cost) methodology. The approach factored in over $200 million in holding costs – the hypothetical costs of holding the land while a hypothetical airport was constructed at the site. This may be appropriate for a DORC valuation but has nothing to do with opportunity cost. Similarly the proposals did not factor in the cost of converting the site to the housing and industrial uses the valuation was based on.

The Commission obtained consultancy advice on land valuation from NECG, Dr Rohan Pitchford, and more recently Dr Collin Gannon. Their advice confirmed that Sydney Airport did not use an opportunity cost valuation. Their advice and the input from

Sydney Airport and the airlines also pointed to the difficulty of tying down an opportunity cost valuation.

Given the difficulties of deriving a valuation based on opportunity cost, the Commission accepted advice from independent consultants to use the historic cost of the site indexed by CPI. Historic cost has the advantage that it is readily identifiable and less subjective than the principles proposed by Sydney Airport. It provides compensation to the owner of Sydney Airport for investments into land already undertaken. It also provides incentives for the airport operator to acquire additional land.

Taxi charges

In mid 2000 Canberra Airport appealed a Commission decision about taxi charges. The issue was whether or not the $2 taxi charge introduced by the airport operator is in the price cap or not. The appeal was to the Federal Court under the *Administrative Decisions (judicial Review) Act 1977 (Cth).*

In March this year, the Federal Court ruled in the Commission's favour. Justice Gyles ruled that the charge is within the price cap because it relates to the use of landside roads at Canberra Airport.

Canberra Airport appealed Justice Gyles' judgement. The appeal was dismissed by the full Federal Court. The effect of the decision is that the Commission must take the proceeds of the taxi charge into account when assessing Canberra Airport's compliance with the price cap.

The decision is also relevant to taxi charges at other privatised airports, including the charges introduced by Brisbane, Melbourne and Perth airports. The Federal Court's decision confirms the Commission's view that these airports must reduce other charges to avoid breaching the price cap.

The implication of the decision should be clear to all airport operators. The Commission operates within a legislative framework. Its role is to apply the legislative framework without fear or favour. The Commission's track record confirms this is exactly what the Commission has done.

Sydney Airport regulatory report

One final issue before I turn to the question of future regulatory arrangements: the Commission has completed and is releasing today its regulatory report on Sydney Airport.

The report shows:

- An increase in Sydney Airport's earnings (before interest and tax) to $131 million for the year to June 2001, an increase of twenty eight per cent. I note that these returns do not reflect the full impact of the ninety seven per cent increase in aeronautical charges approved by the Commission since the price increases were implemented towards the end of the financial year;

- An increase in revenue from aeronautical related activities covered by price monitoring, such as car parking, increased in line with attributed costs; and

- A measurable improvement in quality of service. This confirms the favourable impact of substantial new investment programs undertaken by Sydney Airport in the lead up to the Olympic Games.

The reports are available today for conference participants.

Focus on the Future

I now want to focus on the future of the industry.

Over the next few months the Government will be considering the future regulatory framework for airports. As part of that process it is likely to take into account the PC's report on Price Regulation of Airport Services as well as the views of other interested parties.

The Commission is contributing to the process. It provided a detailed submission to the PC's review and has provided a detailed response to the draft report. The Commission will also work with the Government as it implements new arrangements.

I would like to make a number of general comments about future regulatory arrangements, comment proposals for prices monitoring and then discuss the Commission preferred approach.

General comments

The first point is that **Australia's largest airports have substantial market power** in the provision of aeronautical services. On this point there is substantial agreement. The PC's draft report makes this point as do leading economists including Professor King and Professor Forsyth.

Failure to address this market power will result in large price increases and will have implications for the travelling public and the tourism industry.

A number of airport operators have argued that the airlines have considerable countervailing power, especially now that Qantas has such a large share of the domestic market. This does not stand up to scrutiny.

The PC considered the issue in detail and concluded that airlines do not have significant countervailing power when dealing with large airport operators. The New Zealand experience supports the PC's conclusions. Now only Air New Zealand operates domestic routes. This has not stopped the airport operators from increasing charges, even at some of the smaller airports.

The second point is that any **regulatory arrangements should focus on those services in which the airport operator has substantial market power**. As such the Commission supports the "dual till" approach to regulation.

The challenge in applying the dual till approach is to ensure that the regulatory arrangements capture all of the services which are characterised by significant market power. If the regulatory arrangements are too narrow the risk is that we will see regulatory bypass. To some extent this has already occurred with refuelling charges at Brisbane and Perth Airports.

