AIRLINES FOR AUSTRALIA & NEW ZEALAND

ECONOMIC REGULATION OF AIRPORTS

RESPONSE TO PRODUCTIVITY COMMISSION'S DRAFT REPORT

MARCH 2019

AIR NEW ZEALAND · Jetstar · QANTAS · rex Regional Express · tigerair · Virgin australia

PREFACE

It behoves us all to remember that in conducting this Inquiry, it is the Productivity Commission that is charged with seeking out evidence, whether from submissions or its own research, applying rigour in its analysis of this evidence, properly assessing proposals on their merits, weighing up the alternatives – including the status quo – and ultimately, explaining the rationale for conclusions drawn thus far. The Government, and the Australian people, ought to expect this of such an institution.

It is our view that the Commission's Draft Report falls well short of these expectations.

The tone of this submission from A4ANZ is not one we would have preferred to write in response to the Draft Report. Unfortunately, however, we feel we were left with little choice. Airlines are by no means the only ones with an interest in this Inquiry. We share with many other sector stakeholders a profound sense of disappointment with the Commission's lack of engagement with the evidence already provided, the absence of explanation for why such evidence was deemed irrelevant, and why proposals considered acceptable in other sectors were deemed so unworthy of any further consideration by the Commission; all simply rejected in favour of the status quo.

These other stakeholders – from airport users to politicians to regulatory, legal and economic experts – have expressed to us a view that any further engagement with the Commission's Inquiry is futile. Many were completely discouraged from responding to the Draft Report or attending public hearings. It must be said that this is an extremely damaging outcome from a public policy perspective, and, we are quite sure, not one that the Commission intended.

Rather than disengage, however, at A4ANZ we decided to provide a response, in the interests of continuing our contribution to the formation of evidence-informed policy. We don't pretend to speak for all, but offer our review of the Draft Report, summarised on the following page with key findings and recommendations for the Productivity Commission. We explain these in further detail in the body of the submission.

ABOUT AIRLINES FOR AUSTRALIA & NEW ZEALAND

A4ANZ is an industry group, established in 2017 to represent airlines based in Australia and New Zealand, including: Air New Zealand, Qantas, Virgin Australia, Regional Express (REX), Jetstar and Tigerair. Member-funded and representing international, domestic, regional, full service and low-cost carriers, A4ANZ advocates on key public policy issues relevant to airline operations, including efficient access to domestic airport infrastructure.

The A4ANZ Board identified at the time of the organisation's formation that one of its highest priority issues was ensuring that the regulatory and pricing environment for monopoly airports:

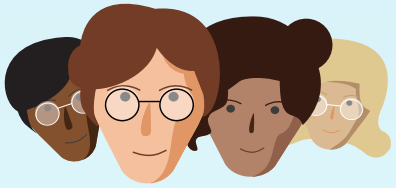
- Encourages competition and innovation;
- More accurately reflects cost inputs;
- Accurately reflects a reasonable and fair return on assets;
- Keeps growth at reasonable not exponential rates;
- Supports investment and maintenance of infrastructure that is fit for purpose, efficient and timely; and
- Maintains accessible airfares for consumers across all areas of Australia and New Zealand.

AIRPORTS INQUIRY: A SERIES OF UNFORTUNATE DECISIONS

PRODUCTIVITY COMMISSION DRAFT REPORT 2019: ECONOMIC REGULATION OF AIRPORTS

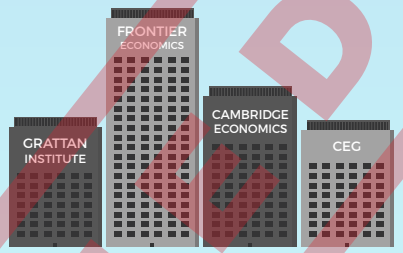
INDEPENDENT EXPERTS

Legal and Regulatory



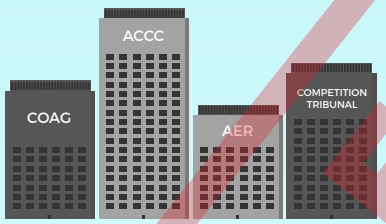
Regulatory system not fit-for-purpose: no credible threat[1,2,3]

ECONOMISTS



Monopoly airports earning excess profits due to market power[4,5,6,7]

GOVERNMENT AND INDEPENDENT AUTHORITIES



Arbitration framework needed for monopoly infastructure: standard in other sectors[8,9,10,11]

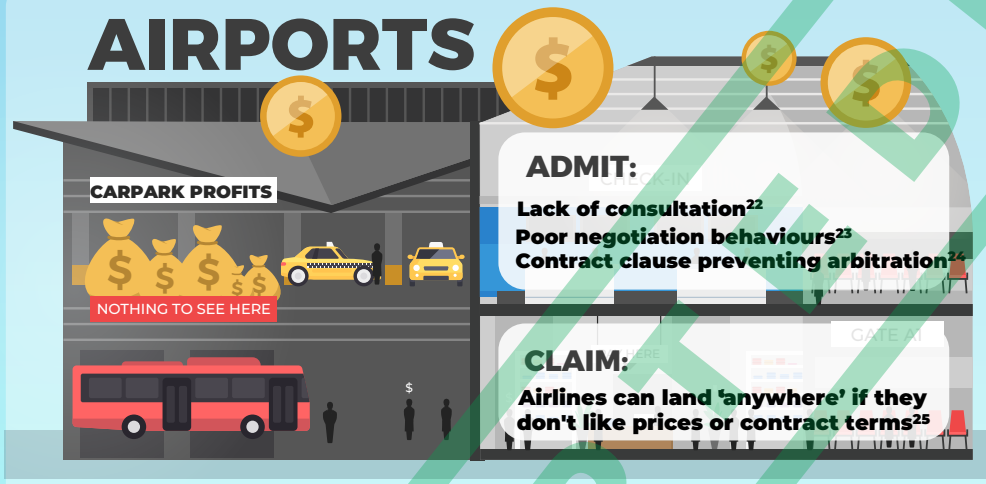
AIRPORT USERS

Evidence of monopoly prices and behaviours, impacting consumers[12,13,14,15,16,17,18]

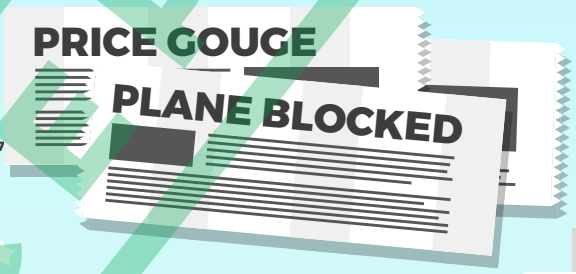
GLOBAL BEST PRACTICE

International and local precedents favour dispute resolution provisions for Australian airports[19,20,21]

AIRPORTS

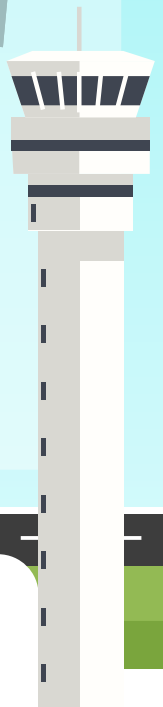


AGGRESSIVE BEHAVIOURS ON DISPLAY[26,27]



AIRPORT INVESTOR CONGLOMERATES

Defending super profits and profit margins.[28] Overstating risk[29,30,31]



REFERENCES
1. Michael O'Bryan QC (2018) 2. Margaret Arblaster (2018) 3. Johnson Winter & Slattery (2018) 4. Grattan Institute (2017) 5. Frontier Economics (2018) 6. Cambridge Economics (2018) 7. CEG (2018) 8. COAG (2016)
9. Australian Competition and Consumer Commission (2018) 10. Australian Energy Regulator(2018) 11. Australian Competition Tribunal (2005) 12. Essential Services Commission (2018) 13. Australia Finance Industry Association (2018)
14. Qantas Group (2018) 15. A4ANZ (2018) 16. Virgin Australia (2018) 17. Regional Express (2018) 18. Andrew's Airport Parking (2018) 19. Australian Competition Tribunal (2005) 20. Canada Transportation Act (2018)
21. MAVCOM (2015) 22. Australian Airports Association (2018) 23. Warren Mundy (2018) 24. Productivity Commission (2019) 25. Productivity Commission (2019) 26. Sydney Morning Herald (2018) 27. Sunday Telegraph (2018)
28.Australian Airports Association (2018) 29. Australian Airport Investors Group (2018) 30. IFM Investors (2018) 31. Infrastructure Partnerships Australia (2018)

AIRLINES FOR AUSTRALIA & NEW ZEALAND

TABLE OF CONTENTS

KEY POINTS AND RECOMMENDATIONS

From our analysis of the Draft Report and related commentary, we found that this Inquiry has been underpinned by erroneous assumptions; and further, that fundamental flaws in the Commission's analytical approach ultimately resulted in findings that cannot be justified, nor left to stand in the Final Report.

Key Points

1. Evidence of the current regulatory regime's limitations has been ignored

The Commission has failed to acknowledge the limitations of the current regulatory regime, ignoring or rejecting evidence and expert advice showing that:

- ACCC monitoring is ineffective in constraining monopoly pricing and behaviours at airports;
- declaration under the National Access Regime is no longer a credible threat;
- the prospect of future Productivity Commission Inquiries does not act to constrain monopoly behaviour;
- the existing regime does not facilitate commercial negotiations;
- there is a need for appropriate, timely pathways to dispute resolution; and
- the existing regime, the protracted disputes and legal processes it produces, comes at a significant cost.

2. Assessment of market power is flawed and dismisses airport user experiences

The Commission's airport market power assessment is flawed, in that it:

- failed to properly consider materiality of factors;
- did not assess market power across all airport services;
- drew conclusions about the lack of exercise of market power from flawed car parking comparisons;
- relied on a case for airline countervailing power that is neither credible nor relevant;
- rejected evidence of persistent high returns at airports as an indicator of market power exploitation; and
- did not satisfactorily address the behavioural elements of airports' exercise of market power.

3. Opportunity is being missed for societal gains from a fit-for-purpose regime

In considering the elements of a fit-for-purpose regime for airport regulation, the Commission has:

- ignored evidence that a sector-specific approach, which has worked in other sectors, is justified for airports;
- failed to acknowledge that the solutions proposed retain the key elements of light-handed regulation;
- rejected evidence favouring a negotiate-arbitrate regime over the existing regulatory settings, as a simple, pragmatic solution to resolve disputes;
- based objections to greater information disclosure on the erroneous assumption that equal bargaining power exists between airport users and monopoly airport operators;
- overstated concerns and failed to substantiate claims about risk and investment uncertainty that will apparently come with the changes proposed; and
- dismissed, without comparative analysis, evidence of wider benefits of a negotiate-arbitrate regime.

Recommendations

1. Factors contributing to status quo bias should be addressed in the Final Report

We encourage the Commission to acknowledge the status quo bias inherent in the Inquiry process, the impact it has had on the conclusions drawn thus far, and take steps to address this before drafting the Final Report. Such steps could include, but are not limited to:

- applying a more rigorous methodological framework that allows for the appropriate consideration and weighting of evidence from a range of airport users in determining the exercise of market power;
- taking appropriate note of independent expert analysis and advice on the existing regime's effectiveness;
- properly acknowledging and learning from precedents in other sectors and jurisdictions that have been informed by extensive consultation and/or robust analysis;
- undertaking a comparative analysis of the different regulatory options, including the status quo; and
- ensuring that all available data and perspectives are taken into account when assessing risks and benefits to the community of the status quo vs an amended regulatory framework.

2. Stated risks of regulatory change should be backed by evidence

Until the Inquiry has been concluded, we believe that the Commission should not engage in making further statements about the hypothetical risks of change, unless such claims are supported by rigorous analysis and evidence. These statements are speculative and only serve to create uncertainty in the sector.

3. Advice should be consistent with monopoly protections in other sectors

Recommendations from the Commission in the Final Report should be consistent with and provide similar protections to those afforded to Australian consumers and society from monopolies in other sectors.

4. The link between the regulatory framework and policy outcomes must be clear

In its Final Report, the Commission should articulate how the regulatory framework for airports it supports is actually achieving the policy objective of facilitating commercial negotiations between parties, and what processes are in place for the efficient and effective resolution of disputes.

5. The Final Report should reflect best available evidence and policy advice

We believe it is essential that the Final Report demonstrates how the Commission has addressed the issues it has considered in its Inquiry, and that its recommendations reflect the best available evidence and policy advice to Government, for the benefit of consumers and the Australian economy.

CONTEXTUALISING THE COMMISSION'S CONCLUSIONS

"There is no justification for significant change to the current form of regulation of aeronautical services at these airports." (Draft Finding 5.1)

A4ANZ was not alone in finding this definitive statement from the Productivity Commission completely implausible. As we outline below, it was a view shared by many others, from consumers and journalists, to economists and parliamentarians.[1] Surely, the weight of evidence, expert opinion, international and local precedent, and reform in other sectors, must have allowed Commissioners room to find at least *some* justification for change? Apparently not.

In this submission, we seek to understand how the Commission arrived at this and other conclusions, and the potential factors at play. We also identify some further questions that we believe would assist Government and stakeholders to better comprehend the context and rationale for the conclusions that have been drawn in this Inquiry thus far.

Rejection of evidence and expertise

In his independent response to the *previous* Productivity Commission Inquiry's Draft Report[2], Prof Stephen Littlechild expressed disappointment over the fact that the Commission had not acknowledged evidence in front of it, remarking (emphasis added),

"*It is disappointing that the Draft Report is unwilling to acknowledge the clear explanations, provided by the ACCC and the airlines, why ACCC arbitration would indeed provide strong incentives to engage in genuine commercial negotiations. And while it was perhaps understandable that the Productivity Commission had pessimistic expectations five years ago, it is equally disappointing that the Draft Report is unwilling to acknowledge the overwhelming evidence that has been presented to it, as to how access to arbitration or its equivalent has actually worked in practice."*[3]

Now a further eight years on, it is clear the Commission did not heed this expert advice, nor amend their approach towards assessing the evidence before it in the current Inquiry.

It is of course entirely reasonable for the Commission to question submissions and proposals from those with a vested interest, such as airlines and other airport users, as the Australian Airports Association (AAA) points out.[4] It is noteworthy that the AAA seem less willing to accept that the same scrutiny ought to apply to them and their own members. What still remains unclear, however, is why the Commission have also rejected readily-accessible insights from well-credentialled, experienced and independent experts, none of whom have a direct interest in the Inquiry, beyond the fact that all Australians have a stake in good economic policy.

These were not opinions from industry groups or individuals with an agenda, as the AAA have attempted to suggest.[5] They were from highly-esteemed public and private organisations and individuals. Some of those whose insights or opinions – found in public documents or submissions made directly to the Inquiry – that were ignored or rejected outright, include:

- The National Competition Council (NCC), in its recent (Dec 2018) draft recommendation on the Port of Newcastle declaration under the revised Part IIIA of the Competition and Consumer Act (CCA)[6];
- The Australian Competition and Consumer Commission (ACCC), in its submission to the Inquiry[7], supported by nearly two decades of airport monitoring reports[8], highlighting the ineffectiveness of the current regime;
- The Australian Competition Tribunal, in its statement of judgement on the Virgin Blue application for the Sydney Airport declaration in 2005[9];
- Frontier Economics, in its submissions on market power[10] and cost-benefit analyses[11,12], supported by global insights and decades of experience in regulatory economics;

- The Grattan Institute, in its 2017 publication *Competition in Australia - Too little of a good thing?*, which highlighted the "super profits" of the 4 major airports[13];
- Professor Peter Forsyth, an expert in transport economics, in his submission to the Inquiry showing that total factor productivity at the four major airports has in fact decreased year on year[14];
- Professor Stephen Littlechild, economist and regulatory expert, in his comments on the previous (2011) Productivity Commission Draft Report[15];
- Michael O'Bryan QC, a member of the panel which oversaw the Harper Review of the CCA, in his memorandum explaining the impact of the changes to Part IIIA of the CCA[16];
- Dr Michael Vertigan, economist, in his review of the Australian gas market, which outlined the benefits of a negotiate-arbitrate regime as protection against monopoly suppliers[17];
- Professor Frederick Hilmer, in the National Competition Policy Review of 1993, which raised concerns about monopoly infrastructure, and the likelihood of these firms being able to charge prices above the efficient level[18];
- Professor Ian Harper, in the National Competition Policy Review of 2014, which reiterated the importance of consumer and community protection against monopolies[19];
- The Council of Australian Governments (COAG) Energy Council, in its gas market reform package of 2017, which adopted the negotiate-arbitrate framework to protect against monopoly pricing[20];
- The Australian Energy Market Commission (AEMC), in its review of the economic regulation of gas pipelines in 2018, which found that the negotiate-arbitrate regime was necessary for an appropriate constraint on market power[21];
- Margaret Arblaster, economist and widely-published airport regulatory expert, in her assessment of the current regulatory model and best practice approach[22]; and
- The European Commission, with its methodological approach to reviewing EU airport charges[23], as well as its preliminary findings.[24]

As noted by others whose views the Commission did find compelling, expert economic evidence plays an important role in regulatory processes and decisions.[25] How and why the insights from this extensive (non-exhaustive) list of highly-regarded, respected institutions and individuals with deep economic, regulatory and subject-matter expertise, came to be deemed irrelevant by the Commission, are questions that remain.

It was certainly not explained by the Commission nor included in its draft report by way of justification of its own conclusions. It is also at odds with its own statement in the Draft Report, that the Commission "*seeks to use the best available evidence and the most rigorous analytical techniques to reach its conclusions*" (Draft Report, p.288). It is genuinely hard to see how these principles have been applied in forming the conclusions reached and views expressed in the draft report.

A fundamental issue may be that the draft report is, according to at least one Commissioner, apparently underpinned by a "*philosophical perspective*" that says that it is "*unfair*" for a monopolist to face regulation, unless it can be shown that they have systematically abused their market power. Otherwise they are, as this Commissioner described it, being treated as "*guilty until proven innocent*."[i]

This is an interesting perspective, particularly given that what has been proposed in terms of a negotiate-arbitrate regime retains a light-handed regulatory approach. Fair from being unfair, these sort of schemes are widely-recognised as providing appropriate fairness through consumer protections from monopolies, without restricting

[i] These were perspectives shared by Commissioner Professor Stephen King, at a *Policy in the Pub* session on Economic Regulation of Airports, hosted by the Economic Society of Australia (Vic branch) on 20 March 2019.

competition or growth. This should not be a particularly controversial position for the Commision to accept, given Commissioner Stephen King has previously said of monopolies that, "*If competition is not possible then the privatised business needs to be regulated so that it cannot exploit its market power".*[26]

Other regulatory and economic experts, after detailed analysis, considered review, and the application of significant experience and expertise, have taken the view that the existence of a credible regulatory threat through an effective dispute resolution process, is in fact necessary to address the imbalance of power between monopoly airport operators and their customers – something we explore later in this submission.

By contrast, the Commission seem to have adopted an approach of saying that they require proof, not on the balance of probabilities, but beyond all reasonable doubt (to continue with their legal analogy), that market power is being systematically exercised at airports, before accepting a reasoned case for similar protections being put in place for airport users.

Just what harm the airports would come to, if this sort of scheme applied to airports, is not articulated. Rather, the burden of proof is placed back on proponents of change. The most perplexing part of that, however, is that the evidence already provided to the Commission has been largely ignored, as we explore throughout this submission. In fact, the Commission has, in more recent commentary, completely dismissed evidence-based proposals for amendments to the light-handed regulatory model as no more than "*red herrings*".[ii]

We have reached the conclusion that one possible – and likely – explanation for the way in which the Commission has approached this Inquiry and the data presented to it, is the presence of *status quo bias*.

Status quo bias at play

Research has shown that when choosing among alternatives, individuals – often inadvertently – display a bias towards sticking with the status quo; and then set about defending that position.

This phenomenon is more prevalent and of more significance in the area of public policy, where the presence of multiple interests creates a certain pressure to stick with or defend what is "known". Once made, policies frequently persist, and are often viewed as a success by evaluators, even if they would have little chance of passing a cost-benefit test applied to a new program or policy.[27]

We believe that it is highly likely that this type of thinking is what led to the overall outcome we saw in the Commission's Draft Report, virtually a repeat of the position taken eight years prior, with little to no recognition of the changed external regulatory environment, nor the growing body of evidence. Put simply, it's hard to come up with other, legitimate reasons for the Commission to deliberately ignore or minimise the weight of evidence pointing to problems with the current regime, and reject well-researched, sensible and pragmatic proposals for reform.

In the face of proposals from credible sources, how else to explain such conclusions as "*On balance, the process and outcomes [of commercial negotiations between airlines and airports] give little cause for concern*" (Draft Report, p.316) and the strongly-worded claim – for which no supporting evidence or analysis is provided - that "*A negotiate-arbitrate framework would have substantial perverse effects that would harm the efficiency of the sector and negatively affect passengers."*? (Draft Report, p.316)

While we respond to these specific issues in more detail later in this submission, we have earlier depicted them in an infographic form for easy reference, and below, we consider how these issues might best be overcome.

[ii] This description was on a slide shared by Commissioner Professor Stephen King, at a *Policy in the Pub* session on Economic Regulation of Airports, hosted by the Economic Society of Australia (Vic branch) on 20 March 2019.

Overcoming policy paralysis

The Productivity Commission is charged with "*providing quality, independent advice and information to governments, and on the communication of ideas and analysis*."[28]

Our contention is that their approach to taking account of, and appropriately assessing the information before it, along with the credibility and expertise of those providing that information, falls short of what Australians should expect of this institution, given the brief outlined above.

Instead, their conclusions left many experts scratching their heads, and to one correspondent describing the draft report as "*the equal worst*" report by the Productivity Commission in the past 25 years, which "*failed to learn from history*."[29]

While that may be a harsh assessment, it is of concern to many that while the Commission outlined their framework for assessing market power – the issues with which we address separately later – they did not provide a framework for how evidence submitted to the Inquiry was treated. Others with an interest in the Inquiry have made submissions in response noting that "*the Draft Report demonstrates a lack of adequate research by the PC*", "*some statements are self-contradictory*", and that "*the PC's assertions do not appear to be based on adequate research and evidence*".[30]

As a summary, we found that the draft report is absent an explanation by the Commission of how the following issues were dealt with in the Inquiry thus far:

- What measures were taken to ensure that the tendency towards *status quo bias* can be overcome?
- Has a sufficiently rigorous analysis of the current regulatory model been undertaken to include an assessment of the benefits and risks of it continuing?
- Has a comparative analysis of other regulatory models been undertaken, *including the status quo* and those that are considered best-practice?
- Is the bar for evidence of benefit and risk set at the same level for the current and new models of regulation?
- Should society be afforded protection from some monopolies but not others?
- In the submissions received, how was opinion balanced again expertise and facts?
- Are the regulatory, legal and economic experts - including from other sectors and jurisdictions around the world - who argued in favour of reform all wrong? If so, where is the supporting evidence for this?

