AIRLINES FOR AUSTRALIA & NEW ZEALAND

ECONOMIC REGULATION OF AIRPORTS

SUBMISSION TO THE PRODUCTIVITY COMMISSION

SEPTEMBER 2018

AIR NEW ZEALAND Jetstar QANTAS rex Regional Express tigerair Virgin australia

PREFACE

The Productivity Commission (PC)'s Inquiry into the Economic Regulation of Airports is timely and much-needed, given the rising chorus of concerns from a range of airport users and the Australian Competition and Consumer Commission (ACCC), about the impact of Australian airports' monopoly powers. Airlines for Australia and New Zealand (A4ANZ) has previously welcomed Government giving the PC a broader scope compared to previous inquiries, to extend its lens beyond the monitored airports.[1] With at least one in three domestic passengers using airports outside of the 'big four', it is a vital inclusion to allow the PC to examine performance and behaviour at all airports where market power exists.

While A4ANZ has attempted to ensure that this submission represents the collective views of our member airlines, the PC is encouraged to consider it together with the airlines' corporate submissions. We also encourage the Commission to consider the airline perspectives together with those of other airport users, including consumers, to allow the PC to capture a holistic picture of the challenges faced by airport users.

A4ANZ's submission details clear responses to each of the *Information Requests* in the PC's Issues Paper, acknowledging, where possible, the PC's appeal for evidence to support claims made. Expert advice received from Frontier Economics, Johnson Winter & Slattery, Michael O'Bryan QC, and Margaret Arblaster are included as appendices to this submission.

In drafting this submission, we have attempted to avoid "rhetorical flourish", favouring a factual approach that draws on published literature, expert analysis and insight, and is weighted heavily towards evidence rather than anecdote; the latter being used simply to provide practical, real-life examples of the scope and scale of the problem. While airlines form our membership, our intent has been to view both the problems and solutions through a broader lens of public interest and frame our submission accordingly.

A number of the case studies we have provided do not identify airports or airlines to protect confidentiality, however, we would be happy to provide this information directly to the PC.

The overall objective of A4ANZ's submission is to contribute to an informed debate on what constitutes effective policy in this area; focusing attention on the minimum change required to create a regulatory environment that facilitates commercially negotiated outcomes and ultimately delivers better outcomes for consumers and society.

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.

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KEY POINTS IN THIS SUBMISSION

Benefits of regulatory reform

- Frontier Economics estimate that the reforms we propose in this submission are likely to reduce administrative and compliance costs for all parties by up to $22.7 million dollars.[a]
- Historically, when airlines have been able to reduce costs in any part of their business they have reinvested in improving the consumer experience, including: reducing fares, increasing capacity on routes, renewing fleet capacity, preserving essential regional air services, collaborating with airports to progress innovations in customer experiences, improving domestic and international service levels, technological innovation; and other new and important initiatives such as pilot academies.
- The amendments proposed would not only allow the monitoring regime to do what is intended, i.e. facilitate commercial negotiations between airports and those seeking access, but would unlock significant benefits to the Australian economy, including:[a]

Benefits to the Australian Economy

- **Consumer surplus of approximately $5.9 billion**
  - generated by a **demand increase** valued at $650 million per annum
- **Travel time savings valued at $819 million**
  - created by **connectivity improvements**; almost $90 million per annum
- **GDP benefits of $10.9 billion**
  - due to productivity gains through increases to trade and foreign investment
- **Creation of 7000 jobs**
  - from the estimated $1.2 billion annual increase in GDP
- **Tourism benefits of $480 million**
  - around **$250m outbound visitor** and **$230m inbound visitor spending**
- Other wider domestic economic benefits from
  - **improvements in air connectivity** and creation of **more competitive markets**.

- Putting consumers' expectations and needs at the centre of this Inquiry creates a more compelling case than ever before to change our regulatory environment; amendments that are necessary in order to facilitate privatised monopoly airports working together with airport users to provide Australians fit-for-purpose infrastructure that delivers optimal quality and efficiency.
- A4ANZ members are committed to building, maintaining and improving positive, constructive commercial relationships with airports; with a view to seeing airports, airlines and the whole aviation sector prosper. The financial analysis contained in this submission clearly shows that the changes proposed by A4ANZ are not only in the airlines' interests, but also their passengers' interests, and the long-term interests of the Australian economy.

[a] Calculated on a Net Present Value (NPV) basis.

A fit-for-purpose regulatory regime

- While airports reasonably expect not to have to operate in a regulatory environment that is overly burdensome or significantly impacts their profitability, so too is it reasonable that consumers are afforded some protection from the consequences of monopoly airport power, as they are in in other sectors.
- The current regime is clearly not fit for purpose, neither through its coverage of airports nor through practical access to remedies when a breakdown in negotiations occurs.
- We have proposed that amendments could be made to the Airports Act 1996 to cause aeronautical services and facilities supplied by airports to be declared services for the purposes of Division 3 of Part IIIA of the Competition and Consumer Act 2010.
- A pathway to negotiate-arbitrate would create a credible regulatory threat and, coupled with information disclosure and consultation requirements, would encourage good-faith negotiations. It would not, as has been suggested by airports, create instability in the sector.
- An enhanced regulatory regime would provide consistent and comprehensive data, and articulate benchmarks that an airport user can use to assess both an airport's performance and its offer. The regime could include the ACCC issuing guidance on a WACC, as is the case in other jurisdictions, but taking into account the concerns expressed by airlines about the way in which risk is dealt with.
- The existence of final offer arbitration will not in itself drive parties to access this pathway each time they cannot agree on terms. Evidence has shown that it in fact has the opposite effect: increasing the likelihood of a commercially-negotiated outcome without involvement of the regulator.

Addressing the market power of Australian airports

- Australia's current light-handed approach to the economic regulation of airports is based, in part, on the implicit assumption that the majority of Australia's airports do not have significant market power. This can no longer be accepted as the case.
- The regime, which is intended to deter abuses of market power does not, and cannot, operate effectively in the absence of a credible regulatory threat.
- The mechanisms intended to create this threat are increasingly ineffective. This view is shared by investors and analysts who note that Australian airports enjoy revenue streams and returns far in excess of their international comparators, unconstrained by regulation.
- Profitability at Australia's major airports is extremely high, in some cases more than double that of other airports around the world. EBITDA margins are growing and are predicted to continue to do so, at an even higher rate than they have done historically.
- Earnings of the major Australian airports have been independently assessed as being consistent with the exercise of market power. Australia's four largest airports are collecting over 25% more revenue per passenger, in real terms, than they were a decade ago.
- While airports must be able to collect sufficient revenues to finance their investments in airport infrastructure and operations, what we have seen instead is the four monitored airports earning excessive profits, totalling more than $16 billion since privatisation.
- While profitability has grown, quality levels remain stagnant, and investment decisions are often made in the absence of any consultation with airport users.

Strong case for regulatory reform

- Australia's airports are natural monopolies, and their behaviour is consistent with this; displayed not only in their charges but also in their approach to negotiations, consultation and investment decisions.
- Assuming that airports and their customers can be left to undertake "commercial negotiations", as would occur in other business settings, completely ignores airports' monopoly status and the fact that they enjoy a natural bargaining advantage over all airport users.
- Australian airports have no incentive to reduce their exploitation of market power. Given their monopoly status, any incentive to reduce operating expenditure is absent, as these costs can simply be passed on to airport users (airlines, retailers, rental car operators, taxis etc.), with the impact ultimately felt by the individual consumer.
- There is little, if anything, currently offsetting this market power. Under the dual till monitoring system, profits derived from non-aeronautical revenue do not provide operators with an incentive to reduce aeronautical charges, which instead have continued to grow.
- Furthermore, there is no evidence to suggest that countervailing power of airlines (regardless of market share) – or indeed any other airport user – is sufficient to offset airports' market power.
- The current regulatory system has been powerless to curtail airports' market power. The ACCC has acknowledged that in circumstances of natural or legislated monopoly, price monitoring will have little or no long term impact on the conduct of the monopoly infrastructure owner; and this has certainly proven true.
- All experts engaged by A4ANZ found that the current regulatory provisions are failing to fulfil the Government's policy objectives in airport regulation; that is, to promote or facilitate commercial negotiations between airports and airlines or other airport users.
- Change is necessary. While airlines have been able to keep downward pressure on airfares over the past decade, globally, fares are expected to rise next year, driven by rising oil prices coupled with competitive pressure from the shortage of pilots, and the impact of costs for mandated upgrades to security and technology that are pending.
- Change cannot wait for another 5-year review cycle. With passenger growth predictions and multiple, large airport infrastructure projects already in the pipeline, doing nothing will take us backwards.

COMMUNITY & INDUSTRY EXPECTATIONS

The Government's objective in tasking the Productivity Commission to undertake a periodic review of airport regulation is to ***"determine whether the economic regulatory oversight of these airports remain in line with community and industry expectations"***.[2]

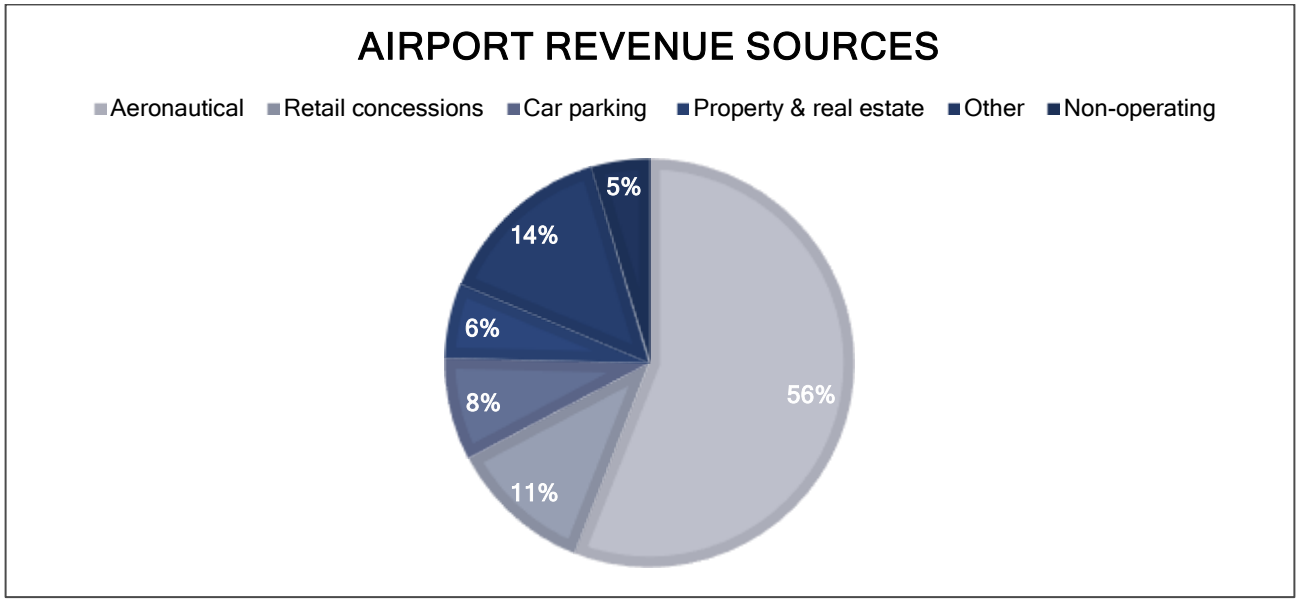
It is not unreasonable to conclude, as others have done, that the interests of airlines and passengers are relatively well-aligned, provided that the airline sector is characterised by well-functioning competition[3], which is of course the case in Australia.[4] It is incumbent upon us all to ensure we have a sound understanding of these interests and expectations before forming an opinion on regulation and/or making recommendations for change.

Expectations of services provided by airports

Airports are unquestionably a critical part of Australia and the world's economy, connecting businesses and individuals. While an airport's main function may be considered its aeronautical infrastructure, over time airports have developed into large business precincts, providing services for different users. The key services they provide include:

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

It is from the provision of these services and the associated charges that airports derive their revenue. Globally, airport revenue is distributed as shown, with aeronautical revenue the main source.[5] In Australia the distribution is similar but with a larger contribution from non-aeronautical revenues at some of the major ports.[6]



The ACCC has documented the significant increase in aeronautical revenue over the past decade. While this is perhaps not unexpected, given that passenger numbers have grown at an average annual growth rate of 3.2%, increasing by nearly 40% in that time[7]; what stands out is the *per passenger* increase in aeronautical revenue of over 25% in real terms at the four major airports.[8]

Airport revenue

According to the airports, aeronautical and non-aeronautical revenues are the major sources of funds for airports to invest in infrastructure and service improvements.[9] Under the existing regulatory framework in Australia, airports are monitored on a "dual till" basis, meaning that these two sources of revenue are considered separately in a way that does not take into account the interdependency between the two. The challenges associated with this model are discussed later in this submission.

Airports Council International (ACI) World Director General Angela Gittens has said that, "a*irports must be able to collect sufficient revenues to finance their investments in airport infrastructure and operations*."[10]

This is of course an entirely reasonable position for any business, and it has formed the basis of the defence of the status quo by those with a major stake in Australia's airports - the superannuation and funds management companies. Yet arguments that the current regulatory model must be protected to allow "*a fair return on capital invested, encouraging significant ongoing investment in new and upgraded airport facilities, to meet continued demand growth*"[11] simply don't hold when we look at the numbers.[12]

Statements about reasonable and fair returns prompt the question of whether it has been necessary for airports to grow their revenue streams to the extent they have, clearly far in excess of what would have been sufficient for them to make the reported $11.5 billion in capital investment at the major Australian airports over the past decade.[13] In the 2016-17 year alone, the total combined profit of the monitored airports grew by 11%, to a record $2.1 billion.[14]

While airports ought to be able to make a return on these significant investments, the returns they are and have been making are not only exceptional by international comparison, but are hard to justify as reasonable or fair. Although we come later in this document to the issue of profitability when discussing market power, it is worth noting that the Grattan Institute classed the Australian airports' returns as "*super-normal profits*"[15], with Frontier Economics conservatively estimating the *excess* returns at the four monitored airports to be more than $16 billion since privatisation.[16]

Quality and efficiency at airports

With Australian airports enjoying profit margins that are significantly higher – in some cases more than double – those of other airports around the world operating in competitive markets or with greater regulation[17], it might suggest that our expectations of airport quality and efficiency in Australia ought to be adjusted accordingly.