The PC's draft report provides the most comprehensive analysis of airport operator market power undertaken to date. In general the conclusions about which services should be regulated are consistent with the analysis undertaken by the Commission. Any regulatory arrangements should capture the services identified by the PC.

The third point is that **the Commission has been actively arguing for deregulation of smaller airports**. This is consistent with the approach adopted in the PC's draft report and consistent with the Government's recent decision to lift price caps at Phase II airports.

The fourth point is that the **new regulatory arrangements should not remove price controls**. I am concerned that lifting price caps and replacing them with prices monitoring could leave us with the New Zealand experience.

It has been more than 10 years since the New Zealand Government privatised Auckland Airport. Rather than impose price caps, the Government relied on a prices monitoring approach, which is now widely recognised as a failure. Aeronautical charges are considerably higher than Australia and the relationship between airport operators and airlines has broken down. Now the parties are involved in lengthy and costly litigation processes.

The impact on consumers of a New Zealand outcome would be substantial. If Australia's major airport operators achieved Auckland Airport's rate of return on assets prices at some airports would more than double and the transfer from consumers to airport operators would be around $1.4 billion over a five-year period.[1]

Recognising these problems a recent review recommended the introduction of price controls in New Zealand.

My concern about prices monitoring in the Australian context is that the industry would rely heavily on the arbitration provisions in Part IIIA of the *Trade Practices Act 1974*. This is not in the interests of anyone in the industry. As with the New Zealand experience the costs and delays will be substantial. The only winners will be the lawyers.

The PC sets out several principles for good regulation. The main ones are that regulation should promote efficiency, minimise the regulatory burden on industry consistent with efficient outcomes and be transparent and low cost. Reliance on arbitration will not meet the principles identified:

- Part IIIA arbitration would make it difficult to achieve efficient pricing outcomes since the negotiate arbitrate model results in consideration of disputes on an ad hoc basis as they arise rather than considering regulated airport services as a whole;

- imposes a *high regulatory burden* on all parties, both in terms of the administrative costs and the delays involved;

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1 For details see the Commission's response to the PC's draft report on regulation of airport services.

- could involve "micro-management" of airports. The complexity of the issue in the dispute between Delta Car Rentals and Melbourne Airport provides an example of this. The dispute involved issues about location of car parks and traffic management as well as pricing.

- is *not transparent* since arbitrations are not public processes; and

- could deter investment because of the lack of certainty.

Importantly the approach fails where regulation is most needed. The time frames involved make the process virtually irrelevant for new entrants. Similarly the costs involved may make the process inaccessible for small users such as new entrants and regional airlines.

The negotiate-arbitrate model makes most sense where flexibility is required. In the case of telecommunications, for example, Telstra is vertically integrated so has incentives to deny access. It could use non-price as well as price methods to do this. Arbitrations have the flexibility to deal with such matters.

In the case of airports the service providers are vertically separated. In general the operators should have every incentive to encourage access. The question then becomes one solely of price. This is best addressed through a price cap or other price controls *not* through Part IIIA.

Prices monitoring

The PC's draft report on regulation of airport services identifies areas in which the airports have significant market power. As mentioned above the PC's analysis is consistent with the Commission's.

Having identified market power the draft report identifies two options for addressing the market power. One is to continue with modified price cap arrangements. The other is to replace the price caps with prices monitoring.

The approach of prices monitoring seems to be favoured by a number of airport operators.

The argument for prices monitoring rests on a *judgement* about the likely behaviour of major airports. Specifically the judgement call is that the non-aeronautical services outside the price cap will moderate airport operator pricing behaviour – making the price cap unnecessary.

The argument is that high aeronautical charges will have an impact on passenger volumes which will in turn adversely affect non-aeronautical activities (such as car parking, retail and car rental concessions). In other words airport operators will take into account the impact of aeronautical pricing on non-aeronautical profits (I note that this implies a 'single-till' approach to price setting).

The Commission sought advice on this matter from two of Australia's leading experts in this area, Henry Ergas from NECG and Dr Collin Gannon. Both point out that the argument about the moderating effect of non-aeronautical activities only holds if demand for aeronautical services is reasonably *elastic*, otherwise restraining aeronautical charges will not maximise profit. However, evidence suggests that demand for aeronautical services is highly *inelastic*[2]. For completeness NECG formally modelled the price choice facing a multiproduct firm. The modelling shows that a high cross elasticity of demand is required before the firm will move away from monopoly pricing.