It appears that this Airports' Inquiry needs an urgent reset to avoid the Final Report becoming a product of the same flawed approach that befell the Draft: status quo inertia. Research tells us that this can in fact lead to significant welfare loss – from decisions *not* taken[31], which is precisely the opposite of what the Commission's work is intended to promote.

A fresh perspective in the development of the Final Report would allow the Commission to take the audience, especially those charged with making policy decisions, through their approach to addressing all of these critical issues and the rationale for their recommendations.

To assist with this process, in our submission we outline the critical mis-steps and shortcomings of the Commission's Draft Report, and outline key areas that would benefit from a significant re-think, prior to the Final Report.

This would allow the Commission's ultimate recommendations to Government to genuinely reflect sensible, pragmatic, and evidence-informed changes to policy and regulatory settings, for the benefit of consumers, the aviation sector, and the Australian economy.

AIRPORT REGULATION IN AUSTRALIA

FACT CHECKING THE DRAFT REPORT

Australia's airports are monopolies and behave as such. With no incentive to charge reasonable prices, their profits have continued to grow over time, with the ACCC's price-monitoring regime powerless to control this. The impact is felt by every Australian airport user, but especially consumers. The Productivity Commission says the system is working fine and doesn't need to change[1], but the evidence says something else. Sensible reform, in the form of a negotiate-arbitrate regime, is required to facilitate genuine, commercial negotiations with airports.

PC CLAIM:

The threat of regulation constrains airports' profitability and exercise of market power.

FACT:

Expert legal and economic analysis shows that the regulatory regime is not working as it should.[2,3]

This has allowed Australian airports to earn margins more than double the international average, over a long period. [4,5]

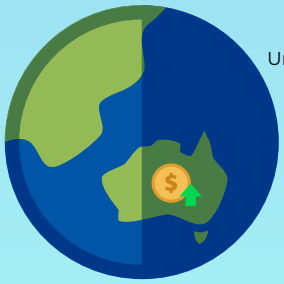
PC CLAIM:

Each of the four monitored airports has generated returns sufficient to promote investment while not earning excessive profits.

FACT:

Airports have been independently assessed as earning "supernormal profits" since 2011.[6] **Revenue per passenger has risen 25% in a decade.**[7] Operating profits/ passenger in 2017 place Australian airports well above global comparators.[8]

REVENUE:



PC CLAIM:

Unable to determine whether airport operators have systematically exercised their market power in landside access.

FACT:

9 of the top 10 most expensive airports in the world for rental car operators are in Australia, more expensive than Heathrow, LAX and Paris CDG.[9]

PC CLAIM:

The arbitration process would be time-consuming and costly, and would change incentives for parties to reach outcomes through commercial negotiation.

FACT:

Access to arbitration is standard practice in the effective resolution of commercial disputes, in many settings.[10]

Standard, commercial arbitration methods can include fixed timeframes and criteria within their guiding principles.[11]

PC CLAIM:

An airline can threaten to withdraw some or all of its services at a particular airport if it is not satisfied with access conditions.

FACT:

Network airlines are simply not in a position to readily withdraw from routes.[12,13] This was well documented in multiple submissions to the PC.

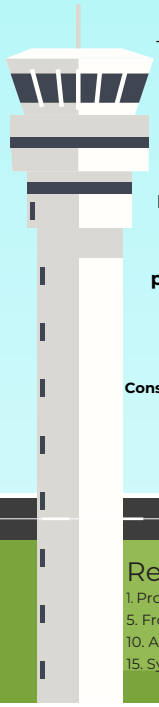
PC CLAIM:

Each party seeks to take advantage of its bargaining power. This is normal commercial behaviour...

FACT:

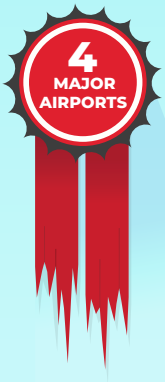
Negotiations are not taking place on a level playing field. Almost all airports in Australia exhibit natural monopoly characteristics.

The imbalance in bargaining power between monopoly suppliers and customers who operate in a competitive market is well documented.[14]



PC CLAIM:

The airports that participate in the second-tier voluntary monitoring do not have a level of market power that warrants intervention.



FACT:

Market power can be measured in several ways. **Tier 2 & regional airports also exhibit market power in their conduct, including lack of consultation, negotiating & investment behaviours.**[15,16,17]

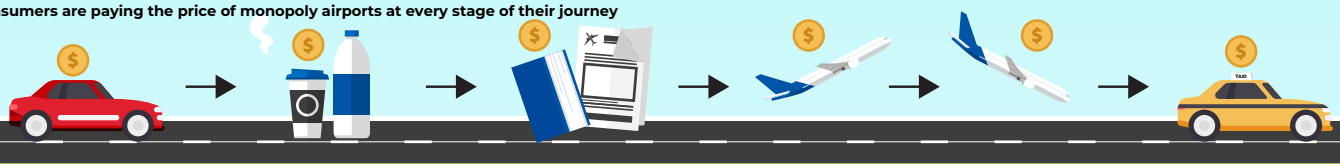
PC CLAIM:

There is little evidence that the monitored airports exercise their market power in car parking.

FACT:

Profit margins for car parking remained very high across all monitored airports - with some airports making a profit of up to 70 cents out of every dollar paid by consumers.[18]

Consumers are paying the price of monopoly airports at every stage of their journey



References:

1. Productivity Commission 2019. 2. Michael O'Bryan QC 2018 3. Frontier Economics 2018 4. Leigh Fisher 2017
5. Frontier Economics 2018 6. Grattan Institute 2017 7. ACCC 2018 8. DIRDC 2018 9. AFIA 2018
10. A4ANZ 2019 11. AER 2018. 12. Norton White 2018 13. Frontier Economics 2018 14. Dunlop & Higgins 1942
15. Sydney Morning Herald 2018 16. Sunday Telegraph 2018 17. AAA 2018. 18. ACCC 2019

AIRLINES FOR AUSTRALIA & NEW ZEALAND

MARKET POWER ASSESSMENT IS FLAWED[iii]

A4ANZ believes that a series of unfortunate assumptions in the Commission's approach to assessing airports' market power have led to unjustifiable findings. It must be asked whether this approach meets their own benchmark of "*best available evidence*" and/or the "*most rigorous analytical technique*" for assessing market power.

At the very least, the draft report should have said why this approach was considered superior to others; particularly since the Commission rejected the outcomes of analysis produced by applying the structure-conduct-performance schema to Australian airports.[32]

Economic literature relies heavily on this schema when looking at indicators of market power. The idea of this is that the structure of a market (in particular, the patterns of firms within the market and the condition of entry) is a key influence on patterns of conduct within the market; and the patterns of conduct within the market will influence the performance of the market – the efficiency with which the market allocates resources.

This suggests that the existence of market power can be assessed in a number of ways.

- The **structure** of a market can be examined to see whether it is of a kind that is likely to produce competitive conduct.
- The patterns of **conduct**, such as pricing and investment behaviour, can be examined to ascertain the extent to which enterprises within the market are behaving in a competitive manner.
- The **performance** of the market can be examined, in particular, by looking at the extent to which firms have been able to generate profits above the level that would be expected in a market characterised by effective competition.

Our commentary in the following sections is focused largely on the structure and performance elements. However, given the Commission's preference for anecdote to inform its conclusions, and their request for further examples of "take or leave it" behaviours (Draft Report, p.118), we have dedicated a later section in this submission to outlining the ways in which an airport's conduct may reflect an exercise of market power.

It would have seemed reasonable for the Commission to also consider these issues with proper reference to the ACCC's Guidelines on Misuse of Market Power.[33] An excerpt of the relevant section is at Appendix A. Surprisingly, however, the Draft Report does not reference the Guidelines, and it would appear from recent commentary that the Commission paid little attention to the advice contained within the guidelines.

Instead, the Commission's reliance on its own "philosophical" position, coupled with a rejection of evidence from a range of other parties, has ultimately led to incorrect conclusions about the degree of market power held by different Australian airports or its exercise, and enabled the Commission to escape the need for any detailed assessment of alternative forms of regulation. Moreover, and most significantly, it has also prevented any serious engagement on how to improve outcomes in the sector.

In the sections that follow, we outline the erroneous assumptions made by the Commission in relation to market power and their consequences.

[iii] This section was drafted with the assistance and expertise of Frontier Economics' regulatory economists, Ms Anna Wilson and Mr Warwick Davis

Commission fails to consider materiality of factors

Whilst not disputing the factors the Commission has considered in assessing airport market power, their importance and materiality must be challenged. To determine if something is a constraint on market power, it is necessary to analyse *the strength* of the response of passengers to this and, the significance of this passenger response, to airports.

This means it is necessary to consider the following aspects:

- the degree to which an increase in airport charges (say by 5-10% higher than the competitive level) will be passed on to different passengers through airfares;
- the routes or connection for which substitution is possible and their relative importance in the airport's overall traffic mix;
- the relative breakdown of passengers by route or travel purpose;
- the demand elasticity of passengers on different routes or with different travel purposes;
- the combined impact/scale of passenger switching in response to the hypothetical airport price rise given the relevant routes for which switching is possible and the passenger mix on these routes; and
- estimates of the amount of passenger switching that would make the hypothetical price increase unprofitable from the point of view of an airport (the critical loss).

Fundamentally, airports are buffered from any passenger responses by airlines. Airports face a derived demand and an extremely low price elasticity. This should not come as news to the Commission, which included a discussion of this matter in Box 3.1 of its Draft Report. However, it appears the Commission has treated this matter as an irrelevant aside, as it does not consider the importance of this in its market power assessments.

This is a mistake. It is highly relevant, as it reduces the materiality of the theoretical factors highlighted by the Commission as constraining market power, namely, modal substitution and destination substitution.

Box 1: Airports face a low elasticity dampening any constraint on market power

An extensive literature review by InterVISTAS Consulting on behalf of IATA[iv] suggests that the following key factors drive air travel demand elasticities:

- Purpose of travel — business travellers are less sensitive to fare changes (less elastic) than leisure travellers, given they generally have less flexibility to postpone or cancel their travel.
- Prospects for modal substitution (Short-Haul Versus Long-Haul Travel) — fare elasticities on short-haul routes were generally higher than on long-haul routes. This reflects the opportunity for inter-modal substitution on short haul routes (e.g., travellers can switch to rail or car).

The generalised findings from the literature review were that elasticities at the route or market level are typically in the range of -1.2 to -1.5. For short haul routes (less than 1-hour travel time) elasticities may be on average 10% more elastic.

It is important to note that these elasticities relate to passengers' sensitivities to changes in airfares not airport charges. These elasticities imply a very small reduction in demand for air travel as a result of a rise in airport charges if they are fully passed through.

It is common in competition cases to apply a SSNIP framework to help define the market or consider the degree to which a firm faces competitive constraints. A SSNIP framework involves considering whether it would be

[iv] Source: Estimating Air Travel Demand Elasticities, Final Report, InterVISTAS on behalf of IATA, December 2007

profitable for an airport to increase its charges by a Small, but Significant Not transitory Increase in Price (SSNIP), typically 5-10% above the competitive level.[v]

According to the AAA's advisor InterVISTAS, airport charges typically represent less than 10% of airfares.[vi]

A simple example shows the general implausibility of passenger constraints on airport market power. If airport charges rise by 10% (and this represents say 10% of airfares) and this increase is proportionately passed through to all passengers, airfares would rise by 1%. Assuming an elasticity of -1.5 would imply demand for air travel to and from this airport would only fall by 1.5%. In other words, a 10% increase in airport charges would lead to a 1.5% decrease in passenger numbers.

Modal substitution is immaterial, even for Canberra Airport

From the point of view of passengers, alternative modes of travel could in theory provide substitutable, but differentiated offerings, for some specific routes, from some airports. However, in our view modal substitution is immaterial for Australian airports.

The Commission identifies Canberra Airport as an exception, noting that there is some scope for modal substitution. It is on this basis that the Commission determines Canberra Airport does not have a level of market power that would justify regulatory intervention.[34] The Commission has based this on:

- there being some scope for modal substitution on the Canberra–Sydney route, given the existence of road transport alternatives; and
- visitors to the ACT being the least likely to use air transport for interstate travel, meaning a relatively large proportion of overnight visitors to ACT arrived by private vehicle.

However, the Commission in its draft report has made no attempt to test whether the prospect for modal substitution is a material constraint on Canberra airport's market power. This is a significant oversight.

The evidence presented by the Commission indicates very little about Canberra's market power. Modal substitution is only relevant on the Canberra to Sydney route – around 30% of passenger throughput at Canberra airport. Furthermore, not all passengers flying this route will consider alternative travel modes viable alternatives. Once they have taken into account the financial cost, travel time differences, frequency of services and other factors such as convenience, reliability and the number of people travelling together. By way of example, business travellers are likely to place a higher value on time than other passengers which may reduce their relative preference for land-based modes such as bus travel. In addition, some passengers would consider having a vehicle at their destination decidedly inconvenient (i.e. passengers connecting to an onward flight).

To understand the extent to which alternative modes act as a competitive constraint on an airport it is necessary to understand:

- how many passengers would switch modes in response to a rise in prices above the competitive level; and
- whether this fall in demand would be significant to, or more particularly unprofitable for, an airport.

The example below highlights how immaterial modal substitution is for constraining Canberra airport's market power (Box 2).

[v] In principle, the application of a SSNIP test should be from the competitive price level. This is unlikely to be possible given airports' existing charges likely already incorporates some element of market power. That said, as a thought process a SSNIP test is still useful.
[vi] AAA Submission to the PC Issues paper, Attachment 3 InterVISTAS (2018) *The Impact of Airport Charges on Airfares*

Box 2: Modal substitution between road and air travel is not a material constraint on Canberra airport

Let's assume Canberra airport raises its aeronautical charges across the board by 10%, consistent with a standard SSNIP test methodology. If airport charges typically represent around 10% of an airfare this would result in an average impact on airfares of approximately 1% (see Box 1).

Let's further assume, given the potential for modal substitution, there is a higher demand response on routes subject to modal substitution. International evidence on price elasticities for air travel suggests that for short haul routes (less than 1hour travel time — Canberra to Sydney is 55min) elasticities may be on average 10% higher,[vii] (i.e. 1.65 if using airfare price elasticity estimate of 1.5 described in Box 1). This reflects the increasing importance of modal comp on these routes. However, for the sake of conservatism, we have assumed a higher price elasticity of 2.2 based on a study of the price elasticity of leisure passengers on Australian short haul routes.[viii]

Note this higher elasticity would only apply to passengers flying the route from Canberra to Sydney. This route represents 30% of total passenger throughput for Canberra airport.

So under these assumptions, a 1% increase in airfares would be likely to lead to a 2.2% fall in demand on the Sydney-Canberra route and a 1.5% fall in demand on all other routes. In total, Canberra airport would face a 1.7% fall in its total passenger demand.

This may be an overestimate of the demand response given a significant proportion of travellers on this route may be business travellers or connecting to international routes which will have dampened elasticity even where there are potential modal substitutes. Also, airlines are unlikely to pass through cost increases to more elastic customers, so the impact may be overstated.

Critical loss analysis

A critical loss analysis, commonly used in competition assessments, suggests this level of demand response would be highly unlikely to constrain Canberra's market power.

The critical loss is the maximum decrease in quantity (as a percentage) that would need to be suffered by the airport before the price increase becomes unprofitable. This is a way of balancing two effects — a price increase will raise the profit margin earned on all passengers, but it will also reduce the number of passengers travelling.

$$Critical\ Loss = \frac{X}{X + m}$$

Where X = given percentage increase in prices (i.e. 10%)

m = price cost margin as a percentage of price

The greater an airports' margin per passenger, the lower the critical loss (i.e. the fall in demand necessary to result in a profit loss). Airport margins for Tier 1 airports are around 75%. If we assume the margin was 100%, this would minimise the critical loss. Under this assumption a 10% increase in charges would be unprofitable if it leads to a fall in demand greater than or equal to 9.1% (i.e. (10%)/(100%+10%) = 9.1%.).

Comparison of this extremely conservative critical loss (9.1%) to the likely fall in demand estimated above (1.7%) shows just how unlikely it is that modal substitution would constrain the market power of Canberra Airport.

[vii] Estimating Air Travel Demand Elasticities, Final Report, InterVISTAS on behalf of IATA, December 2007

[viii] Based on short Haul estimated contained in Hamal - Australian Outbound Holiday Travel Demand Long-haul Versus Short-haul (1998) referenced in Estimating Air Travel Demand Elasticities, Final Report, InterVISTAS on behalf of IATA, December 2007

Destination substitution is the exception rather than the rule

The Commission raises the prospect of destination substitution as being a potential constraint on some airports, on the basis that there is scope for some passengers to view another destination as a viable alternative. We do not dispute the potential for this. However, its materiality *is* in dispute, particularly for the Tier 2 airports.

The Commission identifies this as being a relevant constraint for Adelaide, Cairns, Darwin, Gold Coast and Hobart Airports, given these airports serve a higher proportion of leisure passengers who may have more flexibility in their holiday destination.[35] However, the Commission in its Draft Report has made no attempt to test the materiality of this constraint on these airports' market power. This is a significant oversight.

Destination substitution is only a relevant option for passengers *flying to the airport* in question. It will not be relevant to passengers wishing to depart from the airport. While they can choose an alternative destination, this will not affect their choice of departing airport. Therefore, where airports have a major population base located near the airport, destination substitution become irrelevant, as is the case for Adelaide, Cairns, Darwin, Gold Coast and Hobart Airports.

The example below highlights how immaterial destination substitution would be for constraining these Tier 2 airports' market power.

Box 3: Destination substitution is not a material constraint for a Tier 2 airport.

Let's assume an airport raises its aeronautical charges across the board by 10%, consistent with a standard SSNIP test methodology. If airport charges typically represent around 10% of an airfare, this would result in an average impact on airfares of approximately 1% (see above for a more detailed description).

Let's assume leisure travellers have a higher demand elasticity. For the purpose of this assessment, we have assumed a price elasticity of 2.3. This is the maximum estimated price elasticity for leisure air travellers contained in the literature reviewed by InterVISTAS.[ix] This higher elasticity would only apply to leisure passengers *flying to the airport*, which we have assumed to represent 50% of the total passenger throughout at most Tier 2 airport.

So, under these assumptions, a 1% increase in airfares would lead to a 2.3% fall in demand from 50% of passengers and a 1.5% fall in demand for all other passengers. In total, the airport would face a 1.9% fall in its total passenger demand.

A critical loss analysis (as described in Box 2), suggests this would be highly unlikely to constrain the airport's market power, as the potential fall in demand estimated above (1.9%) is nowhere near the critical loss estimate of 9.1%.

Countervailing power argument is neither credible nor relevant[x]

"*A significant level of market power may create a prima facie case for regulatory intervention, even when the constraints on that power are considered*." (Draft Report, p.67)

Despite this statement, the Commission dedicates a significant proportion of its report to proving the case for airlines having 'significant' countervailing power and in Chapter Three of the Draft Report argues that this is able to mitigate the market power of airport operators; to the extent that apparently Adelaide and Canberra airports are apparently completely constrained from exercising market power, despite clearly publicised examples to the contrary.[36]

[ix] Based on estimates contained in Oum, Zhang, and Zhang - InterFirm Rivalry and Firm-Specific Price Elasticities in Deregulated Airline Markets (1993) referenced in Estimating Air Travel Demand Elasticities, Final Report, InterVISTAS on behalf of IATA, December 2007

[x] This section has been informed by further analyses from Frontier Economics which is included in the submission from the Qantas Group.

The Commission states that many inquiry participants – notably, mainly airports – have claimed that "airlines have significant countervailing power".[37] Unfortunately, the Commission has appeared to accept these claims without interrogation, as the Commission has suggested that airlines can, and do, exert countervailing power on airport operators when they control a significant proportion of the market. In making this assertion, the Commission has appeared to rely on anecdotal evidence which is neither convincing, nor able to be extrapolated across airports.

In order for countervailing power to genuinely mitigate an airport's market power, airlines need to be able to *credibly* threaten to bypass an airport – however, common sense dictates that this is not possible. Indeed, as the Commission notes in the draft report, the only options available to an airline in negotiations with airports are to reduce services to the airport, or refuse to pay. Neither of these are bypass options – rather, they involve airlines no longer providing their customers with services, or in the case of refusing to pay charges – engaging in actions that will only result in delay, as charges ultimately have to be paid.

Standard economics on the credibility of threats, dictates that, in order to be credible, an airport must believe that;

- the airline would carry through with the action threatened; that is, carrying through would be rational (or credible on commercial grounds), for the airline, given its choice between the action and the option of accepting the higher charges, and
- the airport's costs if the threat is carried through will be of similar or greater magnitude to the airline's costs. If the airport's costs are small then it will not be swayed by threats which, if enacted, would impose much greater costs on airlines.

However, as noted by A4ANZ, its members, and independent experts in initial and subsequent submissions to the Commission, network airlines are simply not in a position to readily withdraw from routes. Further, it is highly improbable that airports would suffer comparative or larger losses than that of an airline – as most airports would be able to readily backfill any slots made available by the withdrawal of a service by offering the capacity to other airlines. This has been borne out in the experience of Newcastle Airport, which highlight how quickly this can occur.[xi]

In the unlikely event that airports were unable to backfill available slots, airlines would generally lose a much greater amount as a result of service withdrawals. Modelling suggests that, at both Tier 1 and Tier 2 airports, an airline would incur a loss per flight of between 2 – 10 times greater than those of these airports if it was to reduce services.[38] In addition, the airline would also incur significant losses as a result of the effect on broader network operations, and of course significant reputational damage.

This is an important point, as it negates the false equivalence the Commission has made between an airline's ability to increase capacity on an existing route under specific and – highly unusual – circumstances, with an airline being able to adjust their network and face significant losses (including reputational) for the purpose of withdrawing entirely from a route.[xii]

A note on "switching" as a form of countervailing power

The Commission argues that "*an airport has less market power if an airline can respond to an increase in aeronautical charges by switching to a different airport*" (Draft Report p.91). Concerningly, the Commission appears to imply that this theory would hold across all airports in the Australian market. Despite the absence of evidence confirming this, they suggest that passengers of low-cost carriers (LCCs) are price sensitive, and that this

[xi] From Jan-Oct 2018 Qantas faced pilot shortages, resulting in them being forced to remove approximately 800 services over this period — equating to 1-2 daily return flights. The Qantas group face competition from Virgin on most routes to/from Newcastle, broadly in line with the airlines' average capacity market shares across Australia. When Qantas withdrew these services, Virgin was able to respond to backfill the lost capacity.