The expectation set by the Australian Airports Association(AAA) seems a good place to start. In a recent media release, their CEO Caroline Wilkie argued that the regulatory system in Australia "*fosters collaboration with airline and government partners to direct investment where it is needed most and puts passengers at the centre of the decision-making process.*"[18]

As much as we might wish this statement to be true, it is simply not the case, as the rest of our submission clearly outlines. Governments, airport customers and passengers alike expect airports to use their revenue to make appropriate investments in fit-for-purpose infrastructure to drive improvements in quality and efficiency. While ACI

tell us that charges allow airports to "*maintain service levels to passengers and airlines"*[19], in an environment of such growth and prosperity in Australia, it does not seem unreasonable that service levels should not simply be "maintained" but should in fact be commensurately improved. This is not the trend that has been observed, however, as documented by successive ACCC monitoring reports.[20]

It is also not the experience of those who work at Australia's airports. In a 2011 submission, the Australian Services Union (ASU) - whose members work in airports in check-in and operations, customer service agents, load controllers, freight, catering and maintenance - described workers "*regularly encountering poorly maintained facilities in their daily work, and exorbitant prices for food and parking in their workplace*." The ASU also shared that "*we have observed across Australia that private operators prioritise the maintenance and upgrade of commercial outlets, at the expense of the aviation facilities*."[21]

Consumers too have noticed the same discrepancies between ballooning prices and stagnant service levels, captured in an article by CHOICE titled *Why improve service when you don't have to?*.[22] A related discussion forum had one contributor outlining his experience with the poor facilities at a major Australian airport, concluding with a description of the airport as "*milking the airlines, the passengers, the shops, the charter operators, the taxis and the motorists at every possible turn.*"[23]

This commentary aptly captures the fact that it is the consumer who is ultimately hurt the most by the flow-on effects of monopoly operators over-charging. This was further reflected in a piece outlining how consumers pay as much as 25% more for food and pharmaceuticals at a monopoly airport than they do at the same shops a few kilometres away; "*the bloated prices charged by retailers at the city's gateway*".[24]

This is of course not a new issue, with multiple submissions to the 2011 PC Inquiry raising monopoly pricing, reflected in comments such as the following:

"Refreshment costs and services on-airport are generally well above pricing of similar items off-airport, presumably reflecting, at least in part, the rental costs incurred by business operators."[25]

Whether monopoly pricing at our privatised airports is simply what our society has come to expect, and whether we ought to expect the situation to be different, is clearly something for the PC and indeed Government to consider. A CHOICE forum contributor asked how he, as an individual consumer, might "*successfully challenge and enforce change on any enterprise in a privileged uncontested position that has a monopoly on its services*?" A number of other participants commented on the fact that the ACCC was itself powerless to change the situation. [26]

Expectations into the future

It is hard to argue that a regulatory environment which does not give the consumer a voice is meeting our collective, public interest expectations. This becomes of greater concern when we consider the challenges ahead.

Governments and consumers also have expectations of airfares remaining at their historic lows or even declining further.[27] While airlines have been able to keep downward pressure on airfares over the past decade, globally, fares are expected to rise next year, driven by rising oil prices coupled with competitive pressure from the shortage of pilots.[28] With airports reportedly about to embark on a "capital spending spree"[29], the impact of this planned investment on aeronautical charges, together with the cost of new security requirements, the further pressure this will place on airfares is of great concern. This is particularly the case in a regulatory environment that clearly fosters the monopoly power of airport owners; a power that enables increasing charges to be extracted from airport users.

While airports reasonably expect not to have to operate in a regulatory environment that is overly burdensome or significantly impacts their profitability, so too is it reasonable that consumers are afforded some protection from the consequences of monopoly airport power, as they are in in other sectors.[30]

Just as increasing costs have a flow-on effect, there is an expectation that reduced charges in one part of the supply chain are completely passed on to end users. While there is always a risk that this is not the case, a number of experts consider it plausible that lower airport charges could, and do benefit passengers – not only through reductions in airfares (given our competitive market), but also through improved services.[31] The latter could potentially take the form of: increased opportunities to travel due to higher frequencies; additional routes implemented by airlines in response to lower charges; increased competition between airlines, as lower charges may allow competing airlines to expand their offerings; and/or increased quality of service.[32,33]

Further airport investment is absolutely necessary given predicted growth,[34] but investment must be fit-for-purpose, aligned with the needs of airlines and passengers using the facilities, and demand for air services. The challenges experienced by all airport users in achieving these outcomes are discussed more comprehensively later in this submission. Suffice to say that the current regulatory model clearly does not create the right setting for airports and their customers to work in partnership to ensure that this can happen.

Nearly three years have passed since the ACCC called for action on this, with the Chairman cautioning:

"only using price monitoring for monopoly infrastructure, rather than stronger regulation such as a negotiate/arbitrate regime, can damage Australia's competitiveness and productivity through higher than necessary infrastructure prices and/or reduced service levels"[35]

Putting consumers' expectations and needs at the centre of this Inquiry, there is a more compelling case than ever before for change to our regulatory environment; amendments that are necessary in order to facilitate airports working together with airport users to provide Australians fit for purpose infrastructure that delivers optimal quality and efficiency.

MARKET POWER AND AUSTRALIAN AIRPORTS

This section aims to address Information Request 1, Part 1: ***The Commission welcomes suggestions on approaches for identifying which Australian airports have market power in aeronautical services and the extent of their market power.***

Australia's current light-handed approach to the economic regulation of airports is based, in part, on the implicit assumption that the majority of Australia's airports do not have significant market power. A4ANZ challenges this assumption, and instead suggests that across Australia, monopoly airports are exerting market power – including both capital city and regional airports.

A4ANZ previously engaged Frontier Economics to undertake an analysis of airport market power and develop a framework by which to assess the extent of market power exerted by Australian airports. The resulting report, *The Market Power of Australian Airports*, informs this section of A4ANZ's submission and is included at ***Appendix A***.

Assessing Market Power

Market power can be measured in several ways. Economic literature relies heavily on the structure-conduct-performance schema when looking at indicators of market power. The idea of this schema is that the structure of a market (in particular, the patterns of firms within the market and the conditions of entry) is a key influence on patterns of conduct within the market; and the patterns of conduct within the market will result in the performance of the market – that is, the efficiency with which the market allocates resources. In particular:

- 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; and
- 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.

Below, we examine Australia's airports against the above indicators of market power.

Structure

The natural monopoly characteristics of airports suggest that, as a starting premise, they can be presumed to have market power in providing aeronautical services.

These characteristics suggest a single airport is likely to be able to deliver aeronautical services more efficiently than multiple airports operating in competition. However, this also means airports tend to be geographically spread and hence the scope for direct competition is limited – this is particularly relevant in the Australian context.

The natural monopoly nature of airports stems from the high fixed and sunk costs involved, from their characteristics as a network and from the challenges associated with developing an alternative airport.

The existence of a natural monopoly does not necessarily indicate substantial market power. However, where a natural monopoly has substantial sunk costs and a location that cannot readily be replicated, the market power of the incumbent is likely to be substantial.

A theoretical examination of the potential market power of Australia's airports, resulting from the structure of the market was undertaken by Frontier Economics (***Appendix A***), and is summarised here.

Conduct

As noted above, the conduct of an airport can also be an indicator of market power – the extent of the market power held by airports across Australia becomes apparent in approaches to investment decisions, pricing, and, behaviour during negotiations and/or disputes.

Case studies providing examples of this are outlined in the sections that follow as we seek to understand the true impact of market behaviour on quality and efficiency, and on negotiations.

It is important for the PC to note that it is not only large capital city airports that are able to exercise market power – the conduct of other centres and regional airports across Australia also indicates market power. In fact, as can be seen from the case studies and examples that follow, those airports exhibit very similar behaviours in their dealings with airport users.

For example, a recent survey by the Australian Airports Association confirmed that fewer than half of regional airports (~ 45%) consult with airlines prior to "major capital works entailing increased airport charges"[36], with the concept of genuine, open consultation and co-design representing exceptional, rather than usual behaviour in Australia's airports.

Further illustrating the lack of transparency and consultation, the same survey notes 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[37], often after tickets have already been sold.

This behaviour was illustrated recently by a regional airport giving airlines three months' notice of a 5.7% increase in head tax, on the back of a 12.8% increase only three years prior. This is hardly isolated, or indeed the worst behaviour, as A4ANZ notes that one regional airport recently attempted to increase their head tax by 22% with only two weeks' notice to airlines,[38] with another attempting to effectively double their head tax with minimal notice.[39]

A recent Senate inquiry shone a light on the challenges faced by airlines operating and sustaining services to regional Australia. The high airport charges across regional airports are a significant element of this challenge. This is evidenced not only by small regional carriers going into administration[40], but also by the cessation of some regional routes by major airlines, including other low-cost carriers.

This admission by the airports mirrors issues raised in the previous PC Inquiry. The Overnight Airfreight Operators' Association, for example, provided evidence to support their statement that "*Price increases for airport services have increased dramatically and new charges have been continually introduced with very limited consultation or negotiations*."[41]

This is not an experience unique to airlines. Other airport users have very similar stories to tell of pricing and behaviours influenced by market power. A group of rental car companies, including Hertz, Europcar, Thrifty, Avis and Budget, raised the issue that "*airports have such significant market power that they have the ability to effectively control the nature of rental car operators' access to rental car service inputs, as well as the terms on which that access is provided*."[42] A recent assertion by the AAA that airports forgo car parking revenue to facilitate these services[43] is not only irrational, as given the airports' monopoly status there is no incentive for them to forgo revenue on *any* aspect of their business, but it is simply false, as most airports in fact charge a daily rate for rental car parking akin to that charged to individual consumers.

Off-airport parking operators are another group that have aired concerns about how the regulatory environment allows these behaviours to continue without consequence. In a submission to the 2011 PC Inquiry, these operators voiced concerns about the fees charged for airport access, and the propensity of the airport operators to increase

access fees without any explanation or prior notification to off-site car parking operators;[44] a situation that remains unchanged and problematic today.

Yet another airport user group, limousine hire car services, describe the conduct of one of the major airports as demonstrating "*a desire to only consider options that improve their own profitability-just what any other commercial organisation would do in similar circumstances and regulatory environment*."[45] In other words, the regulatory system provides nothing to restrict monopoly airports from using their market power in this way.

Performance

In its 2016-17 Airport Monitoring Report, the ACCC noted that "*an unconstrained airport would be expected to exercise its market power to earn monopoly profits to the detriment of the broader Australian economy. For example, an airport could seek to charge high prices and/or provide lower quality services and facilities. It could also under-invest in key infrastructure so as to artificially restrict supply and potentially lead to higher prices. An unconstrained airport may also operate inefficiently by allowing its costs to rise or not adopting cost-saving or innovative technologies.*"[46]

As the PC would be aware, there are significant difficulties associated with assessing the financial performance of most of Australia's airports – given a significant lack of readily available, consistent and transparent financial information. This is discussed in greater detail in a later section of this submission.

To independently assess the extent to which Australian airports have exercised their market power following the removal of formal economic regulation and price control, Frontier Economics applied a rigorous methodology to measure the ability of the airports to earn returns above those that would be earned if the airports were constrained by competition or regulation.[b] Due to the scarcity of reliable and consistent data at non-monitored airports, this analysis covered only the four airports that have been the subject of ongoing price monitoring by the ACCC, which have the most complete data sets available. The results of this analysis are summarised in the next section of this submission, *"The Extent of Airport Market Power: The Evidence"*.

[b] The analysis used a range of methods to produce robust results. These were also compared against results of methods regularly used by competition authorities and regulators, such as the ACCC and the New Zealand Commerce Commission.

EXTENT OF AIRPORT MARKET POWER: THE EVIDENCE

In this section of the submission A4ANZ will address the PC's Information Request 1, part 2: ***The Commission is seeking evidence on the extent of market power held by Australian airports, constraints on the exercise of any market power, including whether countervailing power by airlines is sufficient to offset airports' market power. Participants are invited to provide examples of specific airports and airlines, or to discuss these matters in more general terms.***

Profitability of Australian Price-Monitored Airports[c]

Frontier Economics assessed the exercise of market power by measuring the ability of the airports to earn returns above those that would be earned if the airports were constrained by competition or regulation. The analysis covered the four airports that have been the subject of ongoing price monitoring by the ACCC: Sydney, Melbourne, Perth and Brisbane.

As indicated earlier, Frontier followed standard economic analysis in defining excess returns as a return on funds invested above the costs of those funds. Returns are considered across the whole operations of each airport – and are not limited to the assessment of returns to aeronautical activities, as to do so would ignore the interdependency between the pricing of aeronautical and non-aeronautical services and would require arbitrary allocations of shared costs between activities.

Frontier estimated the present dollar value of the excess returns accruing to the owners, suggesting that the dollar value of the overcharging to airport users (including both airlines and other users) is large, even when using the airports' own estimates for cost of capital.

Considering the time value of money, the likely value of excess returns across all four airports is around $7 billion, in 2017 dollars. This figure is considerably higher if one includes the value of the profits accruing to government and captured in the sale prices, with their calculations indicating the value would in fact be over $16 billion in 2017 dollars. Frontier took a conservative approach to their calculations, and as such we might expect that both the excess returns and the margins are even higher than calculated.