The Commission also empirically tested the possible impact of non-aeronautical services on aeronautical pricing. It modelled profit maximising prices for Sydney Airport based on available published elasticities of demand for air travel taking into

2 See for example estimates by the PC.

account the impact of changes in aeronautical charges on non-aeronautical profits. The modelling indicates that *in a genuinely unconstrained environment* Sydney Airport would maximise profits by setting the following charges:

- $120 per departing domestic passenger; and
- $510 per departing international passenger.[3]

This compares with current charges of around $8 per passenger for domestic passengers, and around $35 for international passengers.[4]

The argument that non-aeronautical services will have a moderating effect of on aeronautical pricing behaviour does not stand up to theoretical or empirical scrutiny.

ACCC' preferred approach

The Commission favours ongoing use of incentive regulation in the form of CPI-X price caps. Price caps provide clarity and certainty for all of the parties about pricing outcomes. They also provide strong incentives to service providers to reduce production costs. If well designed they can also provide good incentives for new investment, a point made by the PC.

The approach is consistent with the approach adopted in regulating electricity and gas transmission and distribution in Australia and airports in the U.K.

The approach also has the advantage that it is now widely understood in the industry and many of the implementation difficulties have been worked through.

The difficult conditions being experienced by the industry at the moment makes stability in airport regulation and pricing more important than ever. Assurance of reasonable access prices for all airport users is needed to encourage new domestic

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3 Attachment five shows how the estimates have been derived.

4 Based on a return trip not including the noise levy or government departure taxes.

entrants and safeguard competition. The price increases that are likely to flow from removal of price controls will work against new entry and will work against a recovery in air traffic. This will compound the major downturn already being experienced by downstream sectors. The risks are particularly high for the tourism industry. With four million international tourists per annum and $16 billion in spending the stakes are high.

Investment

One area which needs improving is the new investment provisions.

At last year's AAA conference some speakers argued that the regulatory arrangements and the Commission's implementation of the arrangements had resulted in an "investment freeze".

This assessment is not borne out by the facts. Over $250 million in new investment has been 'passed through' the price cap. The projects have included new common user facilities to accommodate new entrant airlines at Sydney, Melbourne, Canberra, Adelaide and Coolangatta airports as well as substantial airside investment programs at all of the major airports.

In fact the need to promote investment is one of the reasons for regulating. In general an unregulated monopolist will tend to under-invest in the long run relative to the socially optimal level of investment. This is because monopolists have incentives to set high prices resulting in lower demand and output. In turn this results in lower capacity requirements and sub-optimal investment levels. Similarly investment by downstream users (airlines, and companies reliant on airline travel, such as hotel operators etc) would be sub-optimal.

Having said this, I consider that there is considerable scope to improve on the existing arrangements.

There are two main shortcomings with the current arrangements. One is the administrative burden of the current arrangements. The other is the issue of “new” versus “replacement” investment. The Commission’s proposed a ‘hybrid’ model which would effectively address both of these.

The hybrid model adjusts the ‘X’ value or starting point prices to compensate the airport operator for ongoing smaller investments. This approach would minimise regulatory involvement in investment decisions.

At the same time the hybrid model allows the airport operator to increase prices to recover the costs of major new investments such as a new runway or major terminal expansions. The Commission suggests that the distinction between projects that would and would not be eligible for such a pass through could be made on the basis of ‘major development projects’ as defined in the *Airports Act 1996*.

The new provisions should not distinguish between ‘replacement’ and ‘new’ investments. In other words the pass through provision should be available for investments irrespective of whether they replace existing assets or add to capacity or quality.

I turn now to the airline industry.

Airlines

The recent failures of Ansett and Impulse have led some people to question the effectiveness of competition policy in aviation. Some have even turned with nostalgia to the days of the two airline policy and extensive government regulation.

Let me remind people that there was not much ‘good’ for airline travellers in the ‘good old days’. High fares, parallel flight schedules and little innovation were the hallmarks of the old duopoly.

Competition, first from Compass, and subsequently from entrants like Virgin and Impulse, has changed the Australian aviation market forever. New point to point services and lower prices have led to a huge growth in the market. If competition again prevails, these benefits will continue.