[xii] Comments made by Commissioner Professor Stephen King, at a *Policy in the Pub* session on Economic Regulation of Airports, hosted by the Economic Society of Australia (Vic branch) on 20 March 2019.

increases the likelihood that an airline will simply switch if an airport increases charges, thereby giving the airline countervailing power in negotiations.[39]

Relying on evidence and experience from the EU in this instance is particularly fraught, as it is not readily translatable into the Australian market, due to significant structural differences. Similarly, the Commission has seemingly not interrogated statements made by airports about the ability of LCCs to switch.

The example provided by North Queensland Airports – which the Commission presents as an example of LCCs pulling out of a route – states that "*Growth in passengers has been from low cost carriers (LCCs) whose business models are optimised to redeploy capacity to profit maximising routes. At Mackay in the face of declining demand airlines simply scaled back services, and/or withdrew completely.*"[40] The problem with this is that it is not actually an example of a LCC "switching". In presenting this anecdote, without scrutiny, as an example of "switching", the Commission have fundamentally misunderstood the difference between an airline simply responding to market demand, as any business would, with them "switching" their business to an alternative airport in response to excessive charges.

To imply that an LCC "switching" is probable in the Australian market ignores the significant effect that this would have on an airline's network operations and connectivity, not to mention the potential significant investments in infrastructure, and engineering or crew bases. This does not give an airline countervailing power over an airport.

Finally, in the instance that an airline did hold countervailing power – it would only constrain an airport's market power by a degree. A tough reputation and negotiation tactics such as "holding out" on a deal do not necessarily represent genuine countervailing power, any more than the fact that a deal has been done means that airlines or other airport customers were "happy" with the terms and conditions on offer from the airports.

Given that the Commission have referred to the ACCC merger's guidelines when further discussing the relevance of countervailing power as a mitigating factor[xiii], it is worth noting that these guidelines explicitly state that,

> "*The size and commercial significance of customers (sometimes referred to as 'buyer power') is not sufficient to constitute countervailing power"*, and, further, that
>
> "*Buyers need more than size to constrain the exercise of market power by a supplier. For example, if the supplier's product is an essential input for the buyer, the only way the buyer can defeat any attempted increase in market power is if it can credibly threaten to bypass the supplier.*[41]

Once again, this leaves the Productivity Commission taking a position that is at odds with how other regulatory experts interpret the situation. The AEMC, for example, shared its insights on the topic in a recent report,

> *"Some [infrastructure users] are relatively well resourced and well informed with regard to the negotiation process. Some may have a degree of countervailing market power, although the Commission recognises that this may not always be the case. These factors serve to constrain the extent of market power of pipeline service providers - although only to a degree - if these factors completely constrained market power in all cases there would be no need for economic regulation at all."* [42]

Ultimately, countervailing power is largely an irrelevant and immaterial consideration in the Australian aviation sector, as there are very few circumstances where the required conditions for countervailing power would hold, and no real-world examples that the Commission has been able to point to. This is reinforced by BITRE data showing the stability of the Australian domestic network.[43] It is also clearly explained and set out in detail in a separate submission from Qantas in response to the Draft Report, prepared by Frontier Economics.[44]

[xiii] Comments made by Commissioner Professor Stephen King, at a *Policy in the Pub* session on Economic Regulation of Airports, hosted by the Economic Society of Australia (Vic branch) on 20 March 2019.

In any case, the Commission themselves conclude,

> *"It does not follow that regulation is less warranted because airlines have countervailing power. Countervailing power is not helpful from the consumer's perspective, as passengers still pay a high price that reflects the exercise of market power."* (Draft Report, p.101)

From this statement it would appear that, regardless of the questionable position the Commission may have taken on these matters relating to countervailing power, it ought not prevent them from making the regulatory settings for airports more effective, in the interests of consumers.

EVIDENCE FOR AIRPORTS' EXERCISE OF MARKET POWER[xiv]

In relation to the assessment of airports' exercise of market power, it seems that the Commission has not only failed to correctly interpret the various strands of evidence presented in submissions, but also to consider them in a meaningful way. As a result, perverse conclusions have been drawn from these data. We understand that this has arisen because the Commission has:

1. Not assessed the exercise of market power across the entirety of an airport's services — resulting in a partial and ultimately flawed assessment of profitability;
2. Assessed airport profitability by benchmarking monopoly airports against each other and using less reliable measures which are more affected by investment decisions, giving airports "excuses" for high short-term profitability;
3. Failed to interpret and appropriately weight the various other strands of evidence relating to market power exploitation, or indeed bring this evidence together in a meaningful way. This includes:
    - Frontier's evidence on profitability[45], which shows that airports have been highly profitable over the long term when considered against a benchmark WACC - developed using the parameters suggested by the AAA's own submission.[46] This is the most critical evidence relating to market power exploitation;
    - The Commission's analysis of charges. This lacks reliability as it is a partial assessment (focused on landing and car parking charges) and fails to address challenges associated with defining an appropriate benchmark;
    - The various strands of the analysis on evidence relating to operational efficiency. It is difficult to draw any insights from this as the evidence was conflicting and subject to too many limitations, the most significant of which is the fact that operational efficiency ultimately has a weak theoretical link to the exercise of market power.

Weighing up all the evidence relating to the exercise of market power, it remains fundamentally unclear how the Commission reached a view that "*the evidence as a whole does not suggest that the four monitored airports have systematically exercised their market power.*" (Draft Report, p.133)

In the sections that follow, we consider key gaps in the Commission's assessment of market power and how these could be addressed.

Market power must be assessed across all airport services

While never expressly stated in the draft report, the Commission's analysis of market power and the exercise of market power has been undertaken on a service by service basis. The draft report gives no consideration to whether this is an appropriate approach.

We do not believe it is, as airports provide multiple, complementary services using many common assets. Attempting to assess an airport's market power without considering the interactions between these services has resulted in the Commission drawing incorrect conclusions about the existence and exercise of Australian airports' market power.

Far from being a "*red herring"*, as the Commission has described it[xv], it is essential that returns are considered across an airports' total 'passenger and freight related' operations; the Commission's partial approach, which focuses only

---

[xiv] This section was drafted with the assistance and expertise of Frontier Economics' regulatory economists, Ms Anna Wilson and Mr Warwick Davis

[xv] Comments made by Commissioner Professor Stephen King, at a *Policy in the Pub* session on Economic Regulation of Airports, hosted by the Economic Society of Australia (Vic branch) on 20 March 2019.

on the monitored aeronautical services, fails to assess or capture the full extent to which an airport is or may be exploiting its market power.

Ultimately, passengers and their travel decisions are affected by the exercise of airports' market power – whether this occurs when parking a car, buying a drink, through the airfare they pay or the rental car they hire. When considering airport market power and whether its exercise is "*to the detriment of the community*", all of these elements come into play and must be assessed accordingly, and collectively.

Airport pricing and why it matters for a market power assessment

Airports supply a number of different services to different airport users, akin to multi-product monopolies or multi-sided platforms. The key services provided include:

- aeronautical services, such as access to runways, terminals and other airside infrastructure. These services are provided chiefly to airlines;
- landside access to the airport, via roads, parking and loading spaces. These services are provided to airport users, car hire companies, and transport providers (such as taxis);
- retail tenancies. These services are provided to retailers which provide services to airport users; and
- property services. These services are provided to entities that use the airport for business operations, such as logistics companies.

The Commission states "*a conceptual benchmark for an efficient level of aeronautical charges is long-run average cost…firms operating in competitive markets that are not natural monopolies would price at or close to this benchmark*." (Draft Report, p.68) This statement shows very little understanding of the context of airports as multi-product monopolies or multi-sided platform, that takes into account interdependencies or complementarities in services they supply.

The demand for the airports' services is interdependent: the more flights to the airport, the more passengers; the more passengers, the more retail and car parking services consumed, and so on; this affects how airports price. In particular, the structure of the prices charged by the airport will take account of the interdependencies among the demands of the various groups which are served.

Interdependencies can be complicated and are well understood in economic literature to have important implications for the assessment of market power.[47] Namely, that when there is interdependency of prices, one cannot draw any implications concerning market power by examining the relationship between a price and cost for any one service.

Airports may quite rationally charge prices that result in the under- or over-recovery of the "average" costs of aeronautical services, as this can increase their profits overall. Ultimately, this is a decision made by an airport contingent on the relative service elasticities that it faces and any externalities between services.

In contrast to the Commission's benchmark, this means that:

- airports with an efficient price structure may not set prices for aeronautical services (or any other services) that reflect the long run average cost.
- an airport operating in a (hypothetical) competitive market may set prices that bear little resemblance to long-run average costs, and this would not be inefficient.

While not all of an airport's charges will appear high relative to some notion of average cost, it will organise its prices across services to maximise profitability. The exercise of market power *must* be measured with this in mind[48], with the rationale explained as follows:

"To draw sensible inferences about (harmful) market power through price cost margins, loosely speaking one would need to demonstrate that the sum of fees to [both groups served by the platform] could be profitably raised above the costs of providing the service to [both groups served by the platform]."[49]

The corollary of the above is that, in order to draw sensible inferences about market power from profit margins, it is necessary to consider the revenues and costs from *all* services provided by the airport. In other words, the extent to which airports generate monopoly profits should be assessed with respect to the whole of their operations.

In a regulatory context, this is generally referred to as assessing a single till. Single-till regulation is preferred because the regulation of total profit of an airport is consistent with the airport taking into account the externalities that exist between retailing and aeronautical services – and, indeed, of services provided to other groups of customers.[50]

However, the Commission has not considered whether the airport is making excessive margins across all of its services. Rather, the Commission has focused its analysis on prices and profits relating primarily to aeronautical services; seemingly justifying this approach on a lack of information relating to all other services, but not recognising the limitations in the conclusions drawn from such an analysis.

The Commission's approach is therefore intrinsically flawed; there is simply no reason to believe that one can determine whether there are excessive returns from providing aeronautical activities from a comparison solely of the costs of aeronautical services with the revenues from aeronautical services.

The Commission's approach is analogous to determining whether ticket prices at a movie cinema are appropriate, without considering returns that are earned through sales at the snack bar – it is not clear whether any particular cinema has market power, but it is very clear that market power cannot be measured without considering returns across both of those activities.

The fact that airports will consider both the aeronautical and non-aeronautical revenue streams in setting their charges should not be misinterpreted as implying that this constrains the market power of these airports. That airports supply both aeronautical and non-aeronautical services reduces double-marginalisation effects that would arise from separate monopolists of those services.

However, the question facing the Commission is whether a multi-sided platform airport (with market power) can charge higher prices across its bundle of services when compared to a multi-sided platform airport facing competition. Using the cinema analogy above when assessing the market power of a cinema (with a snack bar) it would be appropriate to compare its profits to a cinema that also has snack bar sales. The fact that the cinema can charge higher prices for popcorn due to 'locational rents' is irrelevant as the cinema facing competition can also do so. And both will consider this in setting their ticket prices.

A partial approach to a market power assessment is not only theoretically inappropriate, but airports have the ability to game it. If an airport knows it is only being assessed based on aeronautical charges, it will either shift common costs into the aeronautical side and/or seek greater revenue from unmonitored charges. The fuel throughput levy introduced at Sydney Airport provides a real-world example (see Box 4).

The ACCC has acknowledged these limitations in relation to the airport monitoring regime in the past and, as a result, considers it appropriate: *"…to report on total airport revenue, costs and profits for a number of reasons. These include the difficulties that exist in allocating costs and revenues between aeronautical and non-aeronautical services and the complementarity between airport services*."[51]

Despite this, less partial, single till measures are not given the attention they deserve by either the ACCC in its submission, or – more importantly – the Productivity Commission in its Draft Report.

Box 4: Fuel throughput levy

Airports typically charge the JUHI for using airport grounds for its refuelling infrastructure through some combination of ground leasing and hydrant licencing charges. For a period Brisbane, Perth and Sydney airports treated the revenue they derived from aircraft refuelling as nonaeronautical under Direction 27 (1 July 2002 to 30 June 2007). Subsequent Directions have ultimately required aircraft refuelling to be included as aeronautical revenue, however, the specific charges levied are not monitored.

In 2012 Sydney airport introduced a Fuel Throughput Levy (FTL) that is charged to airlines. The airport does not incur any direct marginal costs associated with aircraft refuelling nor do they provide airlines with any services associated with this charge. Under the definitions in the Airports Act and Airports Regulations 1997 it is unclear whether this is treated as aeronautical revenue or not under the ACCC monitoring regime.

This charge may have been a strategic response by Sydney airport to the fact that aircraft refuelling' revenue became classed as aeronautical revenue and hence subject to ACCC monitoring. In any case, the FTL and aircraft refuelling charges more generally are not directly monitored and so any approach to assessing the exercise of market power which looks at aircraft landing charges will be partial and flawed.

This highlights the ease with which an airport can strategically game a regime that only monitors part of its service revenue or indeed charges.

The definition of aeronautical services included in the Airports Act up until 2007 includes check-in facilities and landside terminal access roads, which are considered aeronautical-related services under direction 27, but excludes aircraft refuelling services.

Source: A4ANZ and ACCC monitoring report

Competition in non-aeronautical markets is insufficient to justify a partial approach

A focus on the relationship between price and cost on an airport's aeronautical activities may be appropriate if:

- the extent of complementarity between an airport's services is weak *and*
- returns on *all other activities* are constrained by competition.

In these circumstances, a finding that returns on aeronautical activities are moderate with respect to aeronautical costs would have some meaning — as it can be assumed the prices for all other services, disciplined by competition, will not be set above cost.

However, there is no evidence that this is an appropriate assumption. Moreover, were it true that returns from other activities were constrained by competition, a comparison of total returns with total costs will still provide an accurate comparison (that is, adding services that recover a normal return to the profit calculation will not create a risk of error). Ultimately, the conclusions reached under a single till approach to assessing market power would be unaffected by the level of competition facing an airport in relation to any one of its services.

Airports do not face effective competition on many or all of the other services they provide. The Commission has acknowledged this in its Draft Report, stating that airport operators have, or have the potential, to exercise market power in relation to landside access, and at-terminal car parking.

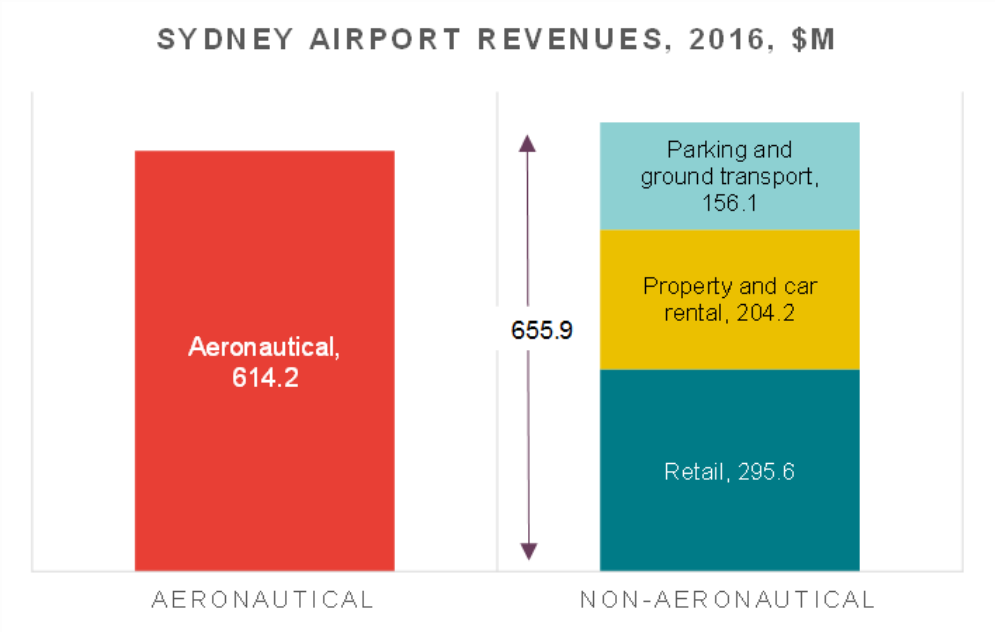
It is difficult to see how airports face competition in relation to airline terminal leases. Furthermore, the Australian Finance Industry Association (AFIA)'s initial submission to the Commission clearly demonstrates how airports both possess, and exercise market power in their dealings with car rental operators.[52] Curiously, the Draft Report barely acknowledges this submission and the robust analysis behind it.

The Commission also rejected the ACCC's annual denouncement of the carparking charges at the four major airports as an exercise of market power[53]; instead including its own comparison table in an attempt to demonstrate that parking at airports was not unreasonable compared to parking at other public places at which convenience is similarly valued such as hospitals and sporting venues. Bewilderingly, the Commission's comparison table highlighted the fact that the pricing at airports was in fact significantly higher in most cases, and sometimes double (Draft Report, p.20).

Whilst the Commission considers airport operators are likely to face greater competitive constraints in the market for at-distance car parking (Draft Report, p.21), this comparison is simply an illustration of the "cellophane fallacy"[xvi] – all true monopolists set prices sufficiently high that some substitution is feasible (see Box 5).

Given that many, if not all, non-aeronautical services are not effectively disciplined by competition, prices for these services may also be set above cost (see Figure 1). Under these circumstances, a partial assessment of the exercise of market power (only in respect to aeronautical services) will – unsurprisingly – have a significant effect on the conclusions reached, as it will fail to assess or capture the full scope of an airport's market power.

Figure 1: Revenue breakdown for different services at Sydney airport



Source: Sydney Airport, Annual Report 2016

[xvi] The cellophane fallacy describes a type of incorrect reasoning that occurs when mistaking a monopolist's apparent inability to exercise market power by raising price above the *current* price for an inability to have *already* exercised market power by raising price significantly above the *competitive* price.

Box 5: The prospect for effective competition in car parking services

In our view, airports do not face effective competition in relation to the majority of non-aeronautical services provided; this includes at-distance car parking. The reasons are as follows.

- First, an airport has market power over bottleneck terminal landside access facilities required by its potential competitors in parking and ground transport. It can leverage this into the other services it provides. For example, an airport can limit access and/or charge fees for access to drop off facilities required by competing car parks. As a result, an airport has the ability to constrain growth or discipline car parking competitors that threaten its profits.
- Second, substitution in an airport's non-aeronautical activities may only occur because prices may already be at levels reflecting the airport's exercise of market power. It is reasonable to assume that an airport's existing charging structure already incorporates some exploitation of market power.
- An airport's prices may be so high that substitution exists, however, this may not indicate an absence of market power. By way of example, there may be many places to park near an airport suggesting that the airport in question faces competition in providing car parking services. However, this competition may only be feasible because of very high prices charged for parking at the airport.

To ignore this point is to commit the cellophane fallacy – named for the infamous du Pont monopolisation case in the United States.[xvii]

Source: Frontier Economics

While the Commission's own analysis of at-distance car parking was stymied by the 'cellophane fallacy', they still had available to them evidence of how off-airport car park operators (and consumers) have been negatively impacted by airports' monopoly behaviours. The Andrew's Airport Parking Group, for example, cited examples of some airports continuing to increase access charges, while withholding or delaying information, and with disappointing levels of consultation.[54]

Despite this, the Commission stated that its "*assessment of whether landside access charges and other terms of access are consistent with airports exercising market power has been constrained by a lack of evidence*" (Draft Report, p.197). However, as noted earlier, the Draft Report barely makes mention of the two submissions made by AFIA, on behalf of its rental car operator members. In the first submission, AFIA provided data highlighting, among other issues, the fact that 9 out of the top 10 most expensive airports in the world for rental car operators are in Australia – more expensive than Heathrow, LAX or Paris-CDG.[55] Their submission also showed that in Australia, rental car companies are in some cases charged up to three to seven times more to operate at airports compared with city locations.[56]

Furthermore, the Commission did not even acknowledge the supplementary letter from AFIA which details the experience of car rental operators facing a Queensland airport providing short negotiation timeframes and rental increases of up to 60%.[57]

Nor did they reference the almost three-fold increase for taxi access documented by the Essential Services Commission in its submission, nor the well-publicised case of the hire car driver fined by Melbourne Airport for

[xvii] See Massimo Motta (2004) Competition Policy, Theory and Practice, *Cambridge University Press*, pp 105-106.

refusing to pay for a permit. Lawyers in the case noted that "*To our knowledge, there is no comparable example to the powers given to the airport operators*."[58]

Given the Commission's claims of lack of evidence and call for further examples of monopolistic conduct, we find these omissions from its Draft Report particularly troubling. Others have also pointed out the inconsistency of the Commission in, on the one hand, claiming there is a lack of evidence, but on the other, so conclusively proclaiming that "*Car parking charges are not due to airports exercising their market power*" (Draft Report, p.2).[59,60]

On the face of it, it would seem that drawing such a firm conclusion would fail to meet the Commission's own – albeit largely unspecified – burden of proof. Perhaps, however, the benefit of the doubt (again, to use the Commission's legal analogy) has been extended to airports to the extent that such proof is only required from those seeking to show that airports *are* exercising their market power, not for those who wish to defend the proposition that they are not.

Data issues arise because of the Commission's partial analytical approach

The Productivity Commission claimed its assessments have been constrained by a lack of cost and revenue data, meaning it is unable to draw conclusions in respect to whether revenues/prices exceed costs in relation to non-aeronautical services.

For example, in its Draft Report, the Commission notes that, *"Airports could exercise their market power in landside access services, such as for those used by taxis and shuttle buses, to encourage people to use airport-owned car parks, but there is insufficient data to determine whether this is the case."* (Draft Report, p.2)

However, here the Commission has created a rod for its own back. While the separate reporting of service-specific and common costs would enable costs and revenues to be better attributed across an airport's services, this is not necessary to assess whether an airport is exploiting its market power. Price-cost margins are not the only (nor in fact the best) indicator of the exercise of market power. There is nothing stopping the Commission from assessing airport profits across the airport's wider operations.

This is a better approach. By focusing on profits accruing from the operations of an airport as a whole or with respect to airports' total 'passenger and freight related' operations (sometimes referred to as a hybrid till), debates about the allocation of costs can be avoided.[xviii]

The data necessary to assess an airport's profits on a single till basis are available within the ACCC's monitoring reports. Furthermore, the Commission were also made aware of this analytical approach in A4ANZ's initial submission to the Inquiry.[61]

Figure 1.7 in the Commission's Draft Report shows that, across the monitored airports, roughly half an airports' revenues are earned from non-aeronautical activities (Draft Report, p.57). Ignoring the profits earned in non-aeronautical services, in an assessment of their exercise of market power, is, quite patently, a material oversight. It is therefore perplexing to have the Commission relegate the issue of car parking charges to the status of "*red herring*" in its deliberations.[xix] We feel certain that Australian travellers would disagree.

Ultimately, the total profits of the airport should be considered as this is the only sensible comparison by which one can measure the exercise of market power.