These results support the conclusion that the earnings of the Australian airports are consistent with the exercise of market power – this also accords with market analysts' views on the major Australasian airports that state that EBITDA margins are growing and will continue to do so, at an even higher rate than they have done historically.[47] Indeed, the monopoly power of Sydney Airport is singled out in recent investment advice from UBS, which states that, "*Sydney Airport has an unregulated revenue stream in a monopoly environment. This is a key reason why it trades at a premium multiple to global peers*."[48]

The analysis undertaken by Frontier is complemented by the findings of the ACCC's 2016-17 Airport Monitoring Report, which found that Australia's four monitored airports made a combined $757.6 million in operating profits from aeronautical activity alone – a 10% increase.[49] Furthermore, the total combined profit increased by 11%, to a record $2.1 billion.[50] It is not a recent trend, however, with the airports now collecting over 25% more revenue for every passenger than they were 10 years ago, in real terms.

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[c] This section is drawn from Frontier Economics' report *The Profitability of Australian Price-Monitored Airports*, May 2018, a copy of which has been made available to the Productivity Commission.

There are negative consequences to this excessive profitability, highlighted in the Grattan Institute report into competition, which clearly stated that "*where profits are high because firms face little competition, they are earned at the expense of customers or suppliers. They are also associated with inefficiencies*."[51]

Indeed, while profits at Australian airports were growing, the ACCC found no commensurate increase in overall quality. Stagnant quality levels in the face of increasing airport profits is unsurprising – as noted by the Bureau of Infrastructure, Transport and Regional Economics, *"Monopoly infrastructure operators have the ability to raise prices above a level that would prevail in competitive markets and little incentive to improve services above a minimum standard of service quality, to the detriment of economic efficiency and the living standards of consumers."*[52]

Indeed, the disconnect between Australian airport charges and quality has been noted not only by the ACCC and domestic airlines, but also by international carriers. In 2015, AirAsia Chief Executive Tony Fernandes noted that "*When you put Australian airport charges and taxes against the world, it is probably one of the highest in the world.*"[53] More recently, a China Eastern Airlines spokesperson said that, "*Australian airports – especially the larger airports continue to increase their charges, but offer deteriorating services to both the Chinese airlines and the inbound Chinese visitors*".[54]

While an argument could be put that the international carriers may be able to exercise choice (albeit limited) between airports, they represent less than 20% of the market in Australia. There are very few circumstances in which it could genuinely be demonstrated that there is competition between airports which might pose a material constraint on the airports. Even where there is the prospect of choice, factors such as access time, and the frequency of air services from an airport, drive passenger decision making. This is explored further in ***Appendix A***.

Relevance of countervailing power[d]

The countervailing power of airlines is sometimes cited as a factor reducing an airport's ability to exploit its market power. Countervailing power is a term used to describe the ability of large buyers in concentrated downstream markets to obtain price discounts or counteract the ability of a supplier to exercise its market power.

In the lead up to the Inquiry, there have been a number of statements made that represent misconceptions about countervailing power. One of these has been to link the concept to an airline's market share on a particular route, failing to acknowledge factors such as the network characteristics of an airline business or the reputational risks, especially in the Australian market.

Even the PC's Issues Paper posits *"For many airports, one or two airlines account for almost all of their passenger movements. An airline may have countervailing market power in this situation — it could withdraw (or threaten to withdraw) from the route if it is unsatisfied with the airport's terms of service, leaving the airport with a significant loss of revenue. The potential loss of an airline could constrain airports from raising their aeronautical charges excessively."*[55]

This statement appears to have oversimplified the concept of countervailing power, as it does not recognise the fact that a necessary condition for countervailing power to exist and to actually mitigate an airport's market power is that airlines must have a *credible option* to cease or postpone their purchase or take up other 'outside alternatives'. In other words, the risk of an airline switching is only relevant where there is another potentially competitive airport

[d] This section contains excerpts from Frontier Economics' report into *The Market Power of Australian Airports* which has been included, in full, as an appendix to this submission.

or destination that could be serviced. Clearly, there are very few circumstances in Australia where this pre-condition would hold.

The fact that an individual airline may threaten to withdraw its services is not sufficient to conclude that the airline has countervailing power. If services from that airport remain profitable and there are alternative airlines able to provide services from that location, then the threat of withdrawing services is not credible and so would not constrain an airport. Indeed, it is relatively rare for A4ANZ member airlines to have domestic route monopolies – and usually, most of the airports involved in the route monopoly would be serviced by other operators flying different routes.

For countervailing power to be at all relevant in relation to an assessment of market power, any costs from a break-down in bargaining need to be predominantly borne by the airport. To explore the likelihood of this, assume that there are several airlines using an airport and competition in the airline market is strong. If any individual airline unilaterally threatened to cease demand, this would result in limited, additional costs being imposed on the airport. This is because there is a high probability that another airline could take the place of the protesting airline. In this circumstance, airlines are unlikely to exert significant countervailing power on the airport.

Even in cases where only one or two airlines service a particular route, A4ANZ members note that, given Australia's highly competitive airline market and historical experience, there is a high probability that if an airline were to withdraw a service on a particular route, another airline would take their place. Our members' experience is that even holding the majority capacity at an airport has no bearing on either the length of time that the negotiations take, nor the eventual result achieved.

There is no evidence to suggest that countervailing power of airlines – or indeed any other airport user – is sufficient to offset airports' market power.

The following sections allow us to outline the much wider-ranging impacts of market power. As the Chair of the ACCC, Rod Sims said in 2016,

"It is wrong to suggest that we should not be concerned about monopoly pricing of infrastructure because the result may be purely a transfer of economic rent. This is very rarely true, it defies commercial and economic logic, and it fundamentally fails to recognise the potentially harmful impact upon investment and innovation along the supply chain."[56]

Later in this submission, we explore and quantify the gains from investment and innovation by airlines increases, in an environment that curtails monopoly pricing.

LANDSIDE ACCESS AND MARKET POWER

This section aims to address the PC's Information Requests 10 and 11:
The Commission is seeking evidence on the extent of market power held by Australian airports in on-airport car parking and landside access services and constraints on the abuse of market power. The Commission is seeking comment on the effectiveness of the price and quality of service monitoring regime for on-airport car parking and landside access.
The Commission would welcome participant views on: whether data that the ACCC collects are suitable for identifying the abuse of market power; evidence that could be used to determine whether airport operators are abusing market power in car parking and landside access; whether regulators have adequate remedies to deal with abuses of market power; the costs of complying with the price and quality of service monitoring regime; alternative approaches to detecting and deterring potential abuses of market power in on-airport car parking and landside access.

It is important to acknowledge that airlines are not the only group of airport users to experience the effects of Australian airports' market power. As previously highlighted, a number of other airport users, including rental car companies, taxi operators, ride share companies and off-site airport parking operators are faced with "take it or leave it" deals - however, many operators note that historically, they have been unable to publicly challenge an airport's monopoly position for fear of commercial retribution.

Indeed, the effect of an airport's unconstrained monopoly power on landside access is demonstrated to an extent in the ACCC's annual Airport Monitoring Reports. However, as noted by the ACCC, the current monitoring regime does not provide an effective constraint on the airports' market power.[57]

The 2016-17 Report noted that landside access revenue at each of the monitored airports increased in real terms – with profit margins for car parking remaining very high across all airports, up to $27 profit per vehicle.[58] The report does note that consumers can generally access cheaper parking (40% on average) at off-airport car parks, a distance from the terminals.[59] However, as noted by the ACCC in 2011, airports are able to control access to landside facilities and therefore are able to discourage competition to on-airport car parking.[60]

Access and pricing of car parking is only one of the ways in which Australian airports exert their market power on landside services. Rental car companies are also impacted by airports' unconstrained monopoly power – this is noted in the collective submission to the 2011 PC Inquiry which states that,

"As a result of their market power, airports have the ability to impose costs on rental car companies, for access to inputs that are necessary for the provision of rental car services, that exceed efficient levels. Because the rental car services market is competitive, the effect of inflated input prices is that in the market at each airport for the provision of rental car services to end users, prices are higher and the level of services consumed is lower than they otherwise would be. This results in efficiency losses and is harmful to the economic welfare of society as a whole."[61]

Unfortunately, the ultimate impact of all of this is felt by the consumer. The flow-on effects of monopoly airport operators over-charging are reflected in food and retail pricing up to 25% higher than prices charged at similar non-airport retailers and additional fees imposed on travellers renting cars, using taxis or ride share services.

Airlines too are impacted by landside access issues resulting from an airport's monopoly position. In one case, a major capital city airport sought to allocate over 87% of road investment to aeronautical users. This of course does not accurately reflect the benefit that non-aeronautical users of airport facilities (e.g. car park users, industrial park tenants and retail operators) derive from those road assets.

Excessive allocation of shared use assets to aeronautical users enables airports to 'double dip', by recovering a high proportion of costs from airlines while at the same time earning significant returns on car parking facilities and charging non-aeronautical users commercial rents that reflect the provision of those services and facilities.

Indeed, profits derived from non-aeronautical revenue do not provide monopoly airport operators with an incentive to reduce aeronautical charges, potentially reducing the exploitation of their market power. However, even if this did occur – on its own it would not be enough. Research has shown that *even when* the profits from other parts of the business are considered, the aeronautical charges of unregulated monopoly airports are higher than those under some regulatory constraint.[62] This issue will be explored in greater detail later in this submission.

MARKET POWER: QUALITY & EFFICIENCY IMPACTS

This section aims to address the PC's Information Request 2, Part 1: ***The Commission is seeking evidence on airports exercising market power, including: excessive charges for aeronautical services; inefficient investment decisions; inefficient operations; poor service quality; their approach to consultation and negotiation with airport users regarding operational and investment matters, and whether airports' conduct facilitates reaching commercial outcomes.***

Quality standards

While the issue of service quality has largely been addressed earlier in this submission, it is worth noting that rising charges, coupled with stagnant or declining service quality are not just the experience of local airlines, but for international carriers too. In addition to the airlines cited earlier, the Board of Airline Representatives of Australia (BARA) noted in May this year that its international airline members are "*operating on a day-to-day basis with airport services that can fall below their reasonable expectations and below the standards they consider to be commensurate with the charges levied…Most agreements with airlines still fall well short of being commercially-balanced*".[63]

The International Air Transport Association (IATA) has also raised the lack of correlation between privatised airports and quality and efficiency standards, with the Director-General recently saying that, "*Privatized airports are definitely more expensive, but there is little difference in efficiency or investment levels compared with airports in public hands. The results of airport privatizations run counter to the results of airline privatization when the cost of travel dropped dramatically*."[64]

Inefficiency of expenditure and investment

Despite the claimed benefits of privatisation, it provides no incentive for allocative efficiency. Instead, when a private firm is not operating in a competitive environment there is in fact a positive incentive to depart from allocative efficiency through the use of monopoly power in pricing.[65]

At Australia's monitored airports, we can track the steady increase in operational expenditure per passenger and find that in real terms, it has increased 2-8% p.a. over the past decade, despite technological innovations in that time, and growing passenger numbers.[66]

Concerns were expressed by regulatory expert Professor Peter Forsyth as early as 2004 that Australia's regulatory regime may encourage excessive investment by airports if the option is always there for them to pass through the costs of those investments.[67] In 2008, Forsyth cited Adelaide Airport's terminal upgrade and subsequent high charges, noting that:

"Airports are happy with the investment mechanism, since they can simply raise prices to cover the costs of the investments they make. However, nothing guarantees that the investments they make are warranted".[68]

A decade on, we should not be surprised to see other Australian airports following a similar pattern. This behaviour has been observed by A4ANZ members at another major capital city airport, which estimated terminal cleaning costs to be almost double that of the actual costs previously incurred – and then attempted to pass on these costs in full to airlines.

Concerns regarding this behaviour are not confined to operational expenditure – with experts warning that there is a considerable danger that if airports can always pass through the costs of their investments by raising prices, there

will be no check on investment programs, leading to a scenario where airports make excessive investments to increase their profitability.[69]

Evidence of inefficient capital investment is exemplified by the case of another major capital city airport which quoted the cost of a terminal upgrade to be $45 million, whereas an airline had estimated the same upgrade would be able to be completed in less time, at a cost of only $25 million.[70] After six months of negotiations, the airport and airline agreed that the airline would manage the terminal upgrade, however, as discussed elsewhere in this submission, protracted negotiations are also associated with costs and inefficiencies.

These concerns are not limited to Australia's major airports. In one case, 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 now has capacity for larger aircraft and 240 passengers at the terminal - seven times that of the 34-seater aircraft currently 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 have remained at pre-upgrade levels.[71]

The inefficiency of airport operations is further exemplified by the significant difference between security screening services managed by airlines, and the cost of equivalent services charged at common user terminals which are managed by the airport authority. In some cases, the difference in price is so stark that airlines opt to pay a competitor airline with screening authority to undertake security screening services on their behalf, rather than pay the exorbitant prices charged by the airport; which may be almost double that of the airline's price.

A4ANZ is also aware that some airports opt not to apply the "pass through" principle to necessary security services, and instead may apply a margin, administration fees, and corporate recovery costs when charging airport users for these services. This is explored further in advice prepared for the Qantas Group which notes that some of the costs passed on by airports go beyond necessary security services, and may include a limited number of general security services required by the airport as part of its business, for example, screening of non-aeronautical staff and goods, licence plate readers, and CCTV in car parks.[72] These examples provide further illustrations of an airport's ability to exploit its monopoly power across multiple aspects of the businesses.

Prioritising efficient operations would ensure that consumers are not the ones ultimately paying through high charges. Yet all Australian airports – given their monopoly status – have minimal incentive to reduce operating expenditure, as these costs can simply be passed on to airport users. The impact of this is ultimately felt by the individual consumer, who is faced with reduced flight and pricing options, and a more expensive travel journey.

IMPACT OF MARKET POWER ON NEGOTIATIONS

This section aims to address the PC's Information Request 2, Part 2: ***The Commission is also seeking evidence on: airlines' approach to negotiations in respect to airports and potential competitors; which parties are affected by airports' exercises of market power; the merits of 'pre-funding' airports' infrastructure investments; the potential costs and benefits of changes to the regulatory regime. The Commission seeks co-operation from submitters in not asserting adverse market behaviour without supplying evidence.***

Market power in airport negotiations

Commercial negotiation is rarely conducted among equals, but this is only considered policy-relevant where one entity's market power derives from an enduring market failure, such as monopoly supply.[73] Somewhat inexplicably, therefore, there appears to be a commonly held view – including by the PC in 2011 – that airports and airlines ought to be left to undertake "commercial negotiations" as would occur in other business settings.[74] This approach completely ignores airports' monopoly status and the fact that they enjoy a natural bargaining advantage over all their customers.