The collapse of Ansett does not represent the failure of competition policy. It appears that Ansett was operating an aging, expensive fleet and was ill adapted to a more competitive environment. If anything, the collapse of Ansett points to the need for more competition. It would not have been in the interest of the Australian travelling public for an inefficient airline to have been protected from the pressures of competition. In any industry high cost operators unresponsive to consumer demand should be replaced by more efficient entrants. In this regard we should not shy away from encouraging and in fact actively pursuing a more competitive airline industry.

It follows that if new airlines are able to provide better services and/or cheaper prices, it is important to have mechanisms to ensure that this occurs and, in particular, that ensure their emergence is not prevented by anticompetitive behaviour. I will come back to this point later in terms of the need for improved mechanisms under the Trade Practices Act to protect emerging competition.

In the past 12 months the Commission approved the acquisition of Hazelton by Ansett and the acquisition of Impulse by Qantas. Both these mergers are worth a brief explanation. In the case of Ansett/Hazelton, the Commission at first opposed the merger but ultimately approved it after Ansett addressed the competition issues by giving up a substantial number of crucial take off and landing slots at Sydney airport.
The Qantas/Impulse case was significantly different. Impulse was exiting the market whether or not the Commission accepted the merger with Qantas. The crucial issue was whether the Qantas acquisition would result in a more competitive outcome than would be the case if Impulse went into receivership or liquidation. After Qantas provided a series of undertakings to the Commission, including the provision of access to scarce landing slots to Virgin and any new entrant to the market, the Commission concluded that acquisition of Impulse by Qantas would lead to the more competitive outcome. Under the slot allocation rules such an outcome would not have occurred had Impulse gone into liquidation.

The Commission will monitor any sale of Ansett assets should the administrators decide to sell parts of the group.

It is important that there be effective competition in the airline industry. Australian air travellers, the tourism industry and infrastructure investors will not benefit from having a dominant airline with monopoly pricing power. Extensive regulation of the behaviour of the dominant firm should be an action of last resort.

It would be far more appropriate to have a non-industry specific competition law which encourages and maintains competitive markets. The best way of achieving this is to strengthen and enhance s.46 of the *Trade Practices Act 1974*.

Since the collapse of Ansett, the Commission has received a number of complaints from the Ansett Administrators and from Virgin Blue regarding the behaviour of Qantas. The Commission is currently investigating these complaints.

Section 46 and the Misuse of Market Power

Section 46 deals with misuse of market power. The Commission intends to recommend that s.46 be extended to cover anti-competitive behaviour by a firm with a substantial degree of market power which has the *effect* of damaging competition. At present the law required proof of anticompetitive behaviour for a breach of Section 46 to be established. It is the Commission's experience that the difficulties in obtaining sufficient evidence to prove the requisite purpose required by the Trade Practices Act diminish the possibility of successful proceedings, require additional resources and cause delay before both interim and final orders can be sought. An *effect* test will include conduct with significant detriment to the competitive process where powerful firms take advantage of market power but where proscribed purpose is either absent or unable to be proved.

The Commission would also seek a ‘cease and desist’ power similar to that in other countries in those circumstances where the Commission suspects that a breach of the Act has occurred. The recipient of the orders could not engage in the conduct specified unless it could prove in court that it did not contravene the Act. This power would be particularly useful in cases involving an allegation of misuse of market power. The problem in the current circumstance is that it takes some time to bring matters to court and the firm breaching the law may actually remove the competition during the time it takes to get to court.

I believe that such powers will assist the development and maintenance of a more competitive domestic aviation industry.

Conclusion

In summary there are a few key messages that I would like to emphasise.

With Ansett’s failure the need to promote airline competition is more important than ever. We need measures to protect new airline entrants from unlawful anticompetitive behaviour and encourage further entry. We are proposing changes to strengthen and enhance s.46 of the *Trade Practices Act 1974* to achieve this.

At the same time we need to protect travellers and new airline entrants from the potential misuse of market power by major airport operators. The current regulatory arrangements have been reasonably effective in achieving that objective. They have:

- constrained aeronautical charges and in doing so protected downstream industries such as tourism;

- paved the way for substantial new investments including terminal and apron facilities to accommodate the new entrant airlines; and

- promoted transparency about airport financial and quality performance.

The current review of airport regulatory arrangements provides an opportunity to improve the arrangements. My view is that the best outcomes will be achieved by retaining a price cap but streamlining the administrative arrangements and further promoting new investment. By contrast a move to alternatives such as prices monitoring will give unsatisfactory outcomes for everyone in the industry, including ultimately airport operators.