[xviii] This is not to say that future monitoring regimes need not have separate reporting of service-specific and common costs, just that this is not necessary when assessing market power.

[xix] This description was on a slide shared by Commissioner Professor Stephen King, at a *Policy in the Pub* session on Economic Regulation of Airports, hosted by the Economic Society of Australia (Vic branch) on 20 March 2019.

Airports have been highly profitable over the long term

In the Draft Report, the Commission notes that

> "*Profits that are persistently high…can indicate that airport operators are exercising their market power by setting prices above the efficient level, with potential negative effects on downstream competition and consumer wellbeing through higher airfares*" (Draft Report, p.162)

A4ANZ agrees with this statement and has previously provided the Commission with evidence of the persistently high profits of the four monitored airports; firstly through a confidential analysis[xx] of profitability undertaken by Frontier Economics[62], and later in a publicly-available analysis[63] that that utilised HoustonKemp's assessment of the WACC parameters.[64]

Frontier Economics' truncated IRR analysis shows that three of the four monitored airports have persistently earned returns above the benchmark cost of capital (again estimated using HoustonKemp's parameters). Figure 3 in Appendix B illustrates this result.

Importantly, this main result is corroborated by other methods including return on assets and margin comparisons across an international sample.[xxi]

The approach used by Frontier Economics is different from the Productivity Commission's approach in two key respects:

- Firstly, it *considers returns across the airport*, rather than restricting analysis to aeronautical services. This approach correctly accounts for market power that is held by airports in non-aeronautical services and avoids arbitrary cost allocations that reduce returns attributed to aeronautical services.
- Secondly, it estimates excess returns using several methods, including the most theoretically appropriate measure of excess returns – *the internal rate of return* or (equivalently) the net present value. This analysis uses cash flow data, which are not subject to accounting treatments of depreciation or amortisation, and opening and closing asset values.

The Commission chose to completely ignore Frontier Economics' assessment of profitability (both the initial confidential and truncated non-confidential versions). The Commission received the confidential version of Frontier's profitability analysis even prior to releasing the Issues Paper in July 2018. The Commission's failure to even consider this – apparently on the basis of the confidentiality request – shows very little regard for the unique challenges faced by users in submitting to the Commission's processes while in negotiations with monopoly airports.

A direct request was made of A4ANZ to release the analysis, simply on the basis that "other parties have requested to see it". At no stage were we advised that refusing to do so meant that it would not be used by the Commission in its deliberations. Furthermore, additional submissions were encouraged and we made clear that the Frontier Economics analysis included in our supplementary submission utilised the same methodological approach as the first confidential piece and reached the same conclusions.

[xx] It was necessary for this to remain confidential because of the challenges faced by airlines in submitting publicly to the Commission while in the middle of sensitive negotiations with monopoly airports.

[xxi] Sydney, Melbourne and Perth airports have been exercising market power, reflected in economic returns to the owners that are well in excess of the cost of funds estimated by the AAA's advisor HoustonKemp. For Brisbane airport, economic returns to the owners are likely to be in excess of the cost of funds during the post-privatisation period, reflecting the exercise of market power. It is only at the top end of HoustonKemp's range that returns would not be considered excessive.

The Commission made clear that submissions could be made confidential, where required, and others participating in the Inquiry availed themselves of this option. However, we could see no other examples in the Draft Report where the Commission stated that a submission was disregarded on the basis that it was confidential.

In fact, despite more than a quarter of all submissions (25/88) containing content labelled confidential, A4ANZ was the sole organisation called out by name as "choosing" not to make public what was in fact a small part of our overall submission, later rectified with a public analysis. It would appear that the respect afforded to other parties wishing to make all or part of their submissions to the Inquiry confidential was not extended to A4ANZ. We do not know why this was the case.

We understand that our carefully-considered decisions regarding both the initial and follow-up analysis meant other stakeholders had limited time to respond to the supplementary submission, but this same issue also faced A4ANZ and its airline members, unable to respond to or challenge all the confidential airport submissions.

Furthermore, the timeframe from the initial submission and its confidential status in no way prevented the Commission's economists from undertaking their own review or repeating the analysis to check its accuracy/credibility. Why Commissioners chose not to is a matter for them, and we would encourage the Commission to address this in its Final Report.

A truncated IRR approach is the most appropriate measure of profits

The Commission states that, "*the return on aeronautical assets (ROAA) is the measure of profitability that most appropriately accounts for the efficient long-run average cost of an airport's aeronautical investments. It accounts for the opportunity cost of alternative investments and explicitly accounts for the level and timing of investment."*[65](Draft Report, p.166)

Based on our understanding of economic literature and advice from Frontier Economics we would argue that each of the three propositions in this statement are either incorrect or incomplete, for the following reasons:

- the ROAA measures returns on costs incurred, and offers no judgement on whether costs are "efficient";
- the ROAA does not "account" for the opportunity cost of alternative investments. In fact, the ROAA must be compared with the opportunity cost of capital to determine whether returns are excessive – an exercise which the Commission elects not to undertake for unclear reasons; and
- the ROAA does not explicitly account for the level and timing of investment – rather, it is subject to the criticism that it accounts for the depreciation of assets in an arbitrary manner that may bear little resemblance to the efficient path of capital recovery. For example, building a new terminal will result in lower returns in early periods as it is underutilised; this is a function of the ROAA relying on accounting data which conventionally depreciates assets using a straight-line approach rather than matching depreciation to asset usage as might be suggested by economic efficiency.

Indeed, contrary to the Commission's definitive statements, it has been forced to try and qualitatively balance evidence around investment and profitability. Take, for example, these comments in the overview of the Commission's draft report:

> *"Substantial investment at Melbourne Airport came with a decline in profitability"*[66] *(Draft Report, p.172)* and, *"Movements in Perth Airport's ROAA appear to be heavily influenced by its investment decisions" (Draft Report, p.174).*

It was precisely for these reasons that the Commission ought to have considered the use of the most theoretically-appropriate measure of economic profits as their principal measures: net present value and internal rate of return

(IRR).[xxii] An IRR/NPV analysis has the greatest probative value. Applying the IRR/NPV method is not straightforward as it relies on cash flow data for a significant period, hence it is less commonly used in profitability analysis. However, with almost 20 years of cash flow data available within the ACCC monitoring data, this approach can be reliably applied.[xxiii]

Frontier Economics' analysis for Commission used the AAA's own benchmarks

Any profitability assessment is meaningless without a benchmark or counterfactual case, i.e. what would have happened were the airports better regulated, or subject to the pressures of effective competition?

The Commission did not clearly specify a benchmark; however, it would be deceptive to imply that it did not benchmark its profit results. It would appear that the Commission benchmarked the four monitored monopoly airports: against themselves over time; and against each other, as is evidenced by these excerpts from the draft report:

> *Melbourne Airport's trend in profitability and high level of operational efficiency do not suggest it is exercising its market power (Draft Report, p.172);* and *Sydney Airport's ROAA averaged about 10 per cent per year over the 10 year period to 2016-17 — still an attractive return, but less than Melbourne and Perth airports, which averaged about 11 and 12 per cent per year, respectively. (Draft Report, p.17)*

This is a strikingly poor approach, because, all the Commission is demonstrating with these comparisons is that:

- some monopoly airports are better at making profits than others; and
- some airports have become slightly better or worse at making monopoly profits over time.

In fact, there are two *appropriate* benchmarks that should have been considered by the Commission. The first benchmark is the opportunity costs of funds employed. The second benchmark is the returns earned by airports in a competitive market – manifestly, Australian airports cannot be used in this comparison. In the long run, a firm constrained by competition would earn no more than the opportunity cost of funds employed; firms that earned more would attract entry by competitors.

The Commission considered estimating the level of risk faced by airport financiers to be highly contentious. However, the Commission's concerns are unfounded; the publicly-available, truncated version of Frontier Economics' profitability analysis differed from the confidential version in only one key respect. It assessed returns against a cost of funds estimated using the parameters determined by the AAA's consultant, HoustonKemp.

Tellingly, Frontier's analysis found that Australian monitored airports are highly profitable even when judged by benchmarks deemed acceptable by the AAA. The fact that HoustonKemp reached the opposite conclusion, with the same data set (resubmitted)[67], is a matter that the Commission ought to specifically address and resolve through its own assessments.

Australian airports are profitable even using other measures

For completeness, Frontier Economics corroborated its results (using the truncated IRR approach), using other measures of profit including returns on assets, capital employed, or equity, and comparative margins.

[xxii] A key issue with an IRR approach is that it requires a full set of cash flows for the relevant assets. However, it can be calculated using periods less than an asset's full life (a 'truncated IRR'), taking the value of assets at the start and end of the analysis period, allowing for the computation of returns earned during the period of cash flows. Frontier Economics implemented this approach for the Australian airports, with different assumptions for opening and closing asset values, relying on ACCC's airports cash flow data (1997-98 & 2016-17).

[xxiii] For completeness, Frontier Economics used two different set of assumptions for the opening and closing values of the airports assets. For further details around this approach see Appendix A of A4ANZ's Supplementary Submission.

Further details of this approach and other measures of profitability are described in the Frontier Economics' report *Market power and the profitability of Australian Airports – Response*.[68]

Figure 4 in Appendix B shows the return on assets for the monitored airports,[xxiv] the sole measure used by HoustonKemp. We compare returns compared to the upper and lower WACC bounds, again based on parameters used by HoustonKemp.

Australian airports' high returns are persistent

In 2006, the Productivity Commission stated that one must be careful not to attribute excess returns to good fortune, noting that "*A more rapid than expected growth in the market, as appears to have occurred at most of the monitored airports, will result in higher than expected revenues and returns because costs do not increase commensurately. Conversely, had the market grown less than anticipated, revenues and profitability would not have met expectations. It would thus be inappropriate to automatically infer misuse of market power from an outcome favourable to the airports that results from unforeseen circumstances."*[69]

The key test of the 'good fortune' argument is persistence: a tendency for returns to return to "normal". In A4ANZ's view, a period of 13 years since the Productivity Commission made the above observation is sufficient time to draw conclusions on persistence. Frontier's analysis has shown that while returns for Melbourne, Sydney and Perth Airports have clearly been above those required to service the cost of funds, there is no general tendency in the more recent data (return on assets) for such returns to become more normal.[xxv]

Persistently high profits are best indicator of market power exploitation

An assessment of long-term profitability, against an efficient benchmark – the opportunity cost of capital – provides the most reliable evidence of market power exploitation.

The Commission has considered three broad areas where performance could be affected by the exercise of market power:

- operational efficiency — whether an airport provides services at relatively low cost and uses its inputs efficiently, with a level of service quality that meets users' reasonable expectations;
- aeronautical revenues and charges — whether the prices of aeronautical services (as measured by revenues and charges) reflect efficient costs; and
- profitability — whether an airports' returns are reflective of the cost of capital, accounting for the long-term nature of airport investments and operational constraints.

This is relatively uncontroversial. However, the Commission has failed to acknowledge the significance of these areas of assessment and the relevance and reliability of the indicators that underpin them.

Excessive returns for an airport are a sufficient but not necessary condition for the exercise of market power. The absence of excessive returns does not demonstrate that an airport has no market power or is in some way prevented from exploiting this, as a lack of excessive returns can also mask inefficiency. The analysis of operational efficiency is only relevant to the extent that airports are not earning excessive returns.

Moreover, analysis of charges (which can only be compared across airports) is a fraught exercise that does not capture the central purposes of the Commission's analysis. It does not matter whether charges of Australian airports are high or low in comparison to overseas benchmarks if these charges result in Australian airports earning excessive returns – it does not detract from the fact that market power has been exercised.

[xxiv] Frontier Economics follows the ACCC's monitoring reports in using tangible, non-current assets.
[xxv] Noting that Perth Airport's move into the WACC range is affected by its asset revaluation.

We suggest a more rigorous analytical approach to assessing market power would have been to follow a framework such as the one set out in Figure 2.

Figure 2 - How the indicators of market power exploitation are related

Source: Frontier Economics

Commission's assessment of airport charges is partial and provides no useful insights

We reject airport charging comparisons as a meaningful measure of the exercise of market power where evidence of excessive profits exists. However, even on their own merits, they are unreliable. There are two key reasons for this:

- As discussed above, it is problematic when an airport provides multiple services, particularly when charges are not monitored for one half of the market. This limitation means the Commission has focused predominately on aeronautical revenue and landing charges. As highlighted earlier, this partial analysis fails to consider a significant proportion of an airport's revenue/charges;
- Secondly, there are challenges associated with benchmarking charges. The Commission states that its preferred benchmark for efficient pricing of infrastructure services is the long-run average cost.[70] This is not appropriate. As described previously, airports are multi-product monopolies. This means an airport with an efficient price structure may not set prices for aeronautical services that reflect some measure of its costs. In addition, the Commission's conceptual benchmark is unable to be calculated in practice. As a result, the Commission has tried to draw insights from a comparison against international airports, which is meaningless unless one can account for differences in costs and regulatory environments.

Different airports face different levels of competitive pressure from other airports, and/or external regulation. Moreover, they may also structure their aeronautical charges differently. The ACCC has clearly articulated this issue in their latest monitoring report[71]:

"Ideally the ACCC would use a direct measure of prices in the form of a price index. However, in most cases it is not possible for the ACCC to compile such an index. For example, the price of using an airport cannot simply be measured by adding up the different charges in place at a given point in time because charges can be levied on different

bases— such as on a per passenger basis or by aircraft weight. Also, airports might offer discounts for certain periods or to certain users, or there might be charges in place, which affect some users but not others.

In addition, the price changes for particular airport users may vary depending on the composition of the airport services they utilise and the times at which they use them. For example, the costs of a domestic flight to an airline are likely to be different to those associated with an international one due to differing security and processing requirements. Similarly, changes in price structure imposed by an airport might affect users in different ways (e.g. lowering the costs for one user while raising them for another)."

Given these constraints, it is unsurprising that the Commission has produced a relatively meaningless analysis relating to airport charges and revenues. What *is* surprising, however, and concerning, is that the Commission has chosen to highlight, and seemingly rely on, a comparison of sample aeronautical charges for the monitored airports against international scheduled prices.[72]

Curiously, they did not adopt the same approach when comparing the prices charged to rental car operators, against international locations, all readily available as part of AFIA's submission.[73]

Regardless, the Commission's real error is in failing to identify that it is necessarily constrained in drawing significant insights from its analysis of charges.

The assessment of operational efficiency is uncertain and meaningless

An assessment of operational efficiency is the weakest strand of evidence relating to market power exploitation. Even privatised and unregulated monopoly airport operators have an incentive to be efficient, and this evidence can only be used to demonstrate the airports are exercising market power even where they are not earning excessive returns.

Not only is operational efficiency less of an indicator of market power exploitation, it is also uncertain and subject to too many caveats in respect to all strands of analysis.

We contend that the Commission is unable to draw any significant insights from its mixed bag of evidence; costs have increased at most of the monitored airports, utilisation of some inputs has declined, as have TFP estimates. However, single year comparisons of costs and utilisation rates with a sample of international airports suggest the monitored airports were average or better than average when compared with overseas airports.

There are, however, *significant* limitations in what can be drawn from the efficiency analysis due to the challenges associated in drawing comparisons between Australian and international airports, given the difference characteristics of airports (size, mix of domestic v international passengers, number of airlines served, and hub characteristics). Additionally, the Commission's DEA analysis was affected by significant heterogeneity in the sample.

Airport conduct as an indicator of market power

As noted in A4ANZ's initial and subsequent submissions to the Commission, the structure-conduct-performance schema offers a sound approach to assessing an airports' market power, and potential exercise of this market power, notwithstanding the limitations outlined earlier.

The conduct of airports – especially during negotiations – is a key indicator of their ability to and willingness to exercise market power. Despite this, a surprisingly small proportion of the Commission's Draft Report is focused on commentary about commercial negotiations for aeronautical services. Surprising because of the amount of evidence supplied to the commission and the fact that one of the pillars of the regulatory framework is in fact to facilitate commercial negotiations.

In just three paragraphs, the Commission reaches the conclusion that they are "*satisfied that airports have not systematically exercised their market power in commercial negotiations with airlines to the detriment of the community*." (Draft Report, p.272) They provide almost no reasoning for how they have reached this conclusion, other than a claim that "*Airports have strong incentives to reach agreements with airlines"* with no further explanation (Draft Report, p.272).

In some parts of the report, this went a step further and amounted to the Commission appearing to acting as apologists and defenders of the airports, or as one correspondent put it, creating a Draft Report that "*does not fall far short of appearing as a media release for Australia's major three east coast airports."*[74]

No scrutiny for proposition that airports are not exercising market power

The A4ANZ team had our own experience of this "airport defender" approach during a meeting with Commissioners and members of the Inquiry research team in December 2018. To illustrate the way in which the current regulatory model creates a disincentive for genuine consultation, and how this negatively impacts costs and efficiency, we shared with the Commission an example (from a list of many) of this type of behaviour by airports, and its consequences.

The example we shared was an experience that one of our member airlines had had of an airport proceeding with a large capital investment, despite the airline asking them to consider more suitable and economically efficient ways to implement the particular technology, backed by a sound business case. The airport went ahead anyway, and the top-of-the-line technology was ultimately rendered useless - for the very reasons the airline had previously warned the airport - and required replacement.[xxvi] It was left to the airline to foot the bill.

What then left us floored was that, following this anecdote, one of the Commissioners responded with the comment: "*but maybe the airport just made a mistake?*" and that was the end of the discussion on that matter. Mistakes are of course always possible, but in competitive markets it is suppliers, not customers, that pay for mistakes. In what other environment is the customer left to pay, despite having had no say over the product, which it didn't believe was necessary or would be effective anyway?

A further example of this was the finding that while Canberra Airport was not deemed by the Commission to have market power, one Commissioner said that "*if someone has evidence that Canberra Airport does have market power, we'd be happy to recommend that it be pushed up [into ACCC monitoring]."*[xxvii] This comment was extremely concerning, given that the Commission already has in front of them evidence showing Canberra Airport's exercise and abuse of market power, including (but not limited to):

- In the AFIA submission, evidence was provided that the charges at Canberra Airport compared to downtown locations are nearly four times as much ($82 vs $21 per transaction) for rental car operators.[75]
- In the Qantas Group's submission, clear evidence of Canberra Airport exerting its market power was supplied given, including[76]:
    - Charging (including security charging) over 200% more than Adelaide Airport;
    - Airport charges (including take-off and landing fees and passenger facilities charges) that contribute 34% of the estimated cost of flying a passenger between Canberra and Sydney. These airport charges account for the single largest cost incurred by Qantas on this route, which is not comparable to any other route's cost base;

[xxvi] The details of this example have been kept deliberately vague for commercial reasons, however, the experience was shared in more detail with the Commission at the meeting.

[xxvii] These were comments made by Commissioner Professor Stephen King, at a *Policy in the Pub* session on Economic Regulation of Airports, hosted by the Economic Society of Australia (Vic branch) on 20 March 2019.

- Jetstar being unable to offer flights from the airport as Canberra Airport's charges could account for up to a third of the airline's low prices, and would distort the airline's underlying cost base on the route. This of course has a negative impact on competition;
- Leasing costs at Canberra Airport independently assessed as being significantly above market values (the full amount of this was disclosed to the Commission);
- The now well-publicised incident in which a Qantas aircraft was held to ransom. Following an unexpected landing due to bad weather, Qantas Group was forced by Canberra Airport to pay a nonstandard $18,000 diversion fee, equivalent to $100 per passenger. The unprecedented charge was 9 times greater than Melbourne and Adelaide Airports, and more than 20 times greater than Sydney Airport. Canberra Airport parked a ground vehicle behind the aircraft and refused to allow the aircraft to leave until payment was made; and
- Examples of lack of transparency over inclusions in charges.

While A4ANZ has been called out by the Commission for making one part of its submissions confidential (albeit with full disclosure of what it was about), no mention is made of the fact that Canberra airport made an entirely confidential submission, which participants to the Inquiry were similarly not able to scrutinise. Was it on the basis of this unseen submission that the Commission concluded that Canberra does not have market power?

Furthermore, it raises the question of just what the Commission's evidentiary bar is, if the above examples do not constitute evidence of market power? It certainly is not made explicit in their Draft Report, and clearly differs wildly to the approach taken in other sectors and jurisdictions.

Clauses prohibiting access to declaration

Equally concerning was the Commission acknowledging that some airports had inserted clauses invoking punitive measures or prohibiting airlines' access to declaration provisions in the National Access Regime.

The very insertion of these clauses and the expectation that airlines will sign contracts containing them represent a gross abuse of market power and ought to have been clearly called out and characterised by the Commission as such.

All the Draft Report had to say on this matter, however, was that these clauses "have no place in agreements" between airports and their customers, and that their presence *could* reduce the effectiveness of the regulatory regime. This is of course an extreme misrepresentation of the facts: with the threat of declaration removed, the airport faces *no* threat, and can behave as it wishes.

The apparent effectiveness of the light-handed regime is predicated on there being a threat of declaration, to hold the airports to reasonable terms. By removing the airlines' ability to enact that threat, the airports are *clearly* exercising their market power; why describe it in any other way? Right there is an example of a "take it or leave it" contract clause. Yet the Commission are seeking more examples, apparently because there is "*no justification*" for change.

Instead, the Commission's 'solution' to address this abuse of market power is to recommend that the Government insert a clause in the aeronautical pricing principles. However, as the Commission well knows, there is no requirement in legislation for airports to adhere to these principles, and no penalties if they don't. Given this fact and the numerous examples airports' behaviour that is well outside what is expected from the principles, this recommendation from the Commission – in the face of such an obvious abuse of market power - seems a long way from the its commitment "*not to hesitate to recommend regulatory consequences for any airport that exercises its market power in a way that causes harm to the community*." (Draft Report, p.289)

In any other area of business or the law, the insertion by a monopoly asset operator of a clause that prohibits a user of that operator's services from exercising their legal rights to access the very provisions designed to protect them and their customers from the effects of market power abuses under the National Access Regime, would be considered as something that is detrimental to the broader community. It appears that the Commission is alone in its view that this is not the case.

Requests for information

The Commission asked for examples of conduct that may reflect an exercise of market power by airports (Information Request 4.1). We should not need to repeat examples already provided, but given they appear to have been dismissed simply as instances of "*argy bargy*" (Draft Report, p.272), we would urge the Commission to revisit submissions already provided to it. This should include all airport users, not just airlines, to understand exactly how Australian airports have exercised their market power through poor monopolistic conduct.

The Commission already has in front of it examples of this behaviour, which is not only exhibited by the major airports; it is found at airports across Australia, irrespective of size, location, passenger numbers, or airline market share.