This natural bargaining advantage is due to both market power and informational advantages. As outlined previously in the ***Market Power and Australian Airports*** section of this submission, airlines typically have few (or no) alternatives. Even where there is competition from other airports, it may be difficult to feasibly relocate services, and that it is likely that airports will have significantly more information about their own assets (e.g. costs, utilisation and capacity) than airlines – giving airports an advantage during negotiations.

Airports have incentives to exploit these advantages in any negotiations, and to display any or all of the following behaviours (not exhaustive):

- adopting a 'take it or leave it' position;
- delaying or refusing to disclose necessary background information or material facts, thus delaying settlement;
- in other ways protracting negotiations;
- developing agreements that fail to provide contractual certainty or lack clarity and transparency;
- using media to put pressure on airlines to accept deals; and
- withdrawing unrelated services during negotiations and disputes.

A4ANZ members' experiences with many airports reflect this imbalance in the bargaining power between airlines and airports, with commercial negotiations between the parties often not conducted in accordance with the Government's Aeronautical Pricing Principles, which include, for example, sharing of risks when there are changes in passenger traffic.[75] This despite the fact that the Government, in its response to the 2006 PC Inquiry, considered that those Pricing Principles should act as a guide for the conduct of *all* airports, whether price monitored or not.[76]

This is not to say, however, that all airports display these behaviours in negotiations; our members have also shared some examples of airports working collaboratively and constructively with them in the process of coming to an agreement, and at an operational level. That said, airports are commercial entities beholden to shareholders and as such have been described as perfectly "*entitled to exploit legislative short-comings with a profit maximisation objective*".[77] It is therefore no surprise that high charges result, and continue to increase each year.

Lack of information and/or transparency

While airports frequently provide a significant volume of information to support capital investment underpinning price negotiations, generally speaking the information is not of the nature necessary to enable the airline to assess the efficiency or prudence of the investment having regard to the need for investment, the scope of the investment or the estimated capital costs.

Airports providing a price model present information in different forms, which often do not clearly articulate the proposed return on and of capital being earned by the airport. In a not uncommon scenario, one major city airport provided a large volume of information supporting its price proposal. However, the capital estimates provided were high-level figures and the information did not clearly articulate the drivers for the investment nor its scope. Further, by providing justification for individual projects separately, airlines can be left unable to obtain an overarching view of the investment program, and ultimately, end up funding investment that they have been unable to assess as prudent.

A further challenge for airlines in the price negotiation process is the treatment of capital investment overruns. Airports seek to shift the risk for overruns in capital projects to airlines by including those cost overruns in the opening asset base at the next price period.

Against this background, the extent to which the engagement between airports and airlines represents "negotiations" is questionable. The fact that an outcome is produced does not have any inherent value and it is likely to be the case that superior outcomes could be achieved from a framework that is more conducive to genuine negotiations.

Furthermore, A4ANZ is aware of airports proposing agreement clauses which create a financial disincentive or a loss of contractual rights if an airline lodged a declaration application or assisted/supported a third party in making a declaration application. This is another example of monopolistic behaviour that runs contrary to both the legislation and public policy objectives. The intent of Part IIIA of the *Competition and Consumer Act* (CCA) is that any business should have the ability to seek access on reasonable terms and conditions to essential facilities such as an airport[78], yet we see private monopoly infrastructure operators attempting to force their customers to forgo their rights in this regard.

Pre-funding airport infrastructure investments

A4ANZ does not support the concept of pre-funding airports' infrastructure investments, as pre-funding capital projects through user charges is costly, unreasonable and it does not reflect the most efficient use of airline investments in airports.

Paying for infrastructure in advance of when that asset is available for use is not currently used in other sectors in Australia; in any other commercial environment. A facility (e.g. shopping centre, cinema, hotel) would not be built until there was a critical mass of demand to make the investment viable. A4ANZ is concerned that if the PC endorses the practice, a precedent for pre-funding assets may be set for other industries and infrastructure across Australia, without considering the unintended consequences of this.

A4ANZ is not alone in this view – among others, the International Air Transport Association (IATA) notes that pre-funding through user charges is unnecessary and is generally not applied in other sectors where either public funding through governments or private sector financing is available for sound business cases.[79]

Prudent investment remains a key challenge for airlines dealing with airports, particularly with respect to forecast growth in demand, investment to accommodate potential new services or change to service expectations of airlines. One example provided to A4ANZ involved a capital city airport investing in a runway with capacity for large widebody aircraft, despite having no demand for such runway capability at that time. Over time, the runway investment has then been inserted into the asset base used to determine domestic airfield pricing, resulting in operators of domestic flights (and international narrow body should they eventuate), paying for infrastructure not required to support its operations. A similar scenario has emerged with a regional airport that failed to demonstrate that demand exists for a runway of the length and width proposed by the airport, yet funding for the runway is being demanded from the airlines.

Pre-funding through user charges also challenges the International Civil Aviation Organization's (ICAO) key charging principle of cost-relatedness, which state that charges should not be used to fully recover costs in advance of commissioning new airport facilities or infrastructure [80]; airlines and their passengers should only be charged for the cost of services provided.[81] While the ICAO guidance allows for pre-funding under specific circumstances and with a prescribed consultation process, they are also clear that this should only occur *after* allowing for contribution from non-aeronautical revenues; a highly improbable scenario under the dual till operation of Australia's airports. Attempting to pre-fund airport infrastructure, such as runways, by passing costs on to current airline customers and their passengers – some of whom may not receive any benefits of the second runway, runs contrary to these principles.

There are clearly more appropriate and cost-effective options to finance aeronautical infrastructure, such as loans, institutional lending or subsidies, closely monitored public-private partnerships (PPPs)[82] or a pre-commitment arrangement with airlines. This would allow a level of funding to be secured by considering the airport's balance sheet together with the forward commitments of the airline customers. Effectively, the financial strength of the tenant or user adds to the balance sheet of the developer in securing loans for the development.

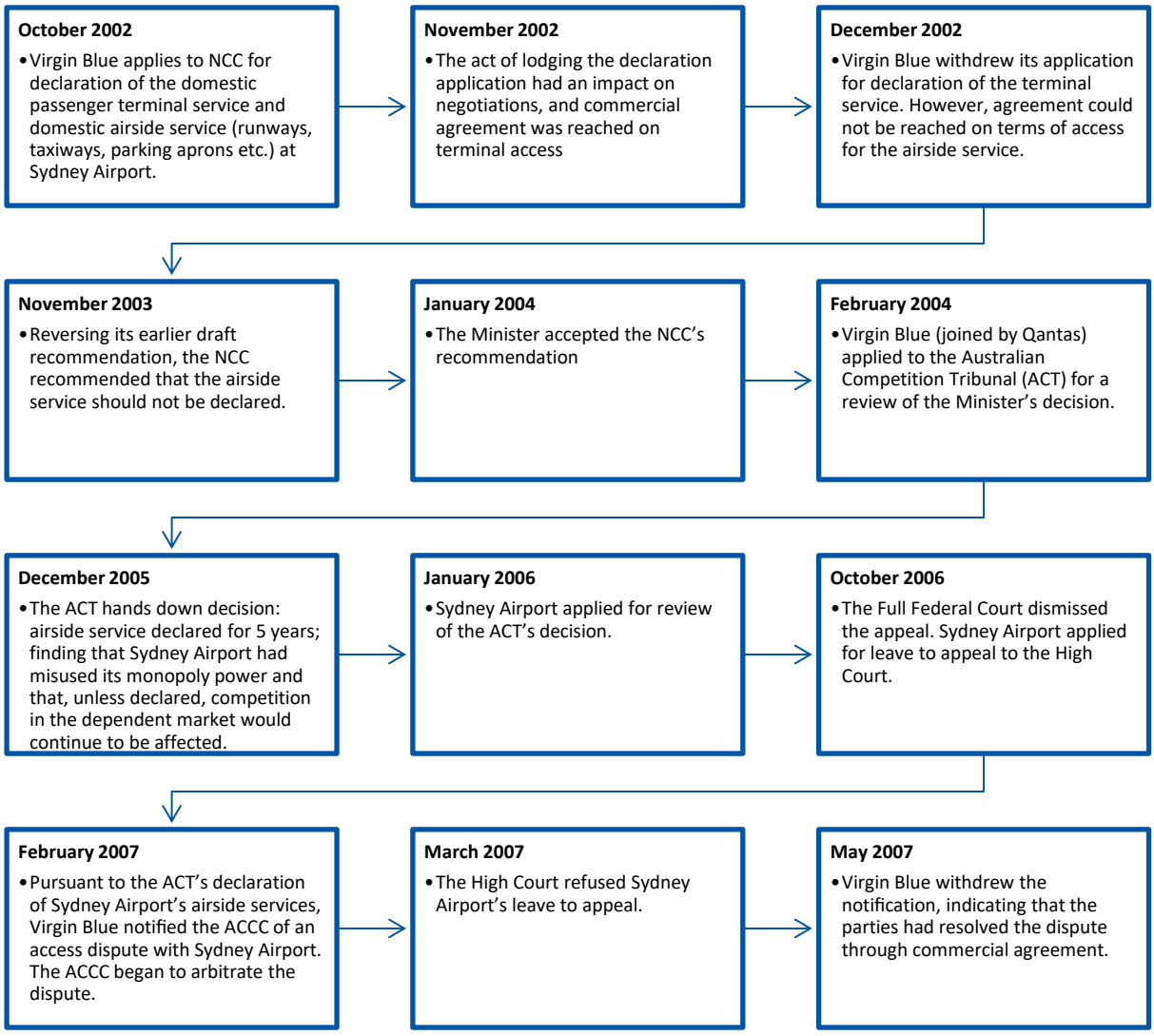
This is not dissimilar to the approach used in other industries such as property development, where financing is often secured through the inclusion of an agreement for lease from the future tenant. A4ANZ suggests that these financing strategies are far more appropriate than attempts by airports to pre-fund infrastructure – especially given that providing an upfront pool of money does not encourage investments to be delivered in a cost effective and timely manner.

Drawn out negotiations come at a cost

A4ANZ would also suggest that it is not only to the benefit of airlines to amend the regulatory system; reform would also have efficiency benefits for airports. A recent example provided by Adelaide Airport highlighted that in order to reach agreement in negotiations between the airport and an airline, the airport's resources included, but were not limited to: 3 full time equivalent staff, 400 hours of meetings, 260 flights, and 120 hotel nights.[83]

A4ANZ member airlines undertake numerous airport negotiations in any given year, with the majority of these negotiations lasting over 12 months – and potentially upwards of three years. Some of them do not reach resolution at all, leaving passengers without services.[84] For the low cost carriers in particular, the lack of an agreement results in reduced choice and price competition for passengers.

A noteworthy example of the time and resources spent on protracted negotiations is the case of Virgin Blue and Sydney Airport in 2002. As is evident from the flowchart below, negotiations between Australian airports and airlines are resource intensive and fraught with complexity. [85]



Not only is this case a demonstration of the cost of protracted negotiations, it also serves as an example of the impact of a regulatory threat on negotiations; something which is now absent in the Australian regulatory landscape. The costs to the airlines in terms of lost productivity is significant. An expedited settlement would allow for better collaboration and value creation; the financial benefits of which are quantified later in this submission.

A4ANZ and its members appreciate that the burden of proof to demonstrate the benefits associated with implementing the proposed changes to the regulatory model lies fairly with those proposing change. We engaged Frontier Economics to assess the potential costs and benefits of proposed changes to the current system, the results of which are discussed in detail later in this submission and included at ***Appendix B***. Of particular note is that the assessment found that the proposed changes to the regulatory regime would not increase administrative and compliance costs, and that the additional benefits of the proposed reform are likely to be material.

Clearly, the ability of the current regulatory model to facilitate genuine commercial negotiations – and in doing so, to fulfil the regime's policy objective – is lacking.

BENCHMARKING TO IDENTIFY ABUSES OF MARKET POWER

This section aims to address Information Request 5 from the PC: ***The Commission is seeking feedback on benchmarks to identify abuses of market power in aeronautical services, including financial benchmarks, operational efficiency benchmarks, service quality benchmarks and others. In proposing benchmarks, the Commission would appreciate some consideration being given to risk.*** This section also aims to address a point from the PC's Information Request 4, which notes that: ***The Commission invites comments on the use of analytical approaches, such as data envelopment analysis and stochastic frontier analysis, to interpret indicators of airport performance***.

Airport Efficiency

Expert advice provided by Margaret Arblaster (included at ***Appendix C***) notes that while international benchmarking studies provide some useful information on comparative airport performance, the studies are generally orientated to operational (technical) efficiency and not designed for the purpose of identifying the use of market power.

For example, the Air Transport Research Society (ATRS) Benchmarking Study is a well-known, highly regarded international airport benchmarking study. However, ATRS note that due to data limitations, their methodology for airport productivity relies on variable factor productivity indicators (not total factor productivity) and that their results do not take into account quality of service.[86] Therefore, attempts to benchmark quality and efficiency at Australian airports in the current regulatory environment would be fraught with difficulty – given the lack of publicly available information on the operation and performance of airports in Australia.

Furthermore, given the unique characteristics of Australian airports (the high proportion of domestic travel, type of ownership, network connectivity, and variable hub characteristics), it is difficult to find appropriate international airports for meaningful comparison via DEA or SFA analysis; they are more likely to match other Australian airports. Attempts to assess efficiency or performance against international airports may therefore produce flawed results, to be interpreted with caution.

Benchmarking WACC

Not only is the current monitoring regime ineffective in constraining airports' market power, but it fails to assist airport users in determining whether the offers they receive from airports are reasonable. Pricing models used by airports produce a return on capital using a weighted-average cost of capital (WACC) multiplied by the asset base – this is a major component of the return for a capital-intensive business. However, the ACCC's monitoring provides no guidance on reasonable values for either of these elements in the return on capital calculation for future years. Consequently, airports use different methodologies when a standardised approach would clearly offer distinct benefits in terms of the costs of negotiations.

While proposed changes to the current ACCC monitoring to address its current limitations are discussed later in this submission, amendments to enhance benchmarking would involve collation of consistent and comparable information across airports and would hence assist airport users to identify if they are receiving a 'good offer' from the airport. An enhanced regime could include the ACCC issuing guidance on a WACC, as is the case in other jurisdictions, but taking into account the concerns expressed by airlines about the way in which risk is dealt with. Together with the other amendments to provide consistent and comprehensive data, this would allow airport users to assess both an airport's performance and its offer; and importantly, provide airport operators with investment certainty.

EFFECTS OF REGULATION AND REGULATOR BEHAVIOUR ON CONDUCT

This section of the submission aims to address Information Request 1, Part 3: ***The Commission is seeking evidence on the effects of regulations and regulator behaviour on the conduct of airport operators and airport users, including in relation to an airport's ability and incentive to exercise any market power.***

ACCC Commentary on current regulatory regime

The ACCC's price and quality of service monitoring regime does not provide effective regulation on a stand-alone basis. Indeed, the ACCC in its 2011 submission to the PC Inquiry, states that *"monitoring does not present an effective constraint on airports setting monopoly prices for aeronautical services and car parking"*.[87]

This view is repeated in the most recent Airport Monitoring Report, where the ACCC notes simply, that,

"Monitoring does not directly restrict the airports from increasing prices and/or lowering service quality. Nor does it provide the ACCC with a general power to intervene in the airports' setting of terms and conditions of access to the airports' infrastructure."[88]

In discussing the limitations of the monitoring regime in section A4.3 of the report, the ACCC further notes that the monitoring of airports is limited in scope and does not enable the ACCC to assess in detail whether an airport has exercised market power to earn monopoly profits.[89]

Mr Rod Sims the current Chair of the ACCC, said in 2015 that *"the current interpretation of light-handed regulation of monopoly infrastructure, which in essence has come to mean price monitoring, is not only ill-conceived in economic theory, it has failed in practice"*.[90]

In the same address, Mr Sims went on to further highlight the deficiencies of the current regime, noting that; "*Many of Australia's key infrastructure assets, including many ports and railways, exhibit such monopoly characteristics. In these circumstances the owner of the infrastructure is able to reduce output and service levels while charging monopoly prices, as basic economic theory suggests, causing significant detriment to users and the economy as a whole."*

"Experience has shown that, in circumstances of natural or legislated monopoly, price monitoring will have little or no long term impact on the conduct of the monopoly infrastructure owner."[91]

A note on international regulatory behaviour

There have previously been calls for a shift from Australia's regime to the information disclosure regime in New Zealand. However, one needs only to look at Auckland airport (AIAL)'s performance under this regime to see it is similarly ineffective at curtailing market power. AIAL's extreme profitability against its inefficient, poor quality performance are a case study in market power exploitation, all of which is able to occur under New Zealand's regulatory regime.[92] Highly regarded by market analysts, AIAL has one of the highest profit margins of any airport in the world, yet has ailing aeronautical infrastructure, desperate for investment and upgrade.[93]

While the pathways to negotiate-arbitrate and the role and processes for intervention by the Commerce Commission[94] would appear to make New Zealand's regulatory settings robust, in fact the model has many weaknesses, including:

- The dual till settings, which mean that only aeronautical charges are monitored, drive airport companies to invest in retail/commercial activity while ignoring aeronautical infrastructure;
- The Commerce Commission publishes a guidance on WACC but it is not enforceable through the Information Disclosure regime;
- The WACC guidance on its own creates a scenario where airports can and do set capital plans but then do not follow through with them – there is no avenue for enforcement or recourse for funds provided by airport users;
- There is no requirement for a contract to be in place – airport users essentially have to take a price from the airport with no certainty on service or efficiency levels; and
- Any intended regulatory threat is essentially removed by the fact that airport operators can simply ignore the Commerce Commission's 5-year review of prices as an airport is allowed under separate legislation to "*set charges as it thinks fit*."[95]

While the Information Disclosure framework has some positive qualities, including WACC guidance, more comprehensive informational requirements and forecasts, New Zealand's approach to regulation of its airports is a major factor in the high costs borne by travellers and airlines. Indeed, under the current regime, New Zealand airports are able to exploit their market power – particularly in the provision of aeronautical services, a fact conceded by the New Zealand Airports Association in a recent submission to the Commerce Commission.[96]

The current method of regulating airports in New Zealand by information disclosure, is, like Australia's, light-handed and *intended* to be a deterrent regime. However, to act as an adequate deterrent, such a regime relies on the following:

- An ability to identify, demonstrate and measure misconduct i.e.
  - An ability to adequately monitor outcomes / behaviour
  - Clarity around what outcomes represent evidence of misconduct
- A credible threat of effective punishment / penalties:
  - Penalties that are suitably high and certain to act as a discouragement
  - Penalties are not perceived as avoidable i.e. firms must not be judgement proof, e.g, too big to fail; OR
  - Regulatory constraint on the exercise of market power

Current behaviour in the Australian regulatory environment

As noted above, threat-based regulation relies on the threat being credible. In Australia, it can be clearly demonstrated, and is now well recognised by experts, that there is a complete absence of a credible threat, despite claims to the contrary. As noted earlier in this submission, this is exemplified by investor statements regarding Sydney Airport.[97,98]

The unconstrained ability of airports to impose charges in the absence of transparency or contestability is a significant issue for all A4ANZ's members. We received numerous examples of additional charges being added, without consultation or even the ability to scrutinise the modelling on which the new costs are being claimed.

In one case, a regional airport sought to include assets funded by a government grant into the aeronautical asset base (which would enable a return on an investment it had effectively never made) so that the Council could recover the grant money from airlines and reinvest that money in other community projects. While there are no

doubt worthy community projects, there is a real question over whether airlines - and their passengers - ought to be subsidising these, particularly given concerns about the costs of airfares in regional Australia.[99]

There are numerous other examples, some of which have already been highlighted earlier in this submission, of the airports showing no restraint in their behaviour under the current regime. Some of them are designed to create operational disruptions and/or brand damage to force airline management to reach agreement, and include the following examples shared by A4ANZ members:

- With no forewarning, blocking the entrance to an airport lounge with chairs
- Switching off Wi-Fi access in a lounge
- Media "shaming"
- Withholding previously agreed rebates or incentives
- Refusal to allow participation in industry stakeholder consultation

In a now widely-publicised incident at Canberra Airport, two aircraft were blocked from departing until an invoice was paid.[100] Not only did this have potential safety implications, but the inefficiencies created by the delay come at a significant cost that flows all the way through to the individual consumer. At the same time, airport operators were engaging in a negative political and media campaign regarding flight cancellations.[101]

The use of the media to influence negotiations was also a tactic employed by Townsville airport to generate negative public sentiment towards Qantas during a dispute about the airport's proposed redevelopment plans.[102]

For the threat to be credible it also needs to apply to the business in question. The examples provided above – one of which the PC included in its Issues Paper – which clearly demonstrate poor conduct by a monopoly operator wielding its power could not have been addressed by the current regulations, as the regime only applies to Sydney, Brisbane, Melbourne and Perth airports.

However, simply expanding coverage of the *existing* regime to cover these second tier and regional airports would not solve the problem, as A4ANZ members have had to face similar - and in many cases worse - examples of market power abuse at the monitored airports.

LIMITATIONS OF CURRENT REGULATORY REGIME

This section aims to address the PC's Information Request 3: ***The Commission welcomes comment on whether it is possible to identify abuse of market power through monitoring of airports' behaviour, whether the monitoring regime should continue, and any alternative approaches to identifying abuses of market power. The Commission is seeking feedback on the matters it should take into account in its assessment of whether the price and quality of service monitoring regime is fit for the purpose of detecting and deterring abuses of market power;*** and part of Information Request 4: ***The Commission welcomes comment on whether the information that the ACCC collects is adequate to detect any abuse of market power by airports. Inquiry participants who consider that the current information collected is not adequate to detect airports' abuse of market power are invited to suggest alternatives to augment or replace this information set. Suggested options should address the question of cost of information, who should pay and why.***

Informational limitations

To fully explore both the background and limitations of the current regime, A4ANZ sought expert advice from Margaret Arblaster.[e] This section contains excerpts from Ms Arblaster's advice, included in full at ***Appendix C.***

As noted previously, the ACCC has repeatedly highlighted the deficiencies and limitations of the current regulatory regime – explored in detail in Appendix 4.3 of the 2016-17 Airport Monitoring Report.[103] Further, Ms Arblaster notes that the current monitoring regime does not meet the objectives that it was intended to achieve – with the design of the framework (including its legislative base) meaning that it is unlikely to deter abuses of market power, and therefore promote economically efficient airport performance.

The information collected by the ACCC's monitoring is not capable of identifying abuse of market power, as the level and structure of prices, and the standard of quality of service are not assessed in the monitoring function. Further, there are limitations in the indicators used, including the fact that they are not able to be readily adjusted to reflect changed market circumstances.

The extent to which monitoring provides transparency of airport performance across multiple useful indicators affects the probability of a stronger regulatory action or regulatory intervention. Under a light-handed regime, the threat of a stronger regulatory action relies on identifying misuse of market power – which the current monitoring regime simply cannot do. An assessment of the exercise of market power would require substantial additional information and analysis.

Price restrictions (previously called price surveillance) and price inquiries are the existing legislative provisions in Prices Surveillance, Part VIIA, of the *Competition and Consumer Act 2010* (the CCA)[104] which support the ACCC's monitoring function. The legislative provisions in Part VIIA of the CCA, with the exception of the monitoring function, were developed in the early 1980s as part of the Hawke Government's *Prices and Incomes Accord*.[105] They were used for a different purpose in that period than they are today. The provisions have changed very little since the 1980s and they are not fit-for-purpose in the current regulatory framework which now applies to *privatised* airports.

The ACCC has also incurred significant costs to administer the framework, in comparison to other areas of regulation. Furthermore, there are simply no features of the framework that promote negotiated outcomes between airports and airport users. The limited coverage of the regime also means that abuses of market power at non-monitored airports (the majority) are not even being documented, nor do they have access to redress. It is

[e] Ms Arblaster has 19 years of experience at the ACCC and its predecessor organisation, the Prices Surveillance Authority .

important to note that the Government's original intent when introducing light-handed regulation was that all airports should be subject to the access provisions in the then Trade Practices Act.[106] The price-monitoring regime was also only recommended for a probationary period of 5 years.[107]

Overall, as Ms Arblaster notes, it is difficult to see what sixteen years of airport monitoring, two PC Inquiries that have reviewed airport monitoring, and over ten years of the ACCC raising concerns about airport performance and market power has achieved. Given the inherent limitations of the airport price monitoring framework, there is a good case for discontinuing it in its current form.

The absence of access to independent arbitration and determination is another key failing. This was highlighted in the 2002 Sydney Airport declaration case cited earlier, with the Tribunal noting that Sydney Airport had an opportunity to impose higher and additional charges upon the airlines; charges that would be unlikely to be accepted in a competitive environment. In what has now proven a prophetic statement, the Tribunal also considered that similar outcomes were likely regarding non-price terms and conditions for the use of facilities and related services at the airport.[108]

A4ANZ also discusses the limitations of the current regime in further detail in the next section.

Modifications to the ACCC's monitoring regime

The ACCC's current airport monitoring regime was intended to identify abuses of market power. Under the proposed remedies this regime would be maintained, with some amendments to better promote negotiated outcomes between airports and airport users.

The current regime is ineffective in assisting users to determine whether the offers they receive from airports are reasonable. This is because, for example, pricing models used by airports produce a return on capital using a weighted-average cost of capital multiplied by the asset base. This is a major component of the return for a capital-intensive business. However, the ACCC's monitoring provides no guidance on reasonable values for either of these elements in the return on capital calculation for future years. As a consequence, airports use different methodologies when a standardised approach would clearly offer distinct benefits in terms of the costs of negotiations.

A more effective monitoring regime could complement the information disclosure regime by helping airport users identify if they are receiving a 'good offer'. An overarching monitoring regime can assist in this, as it can draw together consistent and comparable information, across airports and over time. Notwithstanding some limitations, this can create an important data source for airport users.

That is, the regime would:

- Continue to look at the trends in indicators of costs, profits, prices and quality of service for each Airport over time in order to articulate whether outcomes are improving or declining. Some minor amendments should address limitations associated with the consistency of data and the basis on which some assessments are made (i.e. profitability should be assessed more holistically than just reporting on aeronautical services, with car parking as an adjunct).
- Continue to compare performance across airports, again with minor amendments.
- Articulate benchmarks which an airport user can use to assess an airport's performance and its offer; for example, appropriate methods by which an airport could estimate an efficient return on capital.

Most importantly, these revisions would enhance the utility of the regime without imposing significant further cost on airlines, airports or the ACCC.

CURRENT FRAMEWORK IS NOT FIT-FOR-PURPOSE

In this Section we address the PC's information request 8: ***The Commission is seeking comment on whether the remedies that are available under the current framework for economic regulation facilitate commercially negotiated outcomes in airport operations. Participants are invited to provide the Commission with legal and other advice they have received in relation to the 2017 changes to Part IIIA of the Competition and Consumer Act***

This section has been drafted following advice received from Johnson Winter & Slattery (JWS), who were engaged to provide legal analysis of the current regulatory framework. This advice was peer reviewed by Michael O'Bryan QC, and is provided in full in ***Appendix D***. For this section, we have also drawn on Frontier's Report, *Economic Evaluation of an Alternate Approach to Airport Regulation* (***Appendix B***).