Indeed, the exercise of monopoly powers is even present when an airport's customer is the Government, and by default, the taxpayer. Recent reports document a dispute between the owners of Darwin Airport and federal border agencies over customs and security services, which has seen the Government face rent demands in what they have described as "*an unprecedented lease agreement*."[77]

It seems a rather futile exercise to have the Commission asking for further examples of monopoly behaviour when it has already reached the rather staggering conclusion that there is no problem with the airport conduct outlined in multiple submissions from a range of airport users, and therefore no intervention required. Even more bizarre was the Commission suggesting that for Tier 2 airports like Darwin and Canberra – where the exercise of monopoly behaviour has been widely publicised[78] and even criticised by Government (see above) – there was no need for the ACCC to even monitor their pricing or actions at all (Draft Recommendation 10.3, p.299).

Others were similarly perplexed by this recommendation, with the Australian Mayoral Aviation Council commenting that,

> "*It becomes difficult to reconcile how the Commission can propose termination of the second tier airports' reporting regime and also conclude 'performance are within reasonable bounds' when, at the same time there is a 'cause for concern' and 'further scrutiny is warranted*."[79]

We can only hope that the following examples, together with those already provided but clearly not assessed, will be evaluated through a new lens, given the Commission's specific information request.

Examples of questionable conduct

As noted above, and in A4ANZ's previous submissions to the Inquiry, it is not only the four monitored airports who have engaged in questionable conduct (see also Box 6).

Although we have already outlined numerous issues at Canberra Airport, it is worth sharing here the fact that the airport have required airlines to contribute to funding for check-in counters constructed for other carriers, in addition to funding 100% of their own check-in counters.

The Commission has already been provided with numerous examples of concerning behaviour from regional airports.[80,81,82] We would strongly encourage the Commission to revisit these examples – particularly given the Commission's Terms of Reference and their apparent lack of engagement with these examples when they were first submitted.

Box 6: Dispute between Qantas Group and Perth Airport

Qantas Group (the Group) engaged in good faith with PAPL for more than 18 months to renegotiate the T1/T3 agreement (ASA), which expired on 30 June 2018. Since 1 July 2018, the Group continued to pay a fair and reasonable price.

Qantas Group found that PAPL's proposal was unreasonable and would have increased the cost of the Group using the airport by approximately 38% over the next seven years compared to FY18 – additionally the Group found that PAPL had exhibited a lack of transparency regarding airport capital and operating expenditure.

The Group believes that PAPL's charges are excessive due to unreasonable rates of return and accelerated depreciation – with PAPL proposing to accelerate depreciation of the Group's existing terminals by seeking to recover 20 years of depreciation over the next 7 years.

To resolve this dispute, the Group proposed that the matter be referred to expert determination, however PAPL rejected this offer, and instead chose to go directly to the Supreme Court of Western Australia.

The parties could have agreed an expedited and low-cost dispute resolution process which resulted in binding outcomes in the future, but PAPL declined to try to negotiate such a dispute resolution process. It is important to acknowledge that PAPL's action clearly indicates that PAPL believes a dispute resolution mechanism is needed and that the mechanisms currently available to it are not suitable.

The Qantas Group has noted that it is willing to pay fair and reasonable charges for the use of Perth Airport, and is cognisant that PAPL requires a reasonable return on investment. However, the Group wants to ensure that the travelling public are not paying excessive airport charges above what is necessary and will not accept monopolistic pricing that ultimately disadvantages Australian customers.

Security charges

Another issue faced by airlines at airports across Australia – and particularly regional airports – is the issue of the pass-through of security charges.

Airports of course incur costs relating to security screening measures. When mandated security screening measures were initially introduced, the Government provided guidance on the recovery of Government Mandated Security Costs.[83] This guidance provided that all costs were to be recovered on a pass-through basis meaning airports were not to profit from the provision of security services.

Indeed, A4ANZ is aware of several airports who have suggested that the "pass-through" principle for security costs does not apply to them, hence they apply a margin through a WACC, along with administration and corporate fees.

Some airports undertake reconciliations at least annually which indicate the extent to which they are recovering their security screening costs.[84] While airlines are unable to challenge the airports' reporting of these costs, the reconciliations at least provide some indication as to whether those airports are profiting from security screening measures. However, in the case of some smaller airports, no reconciliation of security screening costs and revenue is provided.[85] This means airlines have no assurance that these costs are being directly passed through without a profit margin for the airport.

In light of the security changes announced as part of the Government's 2018-19 Federal Budget[86], we believe it is imperative that this behaviour regarding the pass-through of security charges is scrutinised by the Commission. It provides a clear example of the exercise of market power.

A4ANZ recognises that as part of the new security measures announced in the 2018-19 Budget, over $50 million in funding was earmarked to support regional airports to upgrade security.[87] However, as noted by other industry stakeholders, including the AAA, regional airports across Australia face a significant shortfall to upgrade terminals and infrastructure to comply with the government's new security requirements.[88]

While the Commission may argue that regional airports "*have trouble making a buck, far less have market power*"[xxviii], how else to explain the behaviours of many of these airports in "recovering" screening costs with no transparency provided, than an exercise of their monopoly position? It seems inevitable that these behaviours at regional airports will persist with the implementation of new security measures. On regional routes where services are already marginal due to the poor economies of scale, there is no ability for airlines to pass on such costs to passengers. Hence the increased airport costs will directly impact the airlines' bottom lines, which in turn will directly affect the viability of the air services to and from these communities.

[xxviii] These were comments made by Commissioner Professor Stephen King, at a *Policy in the Pub* session on Economic Regulation of Airports, hosted by the Economic Society of Australia (Vic branch) on 20 March 2019.

FAILURE TO ACKNOWLEDGE LIMITATIONS OF CURRENT REGIME

In its Draft Report, the Commission has stated that the ACCC's annual monitoring activities are a "*key pillar of the economic regulation of airports*", and that this monitoring is "*critical to maintaining a credible threat to airports*". (Draft Report, p.23)

Interestingly, the ACCC, as the administrator of the monitoring regime, does not share this view. As the ACCC have noted in their original submission to the inquiry, and have again reiterated in their most recent airport monitoring report, monitoring is not sufficient to constrain the major airports from using their market power – and is in fact limited in its ability to address behaviour that is detrimental to consumers.[89]

No credible regulatory threat

As the ACCC, A4ANZ, and other stakeholders have previously submitted; monitoring regimes can influence behaviour – but only if there is a credible threat of regulation. While monitoring may have constrained behaviour in the past – when the airports were first privatised – this is unlikely to be the case today.[90]

The judgement in the Sydney Airport Declaration case in 2005 is instructive in this regard. Justice Goldberg of the Australian Competition Tribunal said: "*We do not agree with this reasoning [that SACL was not exercising market power]. In particular, it assumes the current regulatory framework includes a credible regulatory threat which we have found has not been effective*."

The ACCC's submission to the inquiry also noted that the monitored airports have significantly raised aeronautical charges to airlines over time with the increases across the four airports over the last decade representing an additional $1.3 billion in payments from airlines – and that despite these significant increases in charges, the quality ratings for most monitored airports have changed little over this period.[91]

The ACCC further submitted that high aeronautical charges imposed by airports needed to be addressed by an effective regulatory regime, and has suggested that negotiations between airports and airlines be supported by the fall-back option of seeking an arbitrated outcome on terms and conditions.[92] The ACCC has stated that this would address the imbalance in bargaining power between monopoly airports and airlines – and that arbitration could be conducted by a commercial arbitrator to ensure that outcomes are reached in a timely manner.[93]

Declaration under the National Access Regime no longer a credible threat

Contrary to the conclusions reached by the Commission, the National Access Regime under Part IIIA of the CCA does not provide a credible threat of regulation to airport operators in Australia.

The Harper team themselves inferred that for non-vertically integrated monopolies such as airports, declaration via Part IIIA of the CCA would no longer represent a credible regulatory threat[94] and this was confirmed in advice from Michael O'Bryan QC[95], Johnson Winter & Slattery[96] and Gilbert & Tobin[97] – all of which was presented to the Commission prior to their draft report. The Commission rejected this advice and instead accepted the sole supportive proposition, put forward by DLA Piper[98], whose opinion was completely contradicted by the NCC's draft recommendation on Port of Newcastle in December 2018 (see Box 7).

As per both our initial and subsequent submissions to the Commission, we believe that the 2017 amendments to the CCA, specifically to declaration criterion (a), *will* have a negative effect on an airline's ability to obtain declaration, and ultimately arbitration of terms, under Part IIIA. A4ANZ also sought further, independent legal

opinion from Mr Michael O'Bryan QC.[xxix] Mr O'Bryan's full advice was included as an appendix to A4ANZ's supplementary submission.[99] Mr O'Bryan's advice concludes that, following changes to criterion (a), with effect from 6 November 2017 it will be more difficult to satisfy the new criterion (a) in the case of non-vertically integrated natural monopolies, such as airports.[100]

Box 7: Port of Newcastle Declaration

In Chapter 8 of the draft report the Commission refers to the fact that in December 2018, the National Competition Council (NCC) released its *Statement of Preliminary Views* in relation to its consideration of whether to recommend under section 44J of the Competition and Consumer Act 2010 (CCA) that the designated Minister revoke the declaration of the shipping channel service at the Port of Newcastle. However, what the Commission failed to note was that after a public consultation, the NCC's preliminary view was indeed to recommend that the declaration be revoked.[101]

The NCC considered that as a result of the 2017 amendments to the CCA and specifically, the declaration criteria of Part IIIA of the National Access Regime; *criterion (a) a material promotion of competition* and *criterion (d) public interest* are now no longer satisfied for the Port of Newcastle.[102]

As stakeholders noted in submissions to both the NCC and the PC, changes to criterion (a)'s emphasis from assessing the effects of access, to assessing the effects of declaration, mean that declaration is now less likely where a monopoly infrastructure owner is already providing some level of access without declaration; raising the declaration threshold and potentially reducing infrastructure owners' incentives to negotiate in good faith and provide access on reasonable terms and conditions to avoid declaration.

This Statement of Preliminary Views from the NCC supports the conclusion that, as a result of the CCA amendments, the criteria for declaration has materially changed, hence increasing the threshold for declaration. It is therefore highly improbable that the National Access Regime still provides a credible threat for airport operators.

The prospect of a further Productivity Commission Inquiry does not act as a threat

The idea that the impending threat of a Productivity Commission Inquiry in some five or six years', and the apparent countervailing power of airlines, would sufficiently constrain airports' exercise of market power ought to have conclusively been put to bed following the SACL declaration decision by the Australian Competition Tribunal back in 2005.

The final determination said, "*We are satisfied that the ability of SACL to exercise monopoly power in relation to the airlines' use of the Airside Service is not subject to any effective constraints. We do not consider that the airlines have any significant countervailing power, or that the threat of re-regulation by the Commonwealth Government is an effective constraint upon SACL, or that SACL's ability to derive non-aeronautical revenues operates as a sufficient constraint on SACL's monopoly power.*"

Yet in this draft report, the decades-old myth persists. The Commission claim that the "*ongoing potential for such consequences [tighter regulation] acts as a deterrent against the exercise of market power.*" (Draft Report, p.49)

Not only is this statement fundamentally untrue, but to see the Commission making it in the face of evidence to the contrary serves to further highlight the stark contrast between it and others, such as the ACCC, who have a deep understanding of the challenges of monopoly infrastructure and the importance of effective regulation to mimic the effects of a competitive market.

Currently, however, the only option available to the ACCC would be to undertake a Part VIIA Inquiry. As we have previously outlined, such an Inquiry within the current regime is of limited – if any – benefit, as it is simply a more formal price monitoring process with some capacity to look forward, and it only deals with prices and not quality.

[xxix] Mr O'Bryan QC was a member of the panel appointed by the Commonwealth Government in 2014 to conduct a review of Australia's competition laws and policy (now known as the Harper Review), which resulted in the enactment of the Competition and Consumer (Competition Policy Review) Act 2017.

Furthermore, the impact on the service provider is entirely dependent on the Government taking action to impose a regulatory threat, which is the same pathway and outcome as we have under the current regime.

Although the Commission included commentary surrounding Part VIIA price inquiries in its draft report,[xxx] they should not be viewed as a fit-for-purpose solution. The facilitation of commercial negotiations through an effective threat-based regulatory model is far more effective, and better supported by all but one of the parties: the airports.

Even if a public price inquiry into airport services were to occur, any argument that such an inquiry would, of itself, constrain airport conduct is very weak for the following reasons – as noted in A4ANZ's original submission to the inquiry – including:

- the fact that price inquiries are resource intensive and time-consuming, meaning that there is likely to be a significant delay between the identification of inappropriate conduct and recommendations, let alone implementation, of stronger regulatory measures or other forms of penalty;
- the potential benefits of the public inquiry process appear to have been replaced by Productivity Commission reviews of airport regulatory arrangements (in 2002, 2006, 2011 and current). In these circumstances, it is difficult to see what additional, meaningful constraint could result from the "possibility" of a public price inquiry; and
- while the ACCC must give the Minister a report on the results of each Inquiry, it has no independent authority to implement any recommendations made. In this context, the airports are already well-aware of the distinct lack of Government engagement. For example, in both 2006 and 2011 the Commission recommended an enhanced "credible threat" in the form of a "show cause" mechanism.[103] In the first instance the proposal was abandoned and in the second case, the Government concluded such a process was "*… not warranted, as the ACCC already has the ability under the current regulatory framework to seek additional information from airports if the ACCC considers this necessary*".[104]

In our original submission, A4ANZ referenced advice from Margaret Arblaster on this issue,[xxxi] arguing that Part VIIA Price Inquiries are not an appropriate regulatory solution in this context. It is broadly agreed that the potential for the Australian Government to use either price restrictions, or price inquiry provisions as a threat of a stronger regulatory action against airport market power is neither credible nor desirable.

Further, as stated by the Commission in the draft report, both Ms Arblaster and the ACCC have noted the significant cost burden of a price inquiry, with no obvious benefits, particularly when weighed against alternatives. Ms Arblaster further explains this in her recent submission to the Commission.[105]

Far more desirable is the facilitation of genuine commercial negotiations between parties through a system that encourages reasonable terms and conditions, and a framework for access to dispute resolution if required.

Furthermore, given that the ACCC has shown it is far better placed to advise on this issue than the Productivity Commission, we see little value in setting up future market studies to be undertaken by the Commission, only to deliver the same flawed outcomes.

[xxx] We note that the Commission has also attempted to summarise the views submitted by inquiry participants in Box 9.6 – yet the precis of Margaret Arblaster's comments is not wholly accurate, and would benefit from being revisited by the Commission.

[xxxi] Ms Arblaster is a well-published regulatory expert with significant experience in the Australian and international aviation industry.

Existing regime does not facilitate commercial negotiations

We are in no way attempting to claim that the "*argy bargy*" the Commission documents is unique to the aviation sector,[106] however, the playing field is clearly not level when it comes to negotiations between monopoly airports and their customers, as noted by the ACCC.

Concerningly, however, the Commission's conclusions appear to be based on a fundamental misunderstanding of monopolies. Their perplexing depiction of airline and airport negotiations suggests they believe parties to be evenly matched, stating that "*Each party seeks to take advantage of its bargaining power. This is normal commercial behaviour…*" (Draft Report, p.272)

This is very surprising commentary from the Commission, because these statements *would* be true *if* negotiations were taking place in a competitive market. They are not. Almost all airports in Australia exhibit natural monopoly characteristics.

Economic literature for close to a century has documented the imbalance in bargaining power between monopoly suppliers and customers who operate in a competitive market.[107] Literature and expert commentary abounds on this issue for privatised monopoly assets and the consumer and community protections required[108], with the 1993 Hilmer Review noting that;

"*Where the conditions for workable competition are absent – such as where a firm has a legislated or natural monopoly, or the market is otherwise poorly contestable – firms may be able to charge prices above the efficient level for periods beyond those justified by past investments and risks taken or beyond a time when a competitive response might reasonably be respective. Such 'monopoly pricing' is seen as detrimental to consumers and to the community as a whole*."[109]

Reforms in other sectors have been implemented specifically to address these inequities, with the now Treasurer Josh Frydenberg acknowledging that the recently-introduced negotiate-arbitrate framework for gas pipelines was designed to address concerns about pipeline operators engaging in monopoly pricing.[110]

It is no surprise to see the AAA saying that the current system for airports is working well[111], given the fact that their members, who hold the monopoly bargaining power, can effectively block access to arbitration by airport users. It is quite another thing altogether to have the Commission essentially endorsing this.

It may be instructive for the Commission to again read the Tribunal's 2005 decision, in which they determined that declaration of airside services at Sydney Airport was necessary "*to redress the bargaining power asymmetry presently existing due to SACL's position as a monopoly provider of the Airside Service in Sydney in circumstances where the scope of dispute resolution procedures in relation to access to the Airside Service are severely limited*"[112]

The Commission's suggestion that airport customers, operating in a competitive environment, are genuinely able to take advantage of their bargaining power in what they term "normal" commercial negotiations with monopoly airports, appears to be a strange – and extremely flimsy – argument on which to base their assessment that they have no real concerns about the exercise of market power by airports.

This conclusion places the Commission's logic at odds with long-standing economic theory and widely- accepted requirements - emanating from decades of review - for appropriate consumer and societal protections from monopoly infrastructure asset operators. Why the Commission believe that these theories and protections should not apply to airports is not made clear.

One of the most sensible and widely-accepted ways to provide such protection is by giving parties access to an efficient and effective commercial arbitration pathway for when disputes arise; but not via a process that one party (the monopolist) can simply block.

The need for appropriate and accessible dispute resolution

As the Tribunal said in 2005 "*This situation [at Sydney Airport] is exacerbated by the lack of an appropriate dispute resolution procedure providing independent arbitration in any of the commercial agreements entered into or proposed between SACL and the airlines*."[113]

In the 14 years since this judgement was handed down, the regulatory framework surrounding airports has remained largely unchanged; apart from the fact that the possibility for such a declaration to made again has all but been removed by changes to the CCA in 2017.[xxxii]

Yet, in its draft report, the Commission so conclusively reaches the completely opposite conclusion:

"The Commission would not hesitate to recommend regulatory changes, including price regulation, for any airport found to have systematically exercised its market power to the detriment of the community. ***The ongoing potential for such consequences acts as a deterrent against the exercise of market power****." (Draft Report, p.49)*

As we have outlined previously, there is simply no evidence in support of this final statement, yet plenty, including valid precedents, expert opinion, and numerous anecdotes from a variety of airport users, to suggest the alternate proposition is in fact true. It is also hard to see how the Commission could comfortably assert that the threat of declaration is still effective, when they cite examples of airports' removing the airlines' ability to access declaration by insertion of certain clauses in their contracts.

Moreover, it is interesting to note that one of the Commission's biggest concerns with the proposed negotiate-arbitrate regime appears to be timeframes and costs; and yet, in endorsing the existing provisions under Part IIIA, they fail to acknowledge that the Port of Newcastle case under this regime is now approaching four *years* since lodgement. This stands in stark contrast to the four *months* that the first and only arbitration decision was taken since the gas pipeline regime was introduced.

A case for arbitration

As our submission has shown, in reaching its conclusions the Commission rejected a large body of evidence from a wide range of experts, instead arguing that *"The proponents [of change] have failed to demonstrate why a negotiate-arbitrate framework specific to airports is needed." (Draft Report, p.316)*

One of these proponents was the ACCC, with a proposal for introducing an option for parties to access commercial arbitration. It is perhaps most intriguing that the Commission has ignored advice from the administrator of the current regime, instead proposing enhancing the monitoring currently conducted by the ACCC as a potential solution to addressing airports' market power.

While A4ANZ has also previously suggested certain enhancements to the ACCC monitoring regime to improve the quality of data and analytics, this suggestion was not made in isolation; it formed part of a wider strategy to improve the regulatory framework. Indeed, it is difficult to see, and the Commission has not articulated, what benefit enhanced monitoring alone would achieve, particularly given the increased cost and resource burden to the ACCC. Furthermore, if the Commission see enhanced monitoring as simply a means to increasing the threat of a Part VIIA price inquiry – this is not a credible threat, for reasons detailed earlier in this submission.

As the Commission has stated in the draft report, "*Light handed regulation is intended to achieve outcomes that would be consistent with those found in markets with effective competition, but will only do so if there is: transparency as to how an airport operator is performing over time and a credible threat of further regulatory intervention if an airport operator is found to be exercising its market power to the detriment of the community*."[114]

[xxxii] A comprehensive explanation of why this is the case was provided by Michael O'Bryan QC, in a memo provided as part of our submission to the Productivity Commission.

A4ANZ agrees with this assessment and has similarly noted this in both our initial and supplementary submissions.[115,116] For a light-handed regime to work as intended, it requires a credible threat of greater regulatory intervention. The simplest, most pragmatic solution, is to have a credible threat of arbitration to drive commercial negotiations between airports and airport users, on reasonable terms and conditions.

In the remaining sections of this submission, we outline what effective change would look like, with a clear focus on the minimum change required to create an effective policy and regulatory framework for Australia's airports.

RECOMMENDATIONS IN WHICH COMMON SENSE PREVAILED

While parts of the Draft Report were, as others have noted, an exercise in cognitive dissonance, there were some recommendations in which the application of common sense could be seen; particularly in relation to regional airport operations.

A4ANZ recognises the importance of a strong and viable aviation sector across the entire country – not just metropolitan areas. Indeed, A4ANZ's members are proud to collectively offer close to 3000 services to and from regional Australia every week. A4ANZ welcomed Draft Recommendation 10.7 in the Commission's draft report:

"*The Australian Government should review the efficacy of the Western Australian Strategic Airport Asset and Financial Management Framework in 2022, in consultation with State, Territory and Local Governments. Pending the findings of that review, the Framework should be adapted and rolled out by governments in other jurisdictions with the objective of providing a template for sound asset management practices and greater transparency when determining airport charges at regional airports*." (Draft Report, p.323)

Whilst A4ANZ appreciates the challenges faced by regional airports across Australia, we believe it is also important to recognise the challenges faced by airlines operating services to rural, regional and remote communities.

It is of note that airport charges can represent a significant proportion of airfares – particularly on regional and rural routes. One of biggest roadblocks to the airlines' ability to introduce new and grow existing routes is high airport charges. Indeed, the majority of the most expensive airports in Australia are in northern regional Australia – with costs in some ports more than five times those of the major airports in southern states.[117]

It is evident that airport charges are directly affected by infrastructure investment decisions. There is also a growing trend for local councils to grant long-term lease arrangements and management rights of an airport to a third-party operator, which in some cases, has led to instances of gross over-investment in infrastructure, the costs of which are then passed on to airline customers.

In a survey by the AAA, fewer than half of regional airports (~ 45%) reported that they consult with airlines prior to "major capital works entailing increased airport charges".[118] Given the financial challenges facing many regional airports as noted earlier, this presents an extremely strong argument for improvements in the level of consultation with these airports' customers, to assist in ensuring efficient, targeted investment and reducing unnecessary expenditure.

Clearly, investment in infrastructure and upgrades are necessary, however A4ANZ believes that investment must be fit-for-purpose; that is, aligned with the needs of passengers using the facilities and demand for air services. The best way to determine requirements and ensure this fit is through industry consultation.

Hence, it is vitally important that a condition of Government funding for regional airports is that the airports undertake transparent and genuine consultation with airlines on relevant infrastructure investment and other capital expenditure proposals. This would reduce overcapitalisation, such as creating international airports in regional areas where there is little current or predicted demand.

As noted in A4ANZ's original submission, a regional airport (which currently has one of the highest head taxes across regional networks) embarked on plans to build a new terminal, extend the runway, and upgrade the apron and taxiways at a total cost of over $19 million. Three years on, the airport had capacity for larger aircraft and 240 passengers at the terminal - seven times that of the 34-seater aircraft servicing the region. The regional council had justified the airport upgrade as catering for new aircraft and increased passenger numbers and flights; calculations clearly not based on demand projections as, since completion, passenger numbers and flights remained at pre-upgrade levels.[119]

Unsurprisingly, therefore, A4ANZ also welcomes Draft Recommendation 10.6 in the Commission's draft report.

"The Australian, State and Territory Governments should ensure that:

- *an independent analysis of proposed government funding of regional airport infrastructure is completed, and made available for public comment, before funding is committed. The analysis should:*
    - *assess the economic and financial viability of proposed infrastructure investment;*
    - *assess whether the project is consistent with the long term strategy of the region and the airport's master plan;*
    - *quantify the economic benefits delivered and the recipients of those benefits; and*
    - *assess users' (airlines and communities) willingness to pay for the infrastructure;*
- *government funded investments in airport infrastructure are undertaken using the relevant functional economic region as the basis for decisions, not individual local councils;*
- *any project funded by government is monitored, and an independent evaluation is conducted and published that assesses whether the project outcomes have been achieved.*

The Australian, State and Territory Governments should publish the justification for funding an infrastructure project that was not supported by independent analysis." (Draft Report, p.320)

These are important and timely recommendations. Prioritising efficient operations and fit-for-purpose infrastructure investments ensures that consumers are not the ones ultimately paying for the infrastructure through high charges. This alone, however, does not remove the need for an effective regulatory framework for all airports.

THE NEED FOR A FIT-FOR-PURPOSE REGULATORY REGIME

As both expert independent legal advice[120,121] and the recent NCC decision[122] have demonstrated, the criteria for declaration under Part IIIA of the CCA has been materially changed. The Commission should therefore cease citing the National Access Regime as providing a "credible threat" to airport operators, constraining them in their ability to exercise their market power. There is no evidence it has, or indeed continues to do so.

We have previously acknowledged the reluctance of the Commission to consider a sector-specific approach for airports, but have noted that a range of other industries have taken this option, as outlined earlier in this submission. The establishment of these models have all been informed, at least in part, by Part IIIA provisions, but importantly, their development recognises the need to approach specific industries and their needs differently.

A sector-specific approach is justified

Given the Commission's initial reluctance for an industry-specific model, it was interesting to note the Commission's recommendations for proposed regulatory reforms in the Australian jet fuel market.

In Chapter 8 of the draft report, the Commission notes that the cost of jet fuel accounts for the largest single source of airline operating costs, at about 20 per cent in 2017-18,[123] and posits that a one cent per litre decrease in the jet fuel price could result in a $90 million reduction in operating costs for airlines uplifting their fuel in Australia.[124]

Indeed, the Commission then went on to identify that one option for reform in the market could be to introduce an industry-specific regime for jet fuel infrastructure, such as the access regime for gas pipelines.[125] The Commission further noted that an industry-specific regime could have a number of advantages, including that it could be tailored to the individual circumstances of the industry and that it could provide greater regulatory certainty to infrastructure providers and access seekers.[126]

Given these assertions, it is difficult to see then why the Commission is not even open to discussing, or indeed even undertaking analysis, on the potential benefits of introducing an industry-specific access regime for the aviation sector more broadly. This is particularly baffling given that even the most conservative analysis estimates that the net benefit of introducing such reform would be approximately $445 million. This figure is almost five times the estimate the Commission placed on the benefits of jet fuel infrastructure implementing such a regime.[127]

The logic of the Commission in adopting two completely conflicting positions; recognising benefits of arbitration in one monopoly market but not in another, is hard to follow. It will need to be better articulated if stakeholders, especially Government, are expected to follow it in the final report.

A simple, pragmatic solution: negotiate-arbitrate

The focus of A4ANZ's work has always been to find the simplest, most pragmatic solution, to deliver the outcome required; that is, to have a credible threat of arbitration to drive commercial negotiations between airports and airport users, on reasonable terms and conditions.

As UK regulatory expert Harry Bush CB (on behalf of the AAA), has said, "*it is important that any refinements that are sought by parties are not inconsistent with the thrust of the regulatory framework."*[128] We agree. At no stage have we proposed or sought heavy-handed regulation, or significant changes to how commercial negotiations between airports and their customers are conducted; but there needs to be a levelling of the playing field, through a *credible* threat to make the light-handed regime operate as intended, and effectively.

After significant research and consultation with other industry stakeholders, regulatory and economic experts both in Australia and globally, A4ANZ maintains that a more effective alternative to the current regime is to create an industry-specific regulatory model. In designing this, A4ANZ is seeking the minimum change possible to provide an effective pathway to arbitration in the case of disputes and negotiation breakdowns between airports and their customers.

Negotiate-Arbitrate in Practice

In introducing discussion on the case for reform in Chapter 9 of the draft report, the Commission has chosen to focus on the importance of commercial negotiations. What the report does not recognise, however, is that in most other industries and sectors, in the case of disputes during commercial negotiations, parties usually have access to dispute resolution – which commonly involves commercial arbitration.

When rejecting this suggestion, the Commission argue that commercial arbitration can be to the detriment of one party, and further state that "*government intervention would only be warranted if the negotiating approach of either party were detrimental to the community as a whole*" (Draft Report, p.272). Disregarding for a moment the overall net benefits of introducing commercial arbitration as a dispute mechanism for Australian airports and airlines, it is important to note that neither the ACCC nor A4ANZ's proposed negotiate-arbitrate regime actually involves Government intervention in negotiation breakdowns. Rather, it simply provides either party with a commercial solution in the event of an intractable dispute.

Commercial arbitration is commonplace in other settings and sectors; it is available in the electricity, telecommunications, gas and grain markets, for example. And contrary to recent public comments by the Commission and other stakeholders[129], genuine commercial arbitration is not drawn-out, lengthy, nor to the detriment of parties or other stakeholders in the sector. Timeframes for resolution can be specified and are significantly shorter than alternatives, including court cases.

For example, in the 20 months since the new National Gas Rules became operational in August 2017, there has been only one dispute referred for arbitration.[130] This is of course the purpose of such a regime; it is intended to incentivise parties to reach agreement, before they need to resort to arbitration.

In this case, the single access dispute was referred to the arbitrator by the Australian Energy Regulator (AER) on 29 November 2017, with the final access determination made 12 April 2018 – a period of just over 4 months (which included the Christmas/New Year period) from referral to final decision.[131] Perhaps even more important to note is the fact that just 2 weeks after the final determination, on 26 April 2018, the shipper gave notice that it wished to enter an access contract in accordance with the final access determination.[132]

None of this reflects the drawn-out, costly scenarios being painted by those who wish to retain the status quo.

RESISTANCE TO CHANGE IS BASED ON FLAWED ASSUMPTIONS

Choosing not to support calls for change, the Commission asserted, "*The pillars of the economic regulation of airports should remain in place, including the annual monitoring administered by the ACCC and periodic reviews by the Productivity Commission – both are critical to the regulatory regime to maintain a credible threat to airports of increased regulation*." (Draft Report, p.23)

As noble as the Commission's objectives may be with such a statement, it should be clear from the earlier sections of this submission and the many expert contributions to the Inquiry, that there is simply no existing, credible threat to maintain.

It is one thing to have a "philosophical" objection to regulation[xxxiii], but it is quite another for the Commission to reject, without explanation of these philosophical underpinnings, the considered findings and reasoned arguments of others, e.g. the ACCC, the AEMC, and so on. Not only have the Commission rejected change based on believing – against all the evidence – that the current threat through Part IIIA remains and is effectively constraining market power, but in their preference for the status quo they also cited other, similarly flawed reasons, which we outline below.

Objections to information requirements are unfounded and unfair

In response to proposals that mirror the framework adopted in the gas pipeline sector with information disclosure requirements, the Commission said that it is "*not the role of Government to oversee commercial negotiations to make sure that the parties are meeting some standard of information disclosure at every step*" (Draft Report, p.291) In fact, no party to this Inquiry has suggested that Government do anything of the sort.

The Commission admits that an airport operator may demonstrate "*a lack of good faith bargaining during the negotiation process if it refuses to provide sufficient and timely information to negotiating parties to assess the service offer*", and further, that this sort of behaviour can provide evidence that a negotiating party is exercising market power. (Draft Report, p.111) However, this is then confounded by the Commission's assertion that there is no 'gap' for Government policy to address by asserting that "*information asymmetries are a normal part of bargaining*" (Draft Report, p.289). Not only is this totally inconsistent with the first statement, but it seems to – again – completely ignore the fact that the parties do not have equal bargaining power; only one is a monopolist, with all of the benefits that this position affords.

The Commission have plenty of evidence in front of them that airports are indeed maximising their monopoly position. The evidence has come not only from airlines, but admissions made by the airports' peak body, the AAA.

As noted previously, the AAA's own 2017 survey confirmed that fewer than half of regional airports (~ 45%) consult with airlines prior to "major capital works entailing increased airport charges"[133], with the concept of genuine, open consultation and co-design representing exceptional, rather than usual behaviour in Australia's airports. The same survey noted that increased charges are often levied with little forewarning, with an overwhelming majority (86%) of regional airports admitting that they only give airlines three to six months' notice of changes to airport charges[134], often after tickets have already been sold.

[xxxiii] These were perspectives shared by Commissioner Professor Stephen King, at a *Policy in the Pub* session on Economic Regulation of Airports, hosted by the Economic Society of Australia (Vic branch) on 20 March 2019.

Information asymmetry is not just an issue experienced by Australia's domestic airlines. As BARA's submission to the Inquiry highlighted, international airlines have made repeated calls for improvements to information-sharing during negotiations – particularly regarding airport services, operations and proposed investment activities.[135] In a supplementary submission, the AAA acknowledged this and suggested that Government guidance could be helpful.[136]

In November 2018, in front of an audience of airport operators, the AAA's economist, Warren Mundy said the following:

"*People's expectations aren't being met and if the Government was able to provide some guidance about what reasonable expectations are then I think there's a pretty fair chance that people will act accordingly. If that comes about, and in five years' time the same sorts of conduct are being seen, I think we're probably in for a much poorer outcome next time*." [137]

This statement is clear confirmation that the existing Aeronautical Pricing Principles are being ignored by airports and that their lack of enforceability means that people do not "act accordingly", as suggested. It is also an admission that the current conduct of airports falls short of what is expected in the Principles and provides further confirmation that the five-year horizon for Productivity Commission Inquiries has in no way been a deterrent to this behaviour.[xxxiv]

While the Commission could see no issues with this lack of consultation and information for airport users, the Vertigan review, by contrast, recognised it as a problem for pipeline users, and took steps to address it.[138] In fact, the provision of information to address information asymmetries between monopoly pipeline operators and their customers was their primary recommendation, stating that "*Increased transparency provides parties seeking pipeline services with an improved ability to undertake timely and effective negotiations*."[139] Standards for information disclosure at various stages are included in the new NGR and regulatory framework, but this has not meant that Government are overseeing negotiations at every step, as the Commission has insinuated.

The framework simply provides for pipeline operators to publish the information that shippers need to make an informed decision about whether to seek access to a pipeline service and to assess the reasonableness of an offer made by the pipeline operator. The publication and exchange of this information is intended to facilitate timely and effective commercial negotiations in relation to access to non-scheme pipelines. It does not involve any direct oversight by the Government.

The now Treasurer said at the time that the arbitration framework was designed to address concerns a number of gas shippers had raised about pipeline operators engaging in monopoly pricing. "*Further, the information disclosure requirements will shine a light on pricing and create greater transparency in the market, taking it well beyond the regulatory framework currently in place*," he said, noting that ministers had agreed to review the arbitration framework after two years to evaluate whether *stricter* rules were in fact required.[140]

What is needed in the aviation sector is a similarly sensible, consistent and effective approach that also delivers proportionate and targeted regulation where needed. Rather than scaremongering, airports should work with airlines to ensure more cost-effective infrastructure in the future.

Overstated concerns over risk and uncertainty

The Commission contend that; *"Introducing a negotiate-arbitrate framework would come with risks, many of them significant. The most concerning is that arbitration could collapse to shadow price regulation, with all the attendant*

[xxxiv] The AAA have recently suggested that our reference to Mr Mundy's comments are a "deliberate misrepresentation" of what was said. We completely reject this claim and would be happy to provide the Commission with the audio recording of these comments so that they can decide for themselves what was intended by these remarks, in the context of Mr Mundy's full presentation.

weaknesses of such systems. The arbitration process would be time-consuming, financially costly and would distract airlines and airports from their core business." (Draft Report, p.316)

The Commission do not say on what basis it has made these assumptions, nor does it provide references to support such definitive and alarming statements. Having a body like the Productivity Commission express these views, in the absence of evidence to support them is irresponsible as it in fact *creates* uncertainty.

Further damage in an important public policy debate is done by emboldening others, in their defence of the status quo, to also make claims that are speculative and without substance about risk and an arbitrator's "*likely reactions and views*"[141], or that "*the creation of new mechanisms would simply promote gaming and risk perverse and inefficient outcomes*."[142]

In fact, our research identified that while similar apprehension about shadow price regulation was raised by Infrastructure Partnerships Australia (when it wrote to Dr Michael Vertigan in 2017, expressing concerns about the proposed non-scheme gas pipeline regulations),[143] the COAG Energy Council weighed up the evidence, but took a different view and proceeded to implement the reforms anyway.

There is certainly readily-available evidence to allay the Commission's concerns and those now expressed by others on this front. Since the introduction of the gas reforms in August 2017, the scheme has not collapsed into shadow price regulation. In fact, as we have seen, only a *single* case has been referred for arbitration and a determination made, which took just over 4 months.

This experience, along with the evidence from other sectors and jurisdictions, ought to put to bed the baseless suggestion that introducing such a regulatory context would somehow constrain parties making agreements in preference to seeking a determination.[144]

Furthermore, in July 2018, a review of the gas framework, undertaken by the AEMC, found that, "*the negotiate-arbitrate regime represents an appropriate balance between the direct and indirect cost of regulation on the one hand and the ability for the regulation to constrain market power on the other."*[145]

These sensible reforms were made after an extensive review which took in a large range of stakeholder views and different perspectives, but more importantly, they reflect the fact that evidence was favoured over speculation.

Australia is not alone in having airports raise risk and uncertainty as reasons to do nothing. Globally, airports have similarly argued that the European Commission's review of the Airport Charges Directive (ACD) creates uncertainty and risks affecting the value and attractiveness of European airports as assets. As Airlines for Europe have said, however, "*This is a smokescreen and simply not credible*." [146] Despite the credibility gap, the Commission seem to have adopted the same perspective as the airports.

Some 14 years ago, when ruling on the Sydney Airport declaration, the Tribunal President Justice Goldberg refused to recognise spurious arguments about the risks presented by arbitration, saying,

> "*We consider Mr Houston's analysis to be of little probative value. It is speculative and based on a number of assumptions that will not necessarily be valid at any given point of time. Much would depend upon the nature of the dispute and the extent to which there had been negotiations to resolve the dispute. Any estimate of such costs, particularly where arbitration is not inevitable, is speculative in the extreme. It should also be remembered that the legislation anticipates a speedy and cost efficient arbitration*."[147]

Despite this, the Commission rejected arbitration based on costs and timeframes. It is in fact drawn out negotiations that are time-consuming, financially costly and distract airlines and airports from their core business. For court cases or declaration applications, these costs and timelines are even greater. A negotiate-arbitrate regime is intended to - and in fact has been shown to – *minimise* these losses by encouraging speedier resolution of disputes and setting information requirements and timeframes for arbitrations.

A4ANZ agrees with our European counterparts that "*airlines do not oppose investments in infrastructure and recognise that airport capacity constraints are a challenge*." As they put it simply, "*Investments must be cost-effective and fit-for-purpose to ensure that airlines and their passengers do not pay more than necessary for airport infrastructure. It is airlines that compete for passengers – not airports – and this competition has lowered fares and increased choices, allowing more people to travel than ever before*."

Regulatory regimes can and do deliver efficient investment[xxxv]

There is no basis whatsoever to the Commission's claim that a negotiate-arbitrate scheme for airports "*would profoundly change the way in which contracts are negotiated between airports and airlines, disrupt investment and harm the community.*"[xxxvi] No justification has been provided by the Commission for these extreme statements, which are based on flawed logic and assumptions.

As a further part of its rejection, the Commission claimed there is the potential for a negotiate-arbitrate framework to exert a 'chilling' effect on airport investment by increasing the time taken to commence work and therefore the cost of investment. [148]

Again, no evidence or precedent has been provided to substantiate this claim. Even more concerningly, the Commission has not expressly considered the evidence we provided – a cost-benefit assessment undertaken by Frontier Economics – that countered this argument. The Commission simply described the analysis as "not credible", without further justification. Once again, this superficial approach emboldens those who wish to preserve the status quo to raise further uncertainty, with the AAA's latest response claiming that "*benefits of arbitration may well be illusory*", but again providing no substantive data in support of this.[149]

Under current arrangements, it cannot simply be presumed that airports are investing the right amount on the right things, at the right time. Everything we know about monopolies would suggest that Australian airports in fact face many incentives to invest *inefficiently*. The economic literature supports the fact that when an airport has market power, it faces several incentives that reduce the efficiency of investment:

- Airports may have an incentive to underinvest, as this would allow the service provider to increase profitability by justifying and charging scarcity rents. As noted above, this reduces consumer surplus and results in welfare loss for society.[xxxvii]
- Airports may have an incentive to undertake inefficient investment by spending resources to obtain or protect a monopoly position ("rent seeking" behaviour).[150]
- Airports may not chase productive efficiencies that minimise its costs (or lead a 'quiet life'). A lack of competitive pressure may reduce the incentive for the firm to look for way to minimise costs by adopting cost-saving or innovative technologies.[151]

Furthermore, significant investment can, and is, delivered under effective regulatory regimes. Experience has shown that carefully designed regulatory regimes can and do provide appropriate incentives for investment whilst protecting against the misuse of market power. It is the specifics, rather than the existence of a regulatory regime, that affects investment. Dismissing the case for regulation based on the possibility it might impact on investment is like throwing the baby out with the bathwater.

The AAA's submission notes that capital expenditure (per passenger) incurred at Australian airports is broadly consistent with global peers.[152] In other words, Australian airports have been investing to a similar degree as other international airports on a per passenger basis. These international airports are under different, and often heavier-

---

[xxxv] This section was drafted with input an assistance from Ms Anna Wilson and Mr Warwick Davis, Frontier Economics

[xxxvi] Speech by Commissioner Paul Lindwall to Infrastructure Partnerships Australia Industry Lunch, 19 March 2019

[xxxvii] There is a body of literature on the risk that monopolies will defer investment or under invest in capacity expansions. Dobbs (2004) found that firms with monopoly power who are able to control the scale of their investments will under-invest and will wait too long before adding to such investment. Consequently, prices to final customers are always higher than in competitive markets. .

handed regulatory arrangements and have equally been investing to keep up with growing demand. This implies the presence of a regulatory regime does not necessarily act as a barrier to investment. The level of investment that has taken place at Heathrow (see Box 8) and Changi, which are subject to price and revenue caps respectively, are good examples of this.

Outside of airports, there are plenty of other examples of where significant investment has taken place in regulated industries, as described in our supplementary submission.[153]

The lack of risk, whether perceived or real, to investment, has recently been demonstrated in the Australian gas sector. When the reformed regulatory framework for the gas industry was proposed, investment analysts found that the framework *"[did] not fundamentally alter investment [cases]",* and that the framework "*seemed to strike a reasonable balance between the interests/needs of the shippers and the pipeline operators*".[154] The reform was welcomed by then Minister for the Environment and Energy, the Hon. Josh Frydenberg MP, who did not seem concerned by investment uncertainty, with good reason.

Why the Commission chose to ignore these strong precedents, and evidence of continued investment under more effective regulation, is not articulated in the draft report. Neither is a justification provided for why it instead favoured accepting the proposition from airports that investment will be at risk, despite the paucity of evidence in support of this claim.

Box 8: Heathrow Airport

Heathrow Airport provides a helpful case-study of how a privately-owned airport can deliver significant investment under a form of price control.

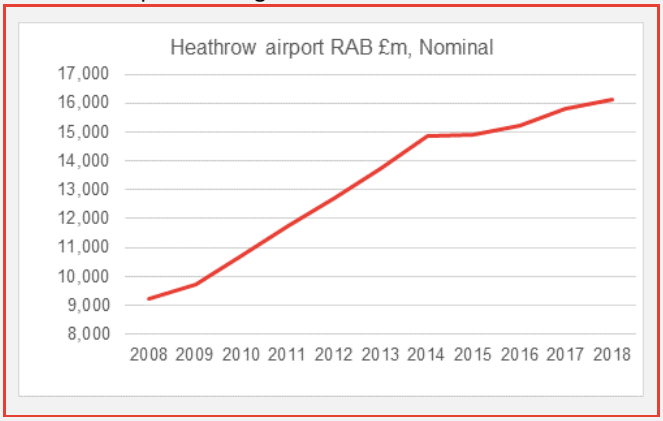
Heathrow is subject to *ex ante* price caps set to recover an efficient level of future expenditure for the airport, based on the airport's proposal and submissions of users. This requires forecasts of future demand and expenditure which can be complex. The forecasts included in the regulatory determination are informed by "constructive engagement". Under this process airports and airlines directly negotiate with each other to determine traffic forecasts, service requirements, and investment programmes.

The AAA's submission notes that since 2002 Australian airports have invested over $15 billion in infrastructure, of which around $10 billion has been in aeronautical assets[155]. And suggests that this investment is a direct result of the current light-handed airport regulatory regime. While these figures appear sizeable, as highlighted in the AAA's own submission, for all but one Australian airport, capital expenditures per passenger are higher at Heathrow Airport, which is subject to more heavy-handed regulation.

Irrespective of whether Heathrow's regulatory regime is viewed as a success, it is clear that it has enabled significant investment to occur.

Furthermore, as demonstrate in the figure below Heathrow's Regulatory asset base has grown significantly by 174% from £9,233 in 2008 to £16,108 in 2018. This implies that investment at the airport has involved major augmentations and not just capital expenditure to maintain and replace the existing assets.