As noted in the attached legal advice and earlier in this document, it is uncontroversial to state that the ACCC's price and quality of service monitoring regime does not provide effective regulation on a stand-alone basis. Indeed, the ACCC provides similar advice in its 2011 submission to the PC Inquiry, that, *"Monitoring does not present an effective constraint on airports setting monopoly prices for aeronautical services and car parking".*[109]

While monitoring provides some insight regarding airport performance, it has a limited ability to directly address detrimental behaviour arising from the exercise of market power. It cannot prevent airports from increasing prices and allowing service quality to decline.

Existing arrangements for mitigating market power are ineffective

Australia's current approach to the economic regulation of airports is light handed and intended to be an *ex post* (deterrent) regime. Airports enter bilateral negotiations with airlines on prices, terms and conditions under a purported threat of re-regulation. However, when looking forward, the mechanisms intended to create this 'threat' look increasingly ineffective. So much so that we consider airports now face a much lower threat of government action to address their market power. This is a view shared by investors and financial analysts who note that airports in Australia enjoy revenue streams and returns far in excess of their international comparators, unconstrained by regulation.[110,111]

These independent perspectives of lawyers and analysts need to be acknowledged, given previous reliance placed on claims by the AAA that airport pricing at the major airports is "*implicitly constrained by the potential for the return of explicit price regulation if the airports are found to have misused their market power*"[112], and that ever since the Sydney Airport declaration, the other airports have been "*petrified*" that another application for declaration will be made.[113] As this submission demonstrates, this is simply not the case.

To act as an adequate deterrent, an *ex post* regime relies on the ability to identify, demonstrate and measure misconduct. The ACCC annual monitoring of prices, costs, profits, and quality of aeronautical services and car parking at the four largest airports is intended to be the main mechanism for this. However, the ACCC has not been able to articulate whether and at what price/profit level an airport is exploiting its market power. This ambiguity around outcomes comes partly from the fact that the ACCC has:

- focussed on assessing airport charges, which are driven by a wider set of considerations and may not relate directly to aeronautical costs;
- assessed profitability only in the short term; and
- no clearly articulated benchmarks against which to assess an airport's performance. (i.e. against the airport's weighted-average cost of capital or based on efficient comparators to that airport[f]).

[f] The challenges associated with identifying appropriate comparator airports are discussed in further detail in an earlier section of this submission.

Another consideration is that ACCC assessments relate to aeronautical services and thus are undertaken on a dual till basis. They do not cover non-aeronautical activities (except for car parking) and thus do not assess the level of prices and profits on a single till basis. This is problematic as an airport services many complementary markets and its charges for aeronautical and non-aeronautical services are interdependent.

The current system also does nothing to prevent costly, potentially unnecessary investments and subsequent excessive price rises. Investment proposals are not subject to scrutiny and could only be – after quite a lengthy process – punished after the fact.[114]

Furthermore, to enable an *ex post* deterrent regime to be effective, it requires a credible threat of punishments or penalties. Penalties that are suitably high and certain to act as a discouragement and that are not perceived as avoidable. The deterrent, in the current regime, is intended to be derived from:

- the threat of airlines taking legal action under CCA (through Part IIIA); and
- the threat of re-regulation on the basis of ACCC monitoring and regular reviews of economic regulatory arrangements by the PC.

The likelihood and consequence of an airport being penalised via these channels is not suitably high to act as a deterrent under current arrangement; in fact, the risk has been declining over time.

An ineffective threat: Part IIIA declaration is lengthy, costly & impractical

Frontier's analysis suggests that the incidence of airline-initiated action under Part IIIA of the CCA is likely to be small. This is unsurprising, as the ACCC notes in its submission to the 2011 PC Inquiry, "*airlines face considerable costs, time and uncertainty seeking declaration under Part IIIA of the Competition and Consumer Act 2010 to constrain airports' behaviour*".[115]

The fact that there have been very few declaration applications since the Sydney Airport case in 2002 reflects this difficulty. It is not, as the AAA have claimed, because the airlines are not aggrieved by the behaviour of airports.[116] Amongst A4ANZ's member airlines, there have been a number of occasions on which advice was sought and counsel engaged, with a view to lodging declaration applications; but they were ultimately abandoned because of the lengthy, costly and highly uncertain processes this course of action entailed.

Furthermore, as Ms Arblaster notes (***Appendix C***), situations of uneven bargaining power, where smaller users are not able to access negotiate-arbitrate regulation (e.g. due to the costly processes or high threshold declaration criteria outlined) could be harmful to competition. Ultimately, and as highlighted earlier in this submission, this can result in smaller market participants being forced to exit, or not to enter the market at all.

Changes to Criterion (a)

Putting aside the costly and time-consuming nature of Part IIIA, recent amendments to declaration criterion (a) will affect an airline's ability to obtain declaration, and ultimately arbitration of terms, under Part IIIA. This is because airlines will have to demonstrate to decision-makers that airports are imposing terms and conditions that they disrupt or threaten airline competition. This is explored fully in ***Appendix B*** – *Annex: The Economics of Applying the Revised Criterion (a) in Part IIIA Proceedings.*

In their economic analysis of the recent changes to criterion (a), Frontier Economics found that the new wording of Criterion (a) has served to make declaration more unlikely — and therefore less of a constraint on airports' behaviour — as declaration would only promote competition in limited and unusual circumstances.

Part IIIA's limited application means it could only rarely (if ever) provide the mechanism of "last resort" for resolving serious and protracted disputes as the PC intended.

The reasoning for this finding is as follows:

- The Criterion (a) test requires that the decision maker – whether this be the National Competition Council (NCC), Minister or the Tribunal – be satisfied that declaration of an airport service would promote competition in a dependent market;
- The most obvious hurdle to airport service declaration is that in the absence of vertical integration, a clear anti-competitive motive for high prices is absent;
- In some limited circumstances, it is conceivable that high prices (whether uniform or discriminatory) could lessen competition in a downstream market, and that declaration leading to reasonable terms could promote competition. However, this is likely to be a difficult burden to discharge as high input prices commonly have little effect on competition in downstream markets; and
- The specification that declaration specifically consider "reasonable terms" may have had the intention to address detriments from monopoly pricing, but is unlikely to, in practice, provide any additional utility to Criterion (a) in relation to airports.

Similarly, legal advice from JWS (***Appendix D***) notes that recent amendments to the relevant criteria were designed to ensure an appropriately high regulatory hurdle must be cleared before "declaration" of any infrastructure services can be achieved. Both the Productivity Commission in 2013 and the Harper Competition Policy Review in 2015 concluded that the declaration criteria should be targeted to ensure third-party access is mandated where it is in the public interest, with monopoly airports' market power cited as a key reason for such provisions.[117]

JWS also note that the recent amendments mean the current Criterion (a) have not yet been considered by the NCC, Tribunal or higher courts, which makes it difficult to predict the ultimate prospect of airlines successfully obtaining declaration. However, it seems clear – and indeed it was the intention of legislators – that the changes to Criterion (a) in particular have increased the overall threshold for declaration.

JWS conclude that the corollary of an increased legal threshold for declaration under Part IIIA, together with the existing significant cost, time and uncertainty associated with the process, is that the threat of declaration is even less effective (and may be ineffective for all practical purposes) as a constraint on airports' market power when negotiating the terms and conditions of access.

Declaration process

The process of seeking declaration and utilising the Part IIIA regime can be lengthy, costly and impractical, illustrated by the earlier case study of Virgin Blue and Sydney Airport in 2002. In fact, the costs associated with this process were cited as a reason for the NCC's initial view that it could not be satisfied that the benefits would outweigh the costs of declaration.[118]

Furthermore, JWS noted that despite legislative amendments to introduce deadlines for various stages in the process, this situation remains the case. By way of illustration, the timeline for a more recent declaration application involving the Port of Newcastle is set out in the table on the following page.[119]

The period from the date of application to the date of resolution was almost three years, however, this does not include the time associated with Glencore producing its application in the first place. Of note is the fact that the Port has subsequently applied to the NCC for a revocation of the declaration under section 44J, based on the new Part IIIA wording, suggesting that they too view the threshold test under the revised Criterion (a) as a more significant hurdle for the access seekers.

Case study: Port of Newcastle

Date	Event	Comments
13.05.15	Application for declaration received by the National Competition Council (NCC)	Applicant was Glencore
18.06.15	Deadline for submissions on the application	14 submissions received
30.07.15	NCC draft recommendation released	
31.08.15	Deadline for submissions on draft recommendation	9 submissions received
10.11.15	NCC sent final recommendation to the Minister	
11.01.16	Minister decision not to declare the service is published	
29.01.16	Glencore applied to the Australian Competition Tribunal (ACT) for a review of the decision	
31.05.16	ACT determined the service should be declared	Reversal of NCC original decision
16.06.16	ACT made orders that the service should be declared	
14.07.16	Port of Newcastle applied to the Federal Court of Australia (FFC) for judicial review of the ACT decision	
28.11.16	Port of Newcastle application heard before the FFC	Two day hearing
16.08.17	FFC handed down its decision dismissing the application for judicial review	Upheld the ACT decision
12.09.17	Port of Newcastle applied for special leave to appeal the FFC decision to the High Court of Australia	
23.03.18	The application was dismissed by the High Court	
02.07.18	Port of Newcastle submitted the NCC should recommend that the designated minister revoke the declaration	

In addition to the ineffectiveness of Part IIIA, Frontier also note that the risk of government-initiated action has also declined over time, and that this may be observed from:

- the existing monitoring regime, which does not provide the ACCC, nor any other authority, with a general power to intervene if misconduct has been identified, and it is evident that the ACCC is reluctant to exercise options available to it that will not address misconduct (such as a pricing inquiry);
- the lack of a formal, periodic review process for Productivity Commission recommendations, as there is no legislative requirement; and
- a history of government inaction in response to ACCC concerns and past Productivity Commission recommendations.

The combined effect of these arrangements means airlines have less bargaining power in negotiations with airports than at the time of deregulation in 2002; Frontier's analysis considers that this represents a deterioration of the threat of arbitration/regulation, meaning that airlines and other airport users will face declining bargaining power when dealing with airports into the future.

Perhaps the most significant finding of this analysis, however, is that all experts engaged by A4ANZ found that the current provisions do nothing to fulfil the Government's policy objectives in airport regulation; that is, to promote or facilitate commercial negotiations between airports and airlines or other airport users.

Why Part VIIA Price Inquiries are not an appropriate regulatory solution[g]

The current economic regulation of airports is based on Part VIIA of the CCA (known as the Prices Surveillance part) and Parts 7 and 8 of the *Airports Act 1996*.[120] There are three main mechanisms available to the Government under Part VIIA of the CCA: price monitoring, price surveillance and price inquiries.

In theory, the information obtained from price and quality of service monitoring enables the ACCC to ascertain whether airports may have misused their market power. If this is the case, the Government can direct the ACCC or another body to conduct a price inquiry, which could result in the reintroduction of explicit price regulation. It is alleged these arrangements are sufficient to implicitly constrain airport conduct. As this submission clearly demonstrates, this theory has not been borne out in practice over the last 16 years. Furthermore, as the PC notes in its Issues Paper, the Government has never recommended a Part VIIA price inquiry for airport services.

In undertaking such an Inquiry, the ACCC would need to consider the level of prices on an individual airport basis, and the task would be akin to a regulatory price determination; very resource intensive, intrusive and complex. If the inquiry established that the level and structure of prices reflected the use of monopoly power, the applicable legislative provisions available in the CCA would be price restrictions. As these are voluntary, they are not likely to be effective for *privatised* firms, and could only apply to price *increases* going forward; hence useless to constrain Australian airports' market power. Indeed, a previous determination by the ACCC stating that a proposed price increase was not justified, was wilfully ignored by Adsteam Marine Ltd in 2002, with no apparent penalty.[121]

It is therefore difficult to envisage an appropriate and timely outcome that could arise from an ACCC price inquiry into the use of airport market power. It is also 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 not credible. 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 provided by JWS, including:

- The benefits of the public inquiry process, as outlined above, appear to have been replaced by PC 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.
- 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.
- 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 PC recommended an enhanced "credible threat" in the form of a "show cause" mechanism.[122] 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*".[123]

Ultimately, a Part VIIA Inquiry offers no 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. 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.

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[g] This section contains excerpts from expert advice from Margaret Arblaster. The full advice is at ***Appendix C***.

Maintaining "dual till" approach to monitoring is inappropriate

As noted earlier in this submission, the dual till approach to monitoring and pricing is inappropriate. A4ANZ and its member airlines are not alone in this view, which is also shared by regulatory experts and IATA.[124]

The dual till approach to monitoring in Australia contains two major flaws. The first is that it does not correctly capture the full scope of activities over which the airports have market power. The second is that it ignores the interdependency between the monitored and non-monitored services, which largely invalidates the interpretation of the findings; considered separately, rather than as a whole.

In the report "*The Market Power of Australian Airports" (**Appendix A**)*, Frontier Economics describes how airports have market power over the bundle of services passengers use (either directly or indirectly). That is, the monopoly is not just restricted to aeronautical services that are acquired by the airlines. Of most significance is that an airport is likely to have market power over bottleneck facilities required by its potential competitors which it can potentially leverage 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 can constrain growth or discipline car parking competitors that threaten its profits.

This might suggest that monitoring could be extended to other services. However, there is an additional complication - the demands for an airport's services are interdependent. By way of example, the more flights to the airport, the more passengers; the more passengers, the more retail and car parking services consumed. This interdependency means that airports may quite rationally charge prices for any one service that result in the under or over-recovery of the incremental costs of that service, as a means to increase their profits overall.

The dual till approach to monitoring or pricing ignores this interdependency and means that any inferences made about an airport's profitability or prices by looking at outcomes (or price-cost relationship) must be treated with care.

A better approach would be to monitor with respect to airports' total 'passenger related' operations, sometimes referred to as a hybrid till approach. A number of jurisdictions now use the hybrid till approach, for example the Civil Aviation Authority of Singapore (CAAS), the Airports Economic Regulatory Authority (AERA) of India, Copenhagen Airport and Paris-Orly Airport (where it is referred to as an adjusted till). The hybrid till approach retains the complexity involved in allocating common costs and revenues between passenger- and non-passenger-related services.