Heathrow Airport's RAB growth from 2008 to 2018



Source: RAB data published by Heathrow Airport

PROMOTING AN EFFICIENT & SUSTAINABLE AVIATION SECTOR

It is difficult to comment on the Commission's assessment of alternate regulatory remedies as it has not completed one – at least not one that is documented in the Draft Report. This is likely due to the fact that the Commission considered "*that governments should only make changes to the type of regulation under which the four monitored airports operate if those airports are systematically exercising their market power to the detriment of the community*." (Draft Report, p.78)

Therefore, the Commission's flawed preceding assessment have meant it has not felt the need to assess alternative forms of regulation in any detail. Its partial analysis and presumption of constraints on market power and the exercise of market power lends it to a conclusion of light-handed regulation that really consists of monitoring alone.

However, we would argue that if the Commission were to reconsider its market power analysis and assess profitability on a single till basis as described earlier in this submission, the results would suggest the need for an effective regulatory regime to apply to, at the very least, the core regulated airports.

The Commission's draft report has spent significant time on the potential errors and risks of regulatory reform, without addressing the protections and safeguards which have been proposed to avoid these. Indeed, based on the draft report it would appear that the Commission has not given any meaningful consideration to the potential benefits of having access issues resolved through an effective, readily accessible dispute resolution mechanism. This is cause for both disappointment and significant concern.

Benefits of an effective regulatory regime all but ignored by Commission

The Commission made no attempt to quantify or substantiate either the benefits or the costs that may result from moving to a negotiate-arbitrate regime. The Commission claimed that the compliance and administration costs of a negotiate arbitrate regime could be significant if airports were required to deal with disagreements over investment (Draft Report, p.315), however, no attempt has been made to quantify these costs, let alone compare them to alternatives, including the status quo.

A4ANZ was in fact the only party to the Inquiry to present, via analysis undertaken by Frontier Economics, a more detailed assessment of the costs and benefits of changing the regulatory regime applying to monitored airports. The Productivity Commission dismissed this analysis in its entirety, based on what it considered to be deficiencies in the report.

Both A4ANZ and Frontier Economics dispute the Commission's critique and the way in which this evidence was contextualised within the Commission's report. This issue is dealt with in more detail in Frontier Economics' own, independent submission to the Productivity Commission.[156]

Litigation preferred over arbitration?

The benefits of a negotiate-arbitrate regime instead of the existing system have not been assessed by the Commission. Despite this, Commissioners appear comfortable with the idea that under the current regime, the resolution of intractable disputes through litigation in the courts (e.g.Perth Airport in its recent WA Supreme Court application against Qantas) is a reasonable option in the scenario that agreement cannot be reached.[xxxviii] That litigation, instituted by Perth Airport, seeks the determination by a judge of of "*a fair and reasonable price for the Aeronautical Services"* provided by Perth Airport to the Qantas Group Airlines since 1 July 2018.[xxxix]

[xxxviii] Comments made by Commissioners Stephen King and Paul Lindwall at a *Policy in the Pub* session on Economic Regulation of Airports, hosted by the Economic Society of Australia (Vic branch) on 20 March 2019.

[xxxix] Writ of Summons filed on behalf of Perth Airport in the Supreme Court of Western Australia (para.14 and 19), 17 Dec 2018

So the Commission suggests that litigation arbitration is an acceptable process and is clearly preferred over commercial arbitration or expert determination[157], which it rejects as unacceptable. This can only be described as an extraordinary proposition, if the Commission had given any consideration to regulatory efficiency.

In its response to the draft report, the AAA unsurprisingly shares this view, arguing that parties benefit from litigation by "*being given a forum to enforce their claims and restrain the actions of others*." They go on to say that "*it is clear that if [the Perth Airport-Qantas] matter does not settle prior to going to trial, precedents will be made that will undoubtedly be of value to the aviation industry and potentially many others. The development of precedent will assist parties to avoid litigation in the future whilst they negotiate in 'the shadow of the law'*."[158]

Through these statements, therefore, both the AAA and the Commission propose that they are not opposed to an arbitrated dispute resolution mechanism to resolve intractable disagreements that sometimes occur in negotiations. Extraordinarily, however, the Commission opines that the only acceptable arbitrated dispute resolution acceptable to them is via the courts or through an application to have an airport declared under Part IIIA. We deal with each of these issues in turn.

The court process

Given the AAA's commentary around precedent setting and the Commission's description of the Perth case essentially being for the purpose of having the court determine what constitutes a reasonable cost, it would appear that what is actually being expressed here is a preference for an arbitrated determination via litigation, rather than expert commercial arbitration. The Commission appears to have accepted the AAA's view that this Court action does not represent an example of problems with the existing regime, but simply that it acts as an acceptable intractable negotiation resolution technique.

This is surely an outrageous proposition for the Commission to support.

Not only is there is ample evidence available to show that litigation through the Courts is an expensive and drawn out process, and it is a widely held view in Australian business that it is to be avoided, but there are a number of benefits to expert commercial arbitration. For example, when the subject matter of the dispute is highly technical, arbitrators with an appropriate degree of expertise can be appointed (whereas a judge cannot be "chosen" in litigation), arbitrators can be bound by directions as to timeframes and matters to be taken into account, arbitration proceedings and determinations can be made confidential, and depending on the regime under which the arbitration is being performed, there are very limited – if any – avenues for appeal.

By contrast, a judge in a litigation is not required to adhere to any particular timeframes nor sector-specific principles. Judgements are also open to appeal, and there are innumerable examples of this resulting in disputes that remain unresolved for years and come at a significant cost to parties, not only in legal fees but lost productivity and opportunities to work constructively together while matters are before a court.

The fact that the Productivity Commission do not seem to have weighed this against the proposals for sensible moves toward an expert commercial arbitration framework – with fixed timeframes and sector- specific arbitration criteria – to apply to airport disputes is a significant failing of this Draft Report.

Rejecting the evidence in favour of these sensible and minimal reforms to the existing regulatory model, the Commission asserted that they were "*not convinced that additional regulation would achieve better outcomes than commercial negotiation*" (Draft Report, p.291)

This would hold true *if* the current model was working effectively to facilitate commercial negotiations. Quite clearly, it is not, and the Perth court case could be just the start. Do the Productivity Commission genuinely believe it is reasonable to recommend to Government that they should accept the litigation process as an acceptable way

forward and then wait until 2024 before a proper assessment is undertaken of whether there might be a better way? One which enhances, rather than detracts from productivity.

Part IIIA access declaration

The Commission also recommends that parties to intractable negotiations can and should pursue the access declaration process under Part IIIA of the CCA. As stated earlier in this submission, we have provided an unequivocal opinion from Michael O'Bryan QC (recently appointed a Justice of the Federal Court), that following the amendments to that legislation effected in late 2017, recourse to access declaration is no longer available in the circumstances of intractable disputes between airports and the purchasers of their services. The Commission has chosen to ignore or reject that opinion, without providing any rationale for doing so.

Putting aside the opinions on the availability of an access declaration under Part IIIA, the Commission is, by implication, proposing that as access declaration is – in its opinion – available to parties involved in airport negotiations, the consequences flowing from declaration are an acceptable form of 'regulation' to deal with intractable disputes encountered in negotiations. The consequence, of course, is a negotiate-arbitrate process under the provisions of Division 3 of Part IIIA the CCA, with the arbitrator being the ACCC.

It is important ensure that the Commission is not under any illusion about what has been proposed by both the ACCC and A4ANZ in earlier submissions. Both have proposed a negotiate-arbitrate process, but, rather than the ACCC being the arbitrator, have said that arbitration should be referred to an expert commercial arbitrator with appropriate directions as to the conduct of the arbitration.

No comparative analysis to assess options

Furthermore, if the Commission is so confident as to the availability of access under Part IIIA, and accepts the merits of a negotiate-arbitrate process that flows from declaration, it must surely accept the efficiency of recommending deemed declaration of airports with market power with the flow on of the negotiate-arbitrate process. Deemed declaration will avoid the inevitable costly and lengthy litigation process on the issue of whether access declaration is available; we have ample evidence of the time, cost and unproductive nature of the drawn-out litigation processes in the historical Sydney Airport declaration[159] and the more recent Port of Newcastle case.[160]

The Draft Report is completely absent any discussion of these potential issues and options, with no comparative analysis of the relative benefits and risks. This is a significant oversight for such an Inquiry.

Had these analyses been properly undertaken, the Commission would know that what A4ANZ and the ACCC have been saying for some time – including in the ACCC's most recent monitoring report – is that this is not so much about applying *additional* regulation, but more about ensuring that the "credible threat" element of the regulatory model is working to constrain market power and facilitate commercial negotiations, as Government policy intends.

To have the Commission instead paint the application of such a regime as an "unfair" burden of regulation on airports ignores the reality of what is actually occurring. As Rod Sims said recently, "*Monitoring alone is not enough to constrain the behaviour of companies with significant market power, such as airports…. Our proposal for independent arbitration is a pragmatic solution for resolving disputes between airports and airlines.*"[161]

Change *is* required: Making the threat credible

The Commission's assertion that the current system is working and that "*strong incentives exist*" for airports to reach agreements with airlines (Draft Report, p.272) is at odds with accepted economic theory, which instead says that the incentives of a monopolist are such that they are unlikely to be substantially affected by the largely non-financial impact of monitoring regimes.

As Rod Sims said in a 2015 presentation on infrastructure regulation, monopolists "*will effectively be able to act in an unconstrained manner with little incentive to undertake efficient investments and operation of infrastructure services. In these circumstances something more than price monitoring is required*."

"*This was recognised by the Hilmer committee when setting out the framework for Australia's national competition policy. The Hilmer review favoured private agreement between access seekers and infrastructure service providers on access terms and conditions, but this was to be underpinned by binding arbitration by a regulator in the event that the parties could not reach agreement*."[162]

The ACMS also recognised this. When commenting on the negotiate-arbitrate framework for gas pipelines they said, "*a "lighter" overall form of regulation (such as price monitoring and reporting) would be unlikely to be appropriate as it would be unlikely to provide a sufficient constraint on the use of market power by service providers or provide sufficient assistance in negotiations*."

As our European counterparts have noted, where airports have significant market power and few competitive constraints, "*they can act independently of the interests of airlines and passengers. They can use this power to charge excessively, run inefficient operations, make expensive or unnecessary investments, and offer inadequate service quality*."[163]

Indeed they can, and do. Beyond the airlines, a range of other airport customers and experts have highlighted this to the Commission, in detailed, carefully-considered and researched submissions to the Inquiry. By setting aside this evidence to largely retain existing arrangements, it would seem to represent, at best, a wasteful exercise for all involved, and at worst, an abrogation of the responsibilities of the Commission in conducting this Inquiry.

Airport arbitration framework

It is also important to note that A4ANZ is not putting forward this proposal so that only airlines may have access to arbitration. Rather, the principle of the negotiate-arbitrate option proposed by A4ANZ is that in the event that commercial negotiations break down, either party can access expert commercial arbitration.

However, where commercial processes are working effectively, resorting to arbitration should rarely be required,[164] and this has been the experience with the new gas rules. As A4ANZ has said previously, the framework would be designed to incentivise parties to negotiate, rather than relying on arbitration, which accords with international experience and local precedents.

At no stage has A4ANZ or, to our knowledge, the ACCC, suggested that airports simply adopt the gas code unchanged, despite this being claimed by the Commission.[xl] Far from being a proposal for – as some others have suggested – "copycat" regulation, the whole focus of our proposal is that the regime be sector-specific, and the characteristics for the regulatory framework can and should be designed to take account of the particular differences.[165]

[xl] These were perspectives shared by Commissioner Professor Stephen King, at a *Policy in the Pub* session on Economic Regulation of Airports, hosted by the Economic Society of Australia (Vic branch) on 20 March 2019.

Surely, however, we ought to learn from the deliberations of experts, and real-world experiences of these other sectors, when looking to how we could do better in airport regulation? That is, after all, what the Productivity Commission is tasked by Government to do, in its commitment to use *best available evidence* to inform its policy advice.

Framework characteristics

Characteristics for an arbitration framework could include, but are no means limited to, the following:[xli]

- Commercial negotiation between parties would occur whenever any party sought access or services at airports;
- After negotiations had commenced either party could signal a breakdown which would trigger the arbitral process;
- Arbitration would be commercially-based, with the arbitrator (drawn from an approved pool) appointed by mutual agreement of the parties, but with provision for imposition of an arbitrator where there is no agreement;
- The framework would be designed for expeditious resolution of the dispute with provisions to avoid delay and gaming. Structures such as 'final offer arbitration' would be considered for inclusion;
- The decision of the arbitrator would be binding on both parties; and
- Oversight and maintenance of the framework will be required, including in relation to procedural rules, pricing principles and the power to appoint an arbitrator to a dispute in the absence of agreement between the parties.

Arbitration process

The framework characteristics outlined above would provide an effective and streamlined mechanism to resolve disputes according to agreed-upon standards, including existing pricing principles that are already in force, or equivalent principles,[xlii] and criteria which guide arbitrators in making their decisions.

Mandating these principles would lend greater clarity and efficiency to the operation of the framework, and should allay concerns raised by the Commission and others about the complexity of the issues on which arbitrators may be asked to decide.[166]

This is important, as the Commission has made claims that an arbitrator "*would not consider the broader public interest, nor the interests of the numerous users of airports not subject to arbitration or not being party to arbitration."* [xliii]This is an ill-informed comment. These aspects can be written into the arbitration criteria, as they have been in the gas pipeline scheme, something the Commission has itself acknowledged (Draft Report, p.312). We urge the Commission to take a second look.

Criteria for arbitrators

Appropriate criteria in the airports' environment may include aspects such as: reflecting outcomes of a workably competitive market, assessments of cost benefit, cost effectiveness, investment efficiency, and a rate of return which is commensurate with prevailing market rates. Given these criteria guide the decision-making, further direction would be necessary in the potential scenario of neither party's offers being within agreed parameters. The Options Paper designing the gas rules suggested that if the arbitrator believes a fair and reasonable settlement lies between the disputant's final offers, the rules of final offer arbitration (FOA) are used, and if it falls outside the range provided by the final offers, conventional arbitration rules are used.[167]

[xli] Adapted from the Vertigan report

[xlii] In an airport-specific regulatory framework, for disputes between airports and airlines, these could be drawn from the existing *Aeronautical Pricing Principles* and adapted as required, through a robust stakeholder consultation process.

[xliii] Speech by Commissioner Paul Lindwall to Infrastructure Partnerships Australia Industry Lunch, 19 March 2019

As we made clear our supplementary submission, A4ANZ is not opposed to the use of conventional or combined arbitration, where appropriate. We believe that, in addition to clear objectives and principles, the key to any arbitration framework is ensuring there are appropriate provisions regarding timeframes, information disclosure and mandated pricing principles.

This is in fact entirely consistent with what we have said previously, despite the Commission's inference that we had made material changes to our position. "*In its initial submission A4ANZ proposed 'that the PC give thorough consideration to the ability of parties negotiating provision of airport service to access "final offer arbitration". In its supplementary submission it suggested that FOA could be considered for inclusion in any arbitration framework as an option that would apply in some circumstances.*" (Draft Report, p.312)

These two positions are not mutually exclusive, despite the Commission, and now the AAA, inferring some kind of complete change of position by A4ANZ.[168] On the contrary; we simply sought to clarify our position as a result of genuine engagement with both the Commission and a variety of other stakeholders in the sector. A4ANZ is an organisation committed to improvement, and we are always open to refining and further articulating our proposals, informed by feedback, further research and expert advice. The Commission ought to be encouraging all stakeholders to do the same.

Arbitration framework implementation

After discussions with a variety of stakeholders, including Government and the ACCC, and considering issues raised in submissions to the Commission, we believe that the introduction of an airports-specific regulatory framework could be approached by minor amendments to the *Airports Act 1996*[169] and *Airport Regulations 1997*.[170] As noted in our supplementary submission, we have explored potential legislative mechanisms which could be used to prescribe which airports the regime could cover, to allow for the implementation of a negotiate-arbitrate framework.

It is important to note that the Terms of Reference for this Inquiry did not limit the Commission to consideration of matters pertaining to the four monitored airports alone, and, as can be seen from multiple submissions to the Inquiry, monopoly behaviours certainly extend well beyond these airports. It is therefore helpful to again look at how this issue was approached in the gas sector, where the Vertigan Report argued that it was not appropriate for access to dispute resolution to be predicated on whether or not the infrastructure asset was covered by an existing scheme; rather, that *all assets with natural monopoly characteristics* should include such a provision.[171]

We believe, therefore, that the most practical way to implement a proposed negotiate-arbitrate regime for airports may be to start with those under Commonwealth control; specifically, those defined in the Act as *core regulated airports*[xliv], with provision for inclusion of further regional airports as required.

Given the issues of monopoly behaviour are clearly not limited to the airports listed above, and there is sound rationale and precedent in other sectors, there remains a strong desire to expand coverage of such a regime to airports not on federally-leased land. Powers could be given to the Minister or Department Secretary to designate airports to come under the regime's coverage, similar to powers in other legislative instruments, e.g. the *Crimes Legislation Amendment (Police Powers at Airports) Bill 2018)*[172] and the *Aviation Transport Security Act 2004*.[173]

Regardless of the mechanisms used, it is for the benefit of efficiency, competition, and the community generally that there exists an appropriate framework to enable disputes between airport access providers and access seekers to be resolved within an appropriate framework.

[xliv] Core regulated airports include the following: Sydney, Western Sydney, Melbourne, Brisbane, Perth, Adelaide, Gold Coast, Hobart, Launceston, Alice Springs, Canberra, Darwin and Townsville.

Concluding comments

The Australian Government cannot afford to leave airport powers unconstrained by the Productivity Commission baulking at the suggestion of sensible, minor reforms.

Reforms that were deemed acceptable in other sectors, are regarded by regulatory experts as reasonable measures, and assessed by economists as having benefits over the status quo. Why these reforms are not similarly acceptable in the airports regulatory context remains unclear.

Returning to the concept of status quo inertia that we introduced at the start of this submission, the Productivity Commission will be well aware that there is also a cost to decisions *not made*, and this will need to be carefully considered by Government if the existing regulatory settings are retained.

Government should expect reasoned, high-quality advice, to ensure that these decisions *can* be made, in the best interests of consumers and the economy. We urge the Productivity Commission to deliver to this expectation in its Final Report.

APPENDIX A

Excerpt from ACCC Guidelines on Misuse of Market Power

Substantial market power

2.13. A firm may only contravene s. 46 if it has a substantial degree of market power.

2.14. Market power comes from a lack of effective competitive constraint. A firm with market power is able to act with a degree of freedom from competitors, potential competitors, suppliers and customers. The most observable manifestation of market power is the ability of a firm to profitably sustain prices above competitive levels. Substantial market power may also enable a firm to raise barriers to entry, profitably reduce the quality of goods or services or slow innovation.[xlv]

2.15. There are a range of factors that can influence the degree of competitive constraint faced by a firm which are likely to be relevant to the ACCC's assessment. These factors can include those outlined by the Trade Practices Tribunal in Re Queensland Co-Op Milling Association Limited and Defiance Holdings Limited:

a) the number and size distribution of independent sellers, especially the degree of market concentration
b) the height of barriers to entry, that is the ease with which new firms may enter and secure a viable market c) the extent to which the products of the industry are characterised by extreme product differentiation and sales promotion
c) the character of 'vertical relationships' with customers and with suppliers and the extent of vertical integration
d) the nature of any formal, stable and fundamental arrangements between firms which restrict their ability to function as independent entities.[xlvi]

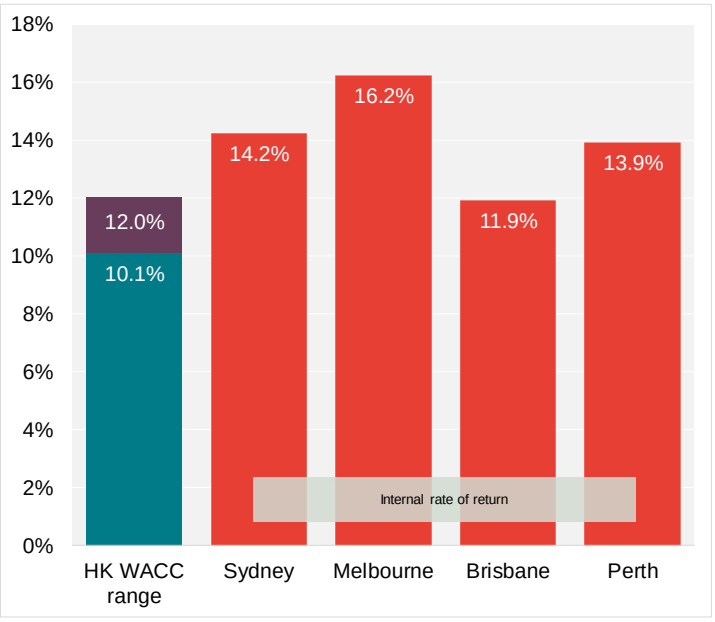
2.16. The ACCC does not impose a market share threshold in determining whether a firm has a substantial degree of market power. While market share can be an important factor, more than one corporation may have a substantial degree of power in a market.[xlvii] Further, a firm may have market power even though it does not substantially control the market or have absolute freedom from the constraint of competitors.[xlviii] Similarly, financial strength does not by itself determine whether a firm has market power.

2.17. The ACCC will assess each case on its merits according to the specific nature of the good or service, the industry and the particular competitive impact likely to result in each case.

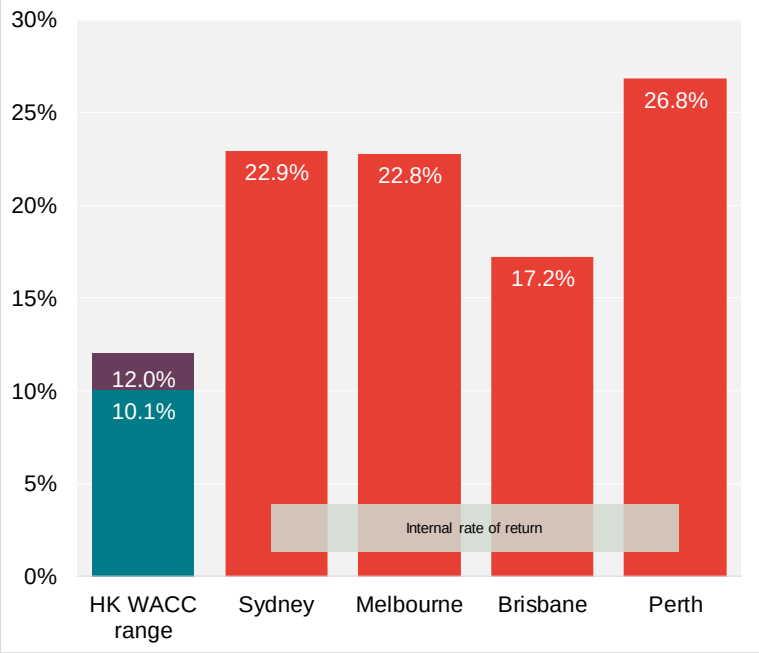
[xlv] See discussion on market power in Kaysen and Turner, Antitrust Policy (1959), p. 75 in QWI at [200]
[xlvi] (1976) 8 ALR 481 at 515–516
[xlvii] Section 46(7) of the CCA
[xlviii] Section 46(5) of the CCA

APPENDIX B

Figure 3: Results of IRR analysis and comparison with cost of capital



Using sale prices as opening values, market value as closing values



Using book values as opening values, and market values as closing values

Source: Frontier Economics calculations based on HoustonKemp WACC parameters for all years
Notes: IRR uses nominal, pre-tax cashflows, over the period 1998-2017 for Melbourne, Brisbane and Perth, and 2002-2017 for Sydney. WACC estimated is nominal, pre-tax and averaged over the same periods. The upper bound of the WACC range corrects for an assumed error – see Appendix D of Frontier Economics' report Market power and the profitability of Australian Airports – Response for further details.