Australian airports are currently experiencing increasing rates of growth on their non-aeronautical businesses, yet this is, quite clearly, having no impact on aeronautical pricing, which continues to rise. This is all possible because of dual till operations.

Clearly, the current regime which supports this framework is not fit for purpose. Its limitations are perhaps best captured in the following description of the Australian regulatory environment, as "*not conducive to the development of genuine commercial bargaining…nor to the discovery and adoption of more efficient ways of operating and investing, many of which rely on increased cooperation between the parties in the industry*."[125]

RATIONALE FOR GOVERNMENT INTERVENTION

"Aligning the incentives of private infrastructure operators and their customers is a goal that governments can actively pursue."[126]

As outlined in the earlier sections of this submission, the current regulatory framework contains significant limitations, is not fit for purpose, and there is now clearly a strong case for change. Privatisation of airport infrastructure promised to offer many benefits: more efficient management of assets, investment, and downward pressure on prices. Yet, in the aviation sector internationally, poorly thought-out airport privatisations have meant the anticipated benefits have not always been realised.[127] Instead, airport privatisation has ultimately resulted in higher costs for users: both airlines and their passengers, an outcome that appears to be seen as inevitable by airports.[128]

However, as has been recognised, the issue is not one of privatisation *per se*, but privatisation in the absence of appropriate regulatory controls where the infrastructure is also a monopoly. This was captured by the Business Council of Australia, stating that "*it would be better to focus on getting privatisation right, which is why appropriate regulation of the privatised asset after the sale to maximise the gains of private ownership is key. The benefits from privatisation are realised when governments put in place adequate regulation to ensure competitive access and pricing*."[129] This position endorsed the earlier directive from the Hilmer Review, that the privatisation of monopolies required safeguarding through regulation[130], to avoid the current situation which sees airports earning what ACCC Chair Rod Sims has termed "*unfettered monopoly profits*"[131] over a long period of time, particularly without quality improvements.

Australia's current light-handed approach to the economic regulation of airports was based, at least in part, on the implicit assumption that Australian airports do not have significant market power. As we have already demonstrated, this is not the case, leaving the current regulatory approach, coupled with recent changes to the CCA, completely inadequate to curtail their market power.

In practical terms, there is now effectively no provision under competition law, or in fact any Australian law that provides relief when dealing with a monopolist (airport) with significant market power – and no ability to prevent the exploitation of market power.

A4ANZ acknowledges that regulation can have unintended or undesirable effects, so it is important to have in place a process to ensure that the regulatory framework is efficient and effective in achieving policy objectives without imposing unnecessary burdens on businesses, community and government. To do this, we have been conscious to ensure that the approach to regulation being suggested – as outlined in the following sections of this submission – fulfils the COAG *Regulatory Best Practice Principles*, which are as follows:

- establishing a case for action before addressing a problem;
- considering a range of feasible policy options including self-regulatory, co-regulatory and non-regulatory approaches, and an assessment of their benefits and costs;
- adopting the option that generates the greatest net benefit to the community;
- ensuring, in accordance with the Competition Principles Agreement, that legislation should not restrict competition unless it can be demonstrated that:
  - the benefits of the restrictions to the community as a whole outweigh the costs; and
  - the objectives of the regulation can only be achieved by restricting competition.
- providing effective guidance to relevant regulators and regulated parties in order to ensure that the policy intent and expected compliance requirements of the regulation are clear;

- ensuring that regulation remains relevant and effective over time;
- consulting effectively with affected key stakeholders at all stages of the regulatory cycle; and
- ensuring that government action is effective and proportional to the issue being addressed.[132]

This accords with practices in the European Union which suggest "fitness checks" to ensure that the regulatory framework for a policy area is fit for purpose and, if not, what should be changed. The aim is to identify excessive burdens, inconsistencies and obsolete or ineffective measures and to help to identify the cumulative impact.[133]

There are a number of potential approaches for Government to consider in solving the problems identified with the current regulatory environment. Following consultation on both legal and economic implications, A4ANZ has formed the view that regulatory remedies based on minor modifications to the existing regime are unlikely to be effective on their own, as there would still not be any credible threat to, or consequence for, monopoly airports exerting market power in airline-airport negotiations.

In the following sections, A4ANZ – with advice from Frontier Economics and JWS – aims to demonstrate to the Productivity Commission a regulatory solution that brings benefits to the aviation sector, the broader community and the Australian economy.

BEST POLICY OPTION

This section aims to address the PC's Information Request 9: ***The Commission is seeking evidence that changes to the current 'light handed' approach to airport regulation are necessary. Participants are invited to suggest alternative approaches, the mechanisms to put such approaches into practice and the potential benefits and costs of the changes.***

Our response to this Information Request draws heavily on advice received from Frontier Economics and JWS (***Appendices B & D,*** respectively).

While perhaps the most likely measures that Governments might look to adopt to enhance the current airport monitoring framework, such as increased informational requirements, it is important to note that experts are agreed that this is unlikely to lead to any substantive improvements in the regime's effectiveness, for reasons provided earlier. Rather than only considering amendments to the current airport monitoring framework, it is far more productive to introduce a more effective regulatory framework that addresses all of the identified limitations.

To be clear, A4ANZ are not advocating for the re-imposition of price controls, as we agree with the expert view that the present situation provides no justification for that.[134] As those in the investment community have stated, "*the re-introduction of heavy handed regulation would adversely impact on the industry by significantly increasing the degree of regulatory risk associated with infrastructure investments, thereby creating a disincentive for efficient investment*."[135] A4ANZ shares these concerns, which is why our proposal is not to introduce heavy-handed regulatory oversight, but instead, to take the existing light-handed model forward through the introduction of a credible threat.

A4ANZ has formed the view that the most effective regulatory solution and the one most likely to result in genuine commercial negotiations between airlines and airports to effect fair outcomes for airport users, is a negotiate-arbitrate model. This is a position previously taken by the ACCC[136], supported by regulatory experts, and would appear to have widespread industry support, given statements by other airport users.[137]

The absence of such a model was cited as the very reason Sydney Airport was able to "*impose higher and additional charges upon the airlines*" and apply a similar approach to non-price terms and conditions for the use of facilities and related services.[138] It is important to note, however, that the existence of this pathway does not in itself prevent the airport raising charges, but instead encourages the sort of negotiated outcome that might occur were the airports operating in a competitive environment. To be clear, there is no evidence to support the airports' claim that genuine regulatory threats will stifle innovation or investment, and this hypothesis should be set aside. As Prof Littlechild noted in 2012, the ability of airport users – or indeed the airports themselves - to access an independent dispute resolution mechanism, "*would not unduly limit the commercial responsibility, risk-taking and initiative of the airport*."[139]

Bringing airport services within scope

To bring aeronautical services and facilities within the scope of Division 3 of Part IIIA of the CCA, A4ANZ asks the PC to consider the addition of a new section 192 to be added to the Airports Act 1996 (Cth) (Airports Act)[140], which would cause aeronautical services and facilities supplied by airports to be declared services for the purposes of Division 3 of Part IIIA.

There are a number of legal mechanisms by which this goal could be achieved, which have been outlined in the advice from JWS and Michael O'Bryan QC (**Appendix D**). The following, non-exhaustive list of declaration mechanisms all favour simplicity over complexity and seek to avoid the potential for legal disputation and delay:

1. The first option is the simplest. The new Section 192 would deem aeronautical services, as defined in regulation 7.02A of the Airports Regulations 1997 (Cth) (Airports Regulations)[141], to be declared services for the purposes of Division 3 of Part IIIA. As shown on the following page, Regulation 7.02A contains a clear and comprehensible definition of airport services that would be subject to light regulation under the proposed regime. This option is akin to the "deemed declaration" advocated by the ACCC in 2011[142] and represents a significant regulatory change, by virtue of employing a statutory provision as the appropriate mechanism rather than a decision by the executive or an appropriate administrative body.

2. The second option is to limit the deemed declaration to those aeronautical services (as defined in regulation 7.02A), or airport services more broadly, in respect of which an airport operator has substantial market power. The concept of "substantial market power" is already a well understood legal standard in Australian competition law. It is commonly thought of as the ability to profitably maintain prices above the competitive level or reduce the quality of services for a period of time without rivals taking customers away.

   If the parties are unable to agree on which services satisfy that definition, the issue would be resolved through court determination. This option targets the credible threat of regulatory intervention to the relevant conduct, namely the potential for airport operators to abuse their market power in the context of supplying goods or services. However, the imposition of this threshold also invites the prospect of disputes regarding which airport services satisfy the definition, arguments that would need to be resolved by court determination. The need for parties to address this type of jurisdictional issue, potentially multiple times across a wide variety of airport services, could give rise to significant delays and cost. This would offset its value as a prospective declaration mechanism.

3. The third option is to empower a relevant Federal Minister to determine, by statutory instrument, that one or more aeronautical services (as defined below), or airport services more broadly, are declared services for the purposes of Division 3 of Part IIIA. The Federal Minister may be empowered to do so if the Minister were satisfied that the determination would promote the efficient supply of the services or the long term interests of users of air services.

   The Federal Minister's decision would be subject to judicial review (i.e. whether the decision has been lawfully made) but the scope of such a review would be limited, given the broad discretion granted to the Federal Minister. The declaration mechanism would not involve a 'merits review' of the Federal Minister's decision i.e. a review of all aspects of the decision, including findings of fact. In these circumstances, careful consideration would need to be given to ensuring independent and unbiased decision-making and minimising the risk of political influence.

4. The fourth option is to empower a suitable administrative body, such as the ACCC, to determine that one or more aeronautical services (as defined below), or airport services more broadly, are declared services for the purposes of Division 3 of Part IIIA. The ACCC has a similar power under Part XIC of the CCA which concerns telecommunications services. As for the Federal Minister, the ACCC may be empowered make such a determination if it were satisfied that the determination would promote the efficient supply of the services or the long term interests of users of air services.

   The ACCC's declaration decision would also be subject to judicial review but not merits review by the Tribunal (or any other Commonwealth merits review tribunal). Again, the scope of judicial review in this context would be limited, given the broad discretion granted to the ACCC.

7.02A Meaning of aeronautical services and facilities[143]

(1) For this Part, aeronautical services and facilities means those services and facilities at an airport that are necessary for the operation and maintenance of civil aviation at the airport, and includes each service or facility that is:

(a) mentioned in an item in Table 1 (aircraft-related); or

(b) mentioned in an item in Table 2 (passenger-related).

Table 1 Aircraft-related services and facilities

Item	Services and facilities
1	Runways, taxiways, aprons, airside roads and airside grounds
2	Airfield and airside lighting
3	Aircraft parking sites
4	Ground handling (including equipment storage and refuelling)
5	Aircraft refuelling (including a system of fixed storage tanks, pipelines and hydrant distribution equipment known as a Joint User Hydrant Installation or JUHI)
6	Airside freight handling and staging areas essential for aircraft loading and unloading
7	Navigation on an airfield (including nose-in guidance systems and other visual navigation aids)
8	Airside safety and security services and facilities (including rescue and fire-fighting services and perimeter fencing)
9	Environmental hazard control
10	Services and facilities to ensure compliance with environmental laws
11	Sites and buildings used for light or emergency aircraft maintenance

Table 2 Passenger-related services and facilities

Item	Services and facilities
1	Public areas in terminals, public amenities, lifts, escalators and moving walkways
2	Necessary departure and holding lounges, and related facilities
3	Aerobridges and buses used in airside areas
4	Flight information and public-address systems
5	Facilities to enable the processing of passengers through customs, immigration and quarantine
6	Check-in counters and related facilities (including any associated queuing areas)
7	Terminal access roads and facilities in landside areas (including lighting and covered walkways)
8	Security systems and services (including closed circuit surveillance systems)
9	Baggage make-up, handling and reclaiming facilities
10	Space and facilities, whether in landside or airside areas, that are necessary for the efficient handling of arriving and departing aircraft (e.g. airline crew-rooms and airline operations centres)

(2) In this regulation, airside area and landside area have the respective meanings given in section 9 of the *Aviation Transport Security Act 2004*.

(3) To avoid doubt, ***aeronautical services and facilities*** does not include services or facilities:

(a) relating to the provision of a high-quality service to certain passengers; or

(b) that are not necessary for the efficient operation of civil aviation.

While the NCC may have previously argued a "deeming provision" circumvents the determination criteria[144], there are clearly some strong arguments that these criteria are not fit for purpose when it comes to non-vertically integrated monopolies, such as airports, that have no incentive to deny access, but every incentive to engage in monopoly pricing. This was partially acknowledged by the Harper Competition Law Review (2015)[145] and made more explicit in the ACCC's analysis of gas pipelines and access pricing in the East Coast Gas Inquiry (2016).[146]

Importantly, amending the Airports Act 1996 would also avoid further changes to Part IIIA of the CCA which would apply to all infrastructure (resulting in unintended consequences), and would be cumbersome to introduce, given the complexity of the legislation.

A4ANZ's proposed approach would provide a mechanism to bring to life the remedy suggested by the ACCC in its response to the 2011 PC's draft report, when it opined:

"An effective solution would be one that encouraged bona fide market-based commercial outcomes; that is, normal commercial agreements arrived at absent the exercise of the airports' market power. Such agreements will promote efficiency and better outcomes for consumers and for businesses in related markets. Such an effective permanent solution could be achieved by addressing the imbalance in bargaining power of the parties, so that the exercise of market power could be constrained."[147]

The solution proposed by A4ANZ would see the ACCC acting as an arbitrator. The position of the ACCC as arbitrator has the benefit of commercial certainty for both airports and airlines, with both parties understanding the likely approach of the ACCC (as the arbitrator) to assessing price, based on well-established regulatory precedents.

In 2011, the Productivity Commission ultimately reached the view that a "deemed declaration" with access to arbitration was not a "subtle change" consistent with light-handed regulation and did not recommend its introduction for reasons that included:[148]

- the ACCC's commentary about airport behaviour provided one party – the airlines –with an incentive to expeditiously seek arbitration; and
- under a different access regime (telecommunications), the ACCC had conducted nearly 100 arbitrations in the five years to 2009 – 2010.