Figure 4: Return on assets and comparison with WACC range, 2003-17

Source: Frontier Economics calculations, using ACCC monitoring data and HoustonKemp WACC parameters (see Appendix D)

REFERENCES

[1] Albanese, A. 2019. At: https://twitter.com/albomp/status/1092987561625018368
[2] Productivity Commission. 2011. Economic Regulation of Airports – Draft Report. At: http://webarchive.nla.gov.au/gov/20120317002820/http://www.pc.gov.au/projects/inquiry/airport-regulation/draft
[3] Littlechild, S. 2011. Submission to the Productivity Commission's Draft Report. At: https://www.pc.gov.au/inquiries/completed/airport-regulation/submissions/subdr116.pdf
[4] Australian Airports Association. 2019. Response to the Productivity Commission's Draft Report. At: https://www.pc.gov.au/__data/assets/pdf_file/0008/238265/subdr094-airports.pdf
[5] Ibid.
[6] National Competition Council. 2018. Statement of Preliminary Views. At: http://ncc.gov.au/images/uploads/Statement_of_Preliminary_Views,_19_December_2018_(PDF,_1.39MB).pdf
[7] Australian Competition and Consumer Commission. 2018. Submission to the Productivity Commission. At: https://www.pc.gov.au/__data/assets/pdf_file/0004/231484/sub059-airports.pdf
[8] Australian Competition and Consumer Commission. 2019. Airport Monitoring Reports. At: https://www.accc.gov.au/publications/airport-monitoring-reports
[9] Australian Competition Tribunal. 2005. Summary of Decision. At: https://www.accc.gov.au/system/files/public-registers/other/831040-1-Virgin%20Blue%20Airlines%20Pty%20Limited%20-%20Tribunal%20Determination.pdf
[10] Frontier Economics. 2018. The Market Power of Australian Airports. Appendix A of A4ANZ's Submission to the Productivity Commission. At: https://www.pc.gov.au/__data/assets/pdf_file/0007/231379/sub044-airports.pdf
[11] Frontier Economics. 2018. The Economic Evaluation of an Alternative Approach to Airport Regulation. Appendix B of A4ANZ's Submission to the Productivity Commission. At: https://www.pc.gov.au/__data/assets/pdf_file/0007/231379/sub044-airports.pdf
[12] Frontier Economics. 2018. Conservative estimate of net benefits of the reforms. At: https://www.pc.gov.au/__data/assets/pdf_file/0004/234166/sub083-airports-attachment4.pdf
[13] Minifie, Jim. 2017. Competition in Australia – Too little of a good thing? The Grattan Institute. At: https://grattan.edu.au/wp-content/uploads/2017/12/895-Competition-in-Australia-Too-little-of-a-good-thing-.pdf
[14] Forsyth, P. 2018. Submission to the Productivity Commission. At: https://www.pc.gov.au/__data/assets/pdf_file/0014/231116/sub015-airports.pdf
[15] Littlechild, S. Op. cit (3)
[16] O'Bryan, M. 2018. *Memorandum prepared for A4ANZ, re: Productivity Commission Inquiry into the Economic Regulation of Airports*. At: https://www.pc.gov.au/__data/assets/pdf_file/0020/234164/sub083-airports-attachment2.pdf
[17] Vertigan, M. 2016. *Examination of the current test for the regulation of gas pipelines – final report.* At: http://www.coagenergycouncil.gov.au/sites/prod.energycouncil/files/publications/documents/Examination%20of%20the%20current%20test%20for%20the%20regulation%20of%20gas%20pipelines%20-%20Final%20Report.pdf
[18] Independent Committee of Inquiry, National Competition Policy (August 1993), 269 (Hilmer report).
[19] Harper, I. 2015. Competition Policy Review – Final Report. At: http://competitionpolicyreview.gov.au/files/2015/03/Competition-policy-review-report_online.pdf
[20] Gas Market Reform Group. 2017. Gas Pipeline Information Disclosure and Arbitration Framework – Final Design Recommendation. At: http://gmrg.coagenergycouncil.gov.au/sites/prod.gmrg/files/publications/documents/gas-pipeline-information-disclosure-and-arbitration-framework-final-design-recommendation-june-2017.pdf
[21] Australian Energy Market Commission. 2018. Review into the scope of economic regulation applied to covered pipelines. At: https://www.aemc.gov.au/markets-reviews-advice/review-into-the-scope-of-economic-regulation-appli
[22] Arblaster, M. 2018. Report on the policy framework for economic regulation of airport services in Australia. In Appendix C of A4ANZ's Submission to the Productivity Commission. At: https://www.pc.gov.au/__data/assets/pdf_file/0007/231379/sub044-airports.pdf
[23] European Commission. 2017. Evaluation of the Directive 2009/12/Ec on Airport Charges. At: http://ec.europa.eu/smart-regulation/roadmaps/docs/2017_move_012_evaluation_airport_charges_en.pdf
[24] European Commission. 2018. The Airport Charges Directive and the level of airport charges. At: https://ec.europa.eu/jrc/en/publication/airport-charges-directive-and-level-airport-charges
[25] Uthmeyer, S. 2009. A paper for the 2009 ACCC Regulatory Conference - Economic Experts: how necessary are they? At: https://www.accc.gov.au/system/files/Uthmeyer%2C%20Simon%20%28Paper%29.pdf
[26] The Conversation, 'A Privatised Monopoly Is Still A Monopoly, And Consumers Pay The Price' 24 June 2014, https://theconversation.com/a-privatised-monopoly-is-still-a-monopoly-and-consumers-pay-the-price-28384
[27] Samuelson W and Zeckhauser R. *Status Quo Bias in Decision Making*. J Risk and Uncertainty, 1: 7-59; 1998
[28] https://www.pc.gov.au/about/contribute
[29] Carew E. *Submission in response to Productivity Commission Inquiry Draft Report*, 26 Feb 2019
[30] Hayes R. *Submission in response to Productivity Commission Inquiry Draft Report,* 19 March 2019 https://www.pc.gov.au/__data/assets/pdf_file/0005/238352/subdr098-airports.pdf

[31] Samuelson W and Zeckhauser R. Op. cit (27)
[32] Frontier Economics. 2018. Market Power and the Profitability of Australian Airports. At: https://www.pc.gov.au/__data/assets/pdf_file/0019/234163/sub083-airports-attachment1.pdf
[33] ACCC, Guidelines on Misuse of Market Power (Aug 2018).
At: https://www.accc.gov.au/system/files/Updated%20Guidelines%20on%20Misuse%20of%20Market%20Power.pdf
[34] Productivity Commission. 2019. Economic Regulation of Airports – Draft Report. At: https://www.pc.gov.au/inquiries/current/airports-2019/draft/airports-draft.pdf
[35] Ibid.
[36] Productivity Commission. Op. cit (34)
[37] Productivity Commission. Op. cit (34)
[38] Frontier Economics. 2019. Countervailing Buyer Power – A report for QANTAS. At: Submitted to the Productivity Commission.
[39] Productivity Commission. Op. cit (34)
[40] North Queensland Airports. 2018. Submission to the Productivity Commission. At: https://www.pc.gov.au/__data/assets/pdf_file/0018/231426/sub049-airports.pdf
[41] Australian Competition and Consumer Commission. 2017. ACCC Merger Guidelines. At: https://www.accc.gov.au/system/files/Merger%20guidelines%20-%20Final.PDF
[42] Australian Energy Market Commission. Op. cit (21)
[43] BITRE. 2018. Aviation Statistics. At: https://bitre.gov.au/statistics/aviation/index.aspx
[44] Frontier Economics. Op. cit (38)
[45] Frontier Economics. Op. cit (31)
[46] Houston Kemp. 2018. Assessing Market Power in Aeronautical Services – Prepared for the AAA. At: https://www.pc.gov.au/__data/assets/pdf_file/0020/231428/sub050-airports-attachment1.pdf
[47] David S Evans, "The Antitrust Economics of Multi-Sided Platform Markets", Yale Journal of Regulation, Summer 2003, Vol 20, no 2, pp 325-381, partic 356-362.
[48] Ibid.
[49] Julian Wright, "One-sided Logic in Two-sided Markets", Review of Network Economics, Vol 3, issue 1, March 2004, p 48.
[50] Estelle Malavolti, "Single Till or Dual Till at Airports: A Two-Sided Market", Paper 14 (2014) Document de travail GREDEG at: http://gredeg.cnrs.fr/working-papers.html
[51] ACCC (2008) Airport monitoring report 2007–08 Price, financial performance and quality of service monitoring p.7
[52] Australian Finance Industry Association. 2018. Submission to the Productivity Commission. At: https://www.pc.gov.au/__data/assets/pdf_file/0008/231776/sub067-airports.pdf
[53] Australian Competition and Consumer Commission. Op. cit (8)
[54] Andrew's Airport Parking. 2018. *Initial submission to the Productivity Commission's 2018 inquiry into economic regulation of airports.* At: https://www.pc.gov.au/__data/assets/pdf_file/0004/231187/sub030-airports.pdf
[55] Australian Finance Industry Association. Op. cit (52)
[56] Australian Finance Industry Association. Op. cit (52)
[57] Australian Finance Industry Association. 2018. Regulation of Airports Inquiry – Further Information on Recent Negotiations with QLD Airport. At: https://www.pc.gov.au/__data/assets/pdf_file/0014/234140/sub080-airports.pdf
[58] https://www.newsline.com.au/2019/01/30/airport-parking-fees-battle-could-open-doors-to-thousands-of-appeals/
[59] Aust Mayoral Council https://www.pc.gov.au/__data/assets/pdf_file/0011/238268/subdr095-airports.pdf
[60] Question to Commissioner Stephen King at *Policy in the Pub,* Economic Society of Australia, 20 Mar 2019
[61] Airlines for Australia & New Zealand. 2018. Submission to the Productivity Commission. At: https://www.pc.gov.au/__data/assets/pdf_file/0007/231379/sub044-airports.pdf
[62] Ibid.
[63] Frontier Economics. 2018. Market Power and Profitability of Australian Airports. At: https://www.pc.gov.au/__data/assets/pdf_file/0019/234163/sub083-airports-attachment1.pdf
[64] Houston Kemp. Op. cit (46)
[65] Productivity Commission. Op. cit (34)
[66] Productivity Commission. Op. cit (34)
[67] Australian Airports Asscoiation. Op. cit (4)
[68] Frontier Economics. Op. cit (32)
[69] Productivity Commission, *Review of Price Regulation of Airport Services*, December 2006, p.28.
[70] Productivity Commission. Op. cit (34)
[71] Australian Competition and Consumer Commission. Op. cit (8)
[72] See figure 6, PC Draft report, p.17
[73] Australian Finance Industry Association. Op. cit (52)
[74] Carew E. Op. cit (29)
[75] Australian Finance Industry Association. Op. cit (52)

[76] Qantas Group. 2018. Submission to Productivity Commission. At: https://www.pc.gov.au/__data/assets/pdf_file/0020/231383/sub048-airports.pdf
[77] Smethurst, A. 2018 *Taxpayer hit for airport safety*. Sunday Telegraph (25 Nov)
[78] Trask S. 24 May 2018. *'Appalling': Alan Joyce likens Canberra Airport to Somali pirates*, Sydney Morning Herald. At: https://www.smh.com.au/national/act/appalling-alan-joyce-likens-canberra-airport-to-somali-pirates-20180524-p4zhc5.html
[79] Aust Mayoral Council https://www.pc.gov.au/__data/assets/pdf_file/0011/238268/subdr095-airports.pdf
[80] Regional Express. 2018. Submission to the Productivity Commission. At: https://www.pc.gov.au/__data/assets/pdf_file/0007/231586/sub063-airports.pdf
[81] Airlines for Australia & New Zealand. Op. cit (61)
[82] Qantas Group. Op. cit (76)
[83] Qantas Group. Op. cit (76)
[84] Virgin Australia. 2018. Submission to the Productivity Commission. At: https://www.pc.gov.au/__data/assets/pdf_file/0014/231440/sub054-airports.pdf
[85] Ibid.
[86] Australian Financial Review. At: https://www.afr.com/news/policy/budget/federal-budget-2018-airport-security-and-rail-links-get-priority-spending-20180508-1o00mu
[87] Ibid.
[88] Australian Airports Association. 2019. https://airports.asn.au/media-releases/sustainable-funding-for-regional-security-upgrades-essential/
[89] Australian Competition and Consumer Commission. Op. cit (8)
[90] Australian Competition and Consumer Commission. Op. cit (8)
[91] Australian Competition and Consumer Commission. Op. cit (8)
[92] Australian Competition and Consumer Commission. Op. cit (8)
[93] Australian Competition and Consumer Commission. Op. cit (8)
[94] Harper, I. Op. cit (19)
[95] O'Bryan, M. 2018. Memorandum prepared for JWS, re: Economic Regulation of Airports – Productivity Commission Issues Paper. In Appendix D of A4ANZ Submission to the Productivity Commission. At: https://www.pc.gov.au/__data/assets/pdf_file/0007/231379/sub044-airports.pdf
[96] Johnson Winter & Slattery. 2018. Memorandum re: Economic Regulation of Airports – Productivity Commission Issues Paper. In Appendix D of A4ANZ Submission to the Productivity Commission. At: https://www.pc.gov.au/__data/assets/pdf_file/0007/231379/sub044-airports.pdf
[97] Gilbert + Tobin. 2018. Memorandum of Advice. In Virgin Australia Submission to the Productivity Commission. At: https://www.pc.gov.au/__data/assets/pdf_file/0014/231440/sub054-airports.pdf
[98] DLA Piper. 2018. Memorandum re: Declaration under Part IIIA of the Competition and Consumer Act 2010 (Cth). At: https://www.pc.gov.au/__data/assets/pdf_file/0017/232820/sub073-airports-attachment1.pdf
[99] O'Bryan, M. 2018. Op. cit (16)
[100] O'Bryan, M. 2018. Op. cit (16)
[101] National Competition Council. Op. cit (6)
[102] National Competition Council. Op. cit (6)
[103] Productivity Commission. 2011. Economic Regulation of Airport Services, Inquiry Report No. 57. Canberra. At: http://www.pc.gov.au/inquiries/completed/airport-regulation/report/airport-regulation.pdf
[104] Australian Government. 2012. *Australian Government response to the Productivity Commission Inquiry into the Economic Regulation of Airport Services, p.1* At: http://webarchive.nla.gov.au/gov/20130425203728/http://www.infrastructure.gov.au/aviation/airport/airport_economic_regulation/response.aspx
[105] Arblaster, M. 2019. Submission in response to the Productivity Commission's draft report. At: https://www.pc.gov.au/__data/assets/pdf_file/0011/237269/subdr091-airports.pdf
[106] Bush CB, H. 2019. Reflections on the Draft PC Report of February 2019 (for the AAA). https://www.pc.gov.au/__data/assets/pdf_file/0004/238054/subdr093-airports.pdf
[107] Dunlop J, Higgins B. 1942. "Bargaining Power" and Market Structures. Journal of Political Economy Vol. 50, No. 1, pp. 1-26
[108] Sims, R. 2015. How did the light handed regulation of monopolies become no regulation? Speech at Gilbert + Tobin Regulated Infrastructure Policy Workshop, Melbourne. [29 October 2015] At:https://www.accc.gov.au/speech/how-did-the-light-handed-regulation-of-monopolies-become-no-regulation
[109] Independent Committee of Inquiry. Op. cit (18)
[110] Macdonald-Smith, A. 2017. Gas pipeline reforms 'like offering ice cream on death row'. Australian Financial Review [7 June 2017] At: https://www.afr.com/business/energy/gas/gas-pipeline-reforms-like-offering-ice-cream-on-death-row-20170607-gwm2ti
[111] Australian Airports Association. Op. cit (4)
[112] Australian Competition Tribunal. Op. cit (9)

[113] Australian Competition Tribunal. Op. cit (9)
[114] Productivity Commission. Op. cit (34)
[115] Airlines for Australia & New Zealand. Op. cit (61)
[116] Airlines for Australia & New Zealand. 2018. Supplementary Submission to the Productivity Commission. At: https://www.pc.gov.au/__data/assets/pdf_file/0018/234162/sub083-airports.pdf
[117] These figures are based on cost/passenger, including security charges. Data source: QF and VA submissions. http://www.aph.gov.au/Parliamentary_Business/Committees/Joint/Northern_Australia/TourismIndustry/Submissions
[118] Australian Airports Association. 2018. AAA Submission to the Rural and Regional Affairs and Transport References Committee. At: https://www.aph.gov.au/DocumentStore.ashx?id=197f8cde-d1fd-40ff-87f7-960e24cd5a54&subId=563473
[119] The Hon. John Sharp. 2018. Remarks at A4ANZ Panel Discussion on 24 May 2018.
[120] Johnson Winter & Slattery. Op cit (96)
[121] O'Bryan, M. Op. cit (16)
[122] National Competition Council. Op. cit (6)
[123] Productivity Commission. Op. cit (34)
[124] Productivity Commission. Op. cit (34)
[125] Productivity Commission. Op. cit (34)
[126] Productivity Commission. Op. cit (34)
[127] Frontier Economics. Op. cit (12)
[128] Bush CB, H. 2019. Op. cit (106)
[129] Wiggins, J. 2019. Airlines lose battle for commercial arbitration in airport disputes. Australian Financial Review – 6 February 2019. At: https://www.afr.com/business/airlines-lose-battle-for-commercial-arbitration-in-airport-disputes-20190205-h1av7f
[130] Australian Energy Regulator. 2018. Information about access determinations. At: https://www.aer.gov.au/networks-pipelines/non-scheme-pipelines/arbitration-of-access-disputes
[131] Ibid.
[132] Australian Energy Regulator. Op cit (130)
[133] Australian Airports Association. Op. cit (118)
[134] Ibid.
[135] Board of Airline Representatives of Australia. 2018. Submission to the Productivity Commission. At: https://www.pc.gov.au/__data/assets/pdf_file/0005/231377/sub042-airports.pdf
[136] Australian Airports Association. 2018. Supplementary Submission to the Productivity Commission. At: https://www.pc.gov.au/__data/assets/pdf_file/0007/232819/sub073-airports.pdf
[137] Mundy, W. 2018. Remarks during 2018 AAA Conference session: *The Truth about Charges, Profits and Airfares*. 14 November 2018, Brisbane.
[138] Vertigan, M. Op. cit (17)
[139] Vertigan, M. Op. cit (17)
[140] Macdonald-Smith, A. Op. cit (110)
[141] Bush CB, H. Op. cit (106)
[142] Australian Airports Association. 2019. Op. cit (4)
[143] Infrastructure Partnerships Australia. 2017. Letter to Dr Michael Vertigan, re: gas pipeline information disclosure and arbitration framework – draft initial national gas rules. At: http://gmrg.coagenergycouncil.gov.au/sites/prod.gmrg/files/submissions/gas-pipeline-info-disclosure-n-arbitration-network/ipa.pdf
[144] Bush CB, H. Op. cit (106)
[145] Australian Energy Market Commission. Op. cit (21)
[146] Airlines for Europe. 2019. Don't believe the airport myths on investments and capacity. At: https://a4e.eu/dont-believe-the-airport-myths-on-investments-and-capacity/
[147] Australian Competition Tribunal. Op. cit (9)
[148] Productivity Commission. Op. cit (34)
[149] Australian Airports Association. 2019. Op. cit (4)
[150] See for example Joskow, Paul (2006) Regulation of natural monopolies, A. Mitchell Polinsky & Steven Shavell (eds), Handbook of Law and Economics
[151] See discussion in the Productivity Commission's 2002 Price Regulation of Airport Services Inquiry Report. p84
[152] Australian Airports Association. 2018. Submission to the Productivity Commission. At: https://www.pc.gov.au/__data/assets/pdf_file/0019/231427/sub050-airports.pdf
[153] Appendix C of A4ANZ supplementary submission to the Productivity Commission, 2018 Inquiry into the Economic Regulation of Airports, 18 December 2018,
[154] Macdonald-Smith, A. Op. cit (110)
[155] Australian Airports Association. Op. cit (152)
[156] See Frontier Economics submission in response to the Productivity Commission's Draft Report. At: https://www.pc.gov.au/inquiries/current/airports-2019/submissions#post-draft

[157] Ashurst, Expert Determination in Australia, July 2017 At: https://www.ashurst.com/en/news-and-insights/legal-updates/quickguide-expert-determination-in-australia/
[158] Australian Airports Association. 2019. Op. cit (4)
[159] Australian Competition Tribunal. Op. cit (9)
[160] National Competition Council. 2018. Application for declaration of shipping channel services at the Port of Newcastle. At: http://ncc.gov.au/application/application-for-declaration-of-shipping-channel-services-at-the-port-of-new
[161]Australian Competition and Consumer Commission. 2019. Op. cit. (8)
[162] Sims, R. Op. cit (108)
[163] Airlines for Europe. Op. cit (146)
[164] Vertigan, M. Op. cit (17)
[165] Bush CB, H. 2019. Op. cit (106)
[166] Bush CB, H. 2019. Op. cit (104)
[167] Gas Market Reform Group. Op. cit (20)
[168] Australian Airports Association. Op. cit (4)
[169] Airports Act 1996. At: https://www.legislation.gov.au/Details/C2018C00408
[170] Airports Regulations 1997. At: https://www.legislation.gov.au/Details/F2018C00818
[171] Vertigan, M. Op. cit (17)
[172] Crimes Legislation Amendment (Police Powers at Airports) Bill 2018 https://www.legislation.gov.au/Details/C2018B00166
[173] Aviation Transport Security Act 2004 https://www.legislation.gov.au/Series/C2004A01242