These concerns may have some basis when it comes to traditional arbitration, as this process has the potential to incentivise "gaming" of the negotiate/arbitrate process with little incentive for either party to negotiate a reasonable outcome. Traditional arbitration leads the arbitrator to generally award its own determination which may or may not be a compromise between the parties' final positions. By contrast, final offer arbitration requires the arbitrator to choose one or other party's offer.

Furthermore, the NCC's objection to deemed declaration and access to arbitration on the basis that it would drive parties to frequently involve the regulator, at a cost greater than any benefit generated,[149] is not supported by the experience in the time that has passed since this opinion was expressed. Firstly, the telecommunications sector regime – cited as one of the reasons for this objection - essentially forced parties to arbitration on every agreement.[150] This has clearly not been the case in other sectors. For example, the experience of the Hunter Valley Rail Network since being subject to an access undertaking in 2011 has not resulted in any cases of arbitration.[151] This should allay concerns that the experience from telecommunications will be replicated or that examples previously provided can be relied upon as a guide to what may happen with airport infrastructure.

In summary, the form the arbitration takes is an important consideration, as is the specific sector to which it is applied. A4ANZ is therefore proposing that the PC give thorough consideration to the ability of parties negotiating provision of airport service to access "final offer arbitration", as an enhancement to the current regulatory regime for airports. Using this method, a dispute between two parties is resolved by an arbitrator choosing between final offers of settlement made by each party to the dispute.

Final offer arbitration is a method commonly used in various sectors in Canada and the United States. This international experience suggests that concerns about invoking a system of independent dispute resolution are unfounded, and in fact would take the current light-handed regulatory model forward.[152]

The Benefits of Final Offer Arbitration (FOA)

***"The theory behind FOA, is that it provides an incentive for both parties to moderate their positions to such an extent that third party intervention is not required. It is specifically designed to be an impasse deterrent."*[153]**

In Canada's shipping sector, where FOA has been in place as part of a threat-based regulatory model for 30 years, experts tracked just nine FOA applications in an eight-year period, with only two of these ultimately proceeding to arbitration.[154] While the literature is inconclusive on whether an FOA regime is more or less likely to lead to parties seeking arbitration than other more conventional forms of arbitration, the Canadian experience is supported by advice from Frontier Economics which notes that they do not consider that direct access to an FOA regime will necessarily encourage parties to seek arbitration as a "default" and thereby increase administrative costs associated with the regime. This position is further outlined on the following page.

In seeking to assess the likelihood of arbitrations arising, it is therefore reasonable to look back at arbitrations under Part IIIA when they were more accessible to airlines (noting the base case for this assessment assumes arbitration under Part IIIA is no longer readily accessible). In fact, since the introduction of Part IIIA, there have only been two notifications of a dispute relating to airport services by an airline. Both were ultimately resolved outside the formal arbitration processes.[h] This suggests there is no *prima facie* evidence for access to arbitration leading to spurious and high levels of arbitration.

As noted earlier, A4ANZ argues that the historically low level of airport-related access disputes under Part IIIA is a function of the fact that seeking declaration (and therefore arbitration) is complex and costly. This should not be taken to mean that by giving effect to a credible threat, large numbers of arbitrations will automatically ensue. Unfortunately, in its 2006 inquiry, the PC appeared to rely on this misconception when it raised concerns that a readily accessible airport-specific arbitration mechanism would *"fundamentally undermine incentives for the parties to negotiate outcomes…."*[155] The implication was that a high bar was necessary to prevent excessive arbitration. The PC again appeared to rely on experiences in the very different telecommunications area where sector-specific arbitration was heavily used.[156]

By contrast, experts from Frontier Economics consider an industry-specific FOA regime will act to enhance negotiations rather than lead to an excessive reliance on arbitration, for three main reasons:

First, the regime is intended to encourage parties to compromise and settle on the basis that an extreme offer will be less likely to be chosen by the arbitrator. In a review of the FOA regime applying to Canadian railways it was noted that *"The Panel believes that the FOA provisions have two important hallmarks of effective economic regulation: First, the arbitration process encourages parties to reach commercial settlement of their disagreement by its all-or-nothing approach.*[157]

Secondly, the information disclosure and transparency provisions will play an important role in actually reducing the scope and likelihood of any possible arbitration. This will be particularly enhanced if, for example, a building block structure for a pricing model and more clearly defined specific pricing and costing rules are developed.

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[h] In 2005, upon application for review by Virgin Blue, the airside services at Sydney Airport were declared by the Australian Competition Tribunal for a period of five years: In January 2007, Virgin Blue notified the ACCC of an access dispute SACL. However, following negotiated commercial settlement, the dispute was withdrawn in May 2007. In 2014 Tiger Airways applied to the NCC to have domestic terminal facilities declared on the basis that it was having difficulties negotiating increased access to terminal facilities. One month after the application was submitted an agreement was reached with Sydney Airport and the application for declaration was withdrawn. Looking more widely there have been at least six cases where airport users have made an application to have services provided on airports declared. Arbitration was commenced, but not completed, following declaration in only the Virgin Blue Case (see ***Appendix C***).

In contrast to the PC's earlier view, it was not the mere existence of a sector specific access regime which led to numerous access arbitrations in the telecommunications sector (see Box on following page); rather, there were two coincident factors that stymied that regime – Telstra's vertical integration meant that it had a strong incentive to delay negotiations, and no coherent, updateable pricing model was ever established.

Thirdly, impeding access to arbitration is entirely unnecessary to reduce reliance on arbitration. Under an FOA regime airlines and airports will clearly have easier access to arbitration; however, the costs associated with arbitration will be predominantly incurred by the parties. This is because under an FOA regime, the arbiter will necessarily be relying on the information and evidence provided by parties to make a compelling case for their offer. This (and the short timeframes imposed on the arbiter) will keep the additional analysis the arbiter is required to do to a minimum. It will also mean the majority of costs associated with arbitration will be incurred by the negotiating parties, suggesting they will only be incentivised to seek arbitration when a party feels it is being significantly disadvantaged, when compared to the outcome that could be expected from an arbitration.

For these reasons, A4ANZ do not consider that direct access to an FOA regime will encourage parties to seek arbitration as a "default". Other negotiate-arbitrate regimes that are supported by well-designed information disclosure and transparency provisions, and that place the majority of costs of arbitrations on parties to the dispute have similarly been shown to discourage reliance on arbitration.

Even in the unlikely event that parties were somehow drawn to involve the regulator, there would need to be a significant number of arbitrations under a new regime to counteract the estimated administrative and compliance costs savings of $22.7 million outlined later in this submission. For example, Frontier have assumed that each time-limited FOA arbitration may cost airlines, airports and the arbitrator $1 million in total; with this being the case, the regime would need to drive over 22 arbitrations in the next 15 years to outweigh the wider administrative and compliance cost savings it generates. Clearly this is an unlikely scenario given that, in over 22 years of access regulation in Australia, there have been just six cases where airport users have made an application to the NCC, or the ACCC, to have services provided on airports covered by negotiate-arbitrate regulation. In just one of those cases an arbitration commenced, but was not completed, following declaration.

Given all of the above, Frontier concluded that the proposed remedies will not increase administrative and compliance costs.

A4ANZ is proposing that the Final Offer Arbitration provisions for airport services could build on those of the Canadian Transportation Act 1996, which outline the arbitration process, timelines and information disclosure requirements .[158] Importantly, the Canadian Act states contains a requirement that parties need to exchange the information in support of their final offer within a specified time period.[159] By adopting a similar process in Australia, A4ANZ believes that parties will be better informed in their negotiations, and hence may be able to reach agreement on some or all of the elements of the negotiations, prior to the arbiter's binding decision. If parties must undertake the work required to develop a considered offer to present to the arbiter, then they will also be better able to reach a view about the expected net benefits of seeking arbitration.

Also important to note is that, in the case of an impasse between an airport and one airport user, the involvement of the regulator is contained to those two parties. Consistent with the current situation of bilateral negotiations, an application for arbitration by one airport user would not – necessarily - impact negotiations with other airport users, nor do the arbitration decisions apply universally.

In summary, the mere existence of final offer arbitration will not of itself drive parties to access this pathway each time they cannot agree on terms. It in fact has the opposite effect, of increasing the likelihood of a commercially-negotiated outcome, without involvement of the regulator.

Experiences with arbitration under telecommunication-specific legislation easily misinterpreted

In its 2011 report the PC raised concerns with sector specific arbitration mechanisms on the basis that *"…under the access regime for telecommunications, the ACCC has conducted nearly 100 arbitrations in the five years to 2009-10".*

These arbitrations occurred under an access regime introduced in 1997 under Part XIC of the *Trade Practice Act 1974.* The access regime applied to 'declared' services; essentially, those services which had monopoly or bottleneck characteristics. In the first instance, prices for these services were to be negotiated between access providers and access seekers. The ACCC was able to intervene at the request of parties, for example by issuing a final determination in access dispute. In selecting an access pricing approach for fixed line services, the ACCC decided that access prices should be set at no more than the total-service long-run incremental cost (TSLRIC) of providing the relevant access services.[i] This was an attempt to set prices at the efficient forward-looking costs of supply.

However, the practical problems associated with implementing a TSLIRIC approach to pricing, as outlined below, effectively prevented pre-arbitration negotiations from being successful.

Estimating TSLRIC requires a number of assumptions to be made around approach and a general lack of agreement about how to implement a TSLRIC led to a proliferation of estimation models. This significantly increase the scope of negotiations and prospect for differential positions.

When compared with other pricing approaches based on the depreciation of actual costs incurred, TSLRIC modelling is highly speculative and requires a greater degree of foresight (well beyond five years). In particular long-term forecasts of future asset price changes and assumptions about obsolescence of assets. These assumptions are highly speculative particularly in the presence of rapid technological change.

In addition to the contention that surrounded setting TSLRIC-based prices for the first time a greater challenge emerged from how to update the costs and prices over time. In particular this required an estimation of a 'modern equivalent asset' that would be built to provide service today and into the future. It is an imaginary cost of an imaginary network, and, that being the case, it can be imagined in different ways.

As a result of the above access seekers and providers struggled to agree a set of modelling principles and inputs and ultimately a mechanism for updating prices over time to produce predictable and stable prices. In our view, this provides valuable lessons for the design of an appropriate airports regulatory regime.

Source: Frontier Economics

[i] ACCC (1997) cited in Davis, Warwick. 2011. 'From futility to utility – recent developments in fixed line access pricing'. Telecommunications Journal of Australia. 61 (2): pp. 32.1 to 32.16.

IMPLEMENTATION

To bring the proposed amended regulatory regime to life, there needs to be a clear pathway to access arbitration. There are a number of means by which such a regime could be implemented for airports and airport users. The simplest means is to use the existing arbitration framework within the National Access Regime in Part IIIA of the CCA, with some minor modifications.

Application for arbitration

Aeronautical services and facilities could be subject to a similar light regulation regime as applies to gas pipelines. Under that regime, contained in the National Gas Law,[160] compulsory arbitration is available (and only available) if the supplier and acquirer of the services are unable to agree terms and conditions of supply.

As noted above – and as in the Canadian transport model, access to final offer arbitration would be expected only to occur if parties are unable to agree on matters raised in the context of the negotiation of any agreement concerning the use of the airport's facilities or services or concerning the conditions, or the amount to be paid for that use. It would be at this point that the airport user (or the airport) may, after reasonable efforts to resolve the matter have been made, apply to the ACCC to arbitrate the matter.

The steps that then follow ought to be subject to consultation with affected parties but could draw on those already in practice in Canada and in other sectors in Australia, and similarly, have tight time restrictions for the provision of information and submission of final offers. In the event that an arbitration still occurs, any decision of the ACCC would be expected to also be conducted within a particular timeframe, and be binding on the parties for a specified period. The outcomes of the arbitration would not automatically apply to other parties, who may have differing points of disagreement in their negotiations and/or be able to reach agreement without arbitration.

It is important to note, as highlighted in Ms Arblaster's report (***Appendix C***), that the ACCC already has guidelines for its role in dispute resolution and arbitration[161], which we would expect them to retain, as they include the following features:

- parties can continue to negotiate while the ACCC arbitrates a dispute;
- parties can withdraw from an arbitration at any time before the ACCC makes its final determination;
- the ACCC satisfies itself that there is genuine disagreement between the parties at the outset of an arbitration;
- arbitration hearings are conducted in private;
- the structure and processes for conducting an arbitration can vary to suit the parties to the dispute and matters in dispute;
- the ACCC aims to conduct an arbitration with as little formality as possible; and
- the ACCC gives directions in relation to confidentiality for the arbitration process.

Importance of information disclosure

As highlighted earlier in this submission, a lack of information can put airport users at a significant disadvantage when negotiating with monopoly airport operators. Similar concerns have been raised in the energy sector about the information asymmetries shippers can face in negotiations with gas pipeline operators and the detrimental effect this can have on their bargaining power and ability to readily identify exercises of market power.[162]

The Australian Energy Regulator recognised this and has in place information disclosure requirements. The goal of this is to not only reduce the information asymmetry in negotiations but facilitate more timely and effective negotiations to limit any reliance being placed on the arbitration mechanism.[163]

Guidance is also available on this issue in the aviation sector. Following the 2009 EU Directive on Airport Charges[164] and extensive consultation and review by a forum of Airport Charges Regulators, IATA produced comprehensive Detailed Transparency Requirements outlining the key information required and the justification for its inclusion.[165]

In order to ensure that any change to the regulatory regime is appropriate, reasonable and fit for purpose, A4ANZ believes that there must be comprehensive and ongoing consultation with all airport users.

Governance and consultation

Once implemented, it should not be assumed that the presence of a credible regulatory threat will automatically lead to timely and effective consultation, and we would recommend that the PC also consider guidance on this topic. This will avoid issues such as those referred to earlier in this document and captured below by IATA[j]. Following best practice guidance on governance and consultation:[166]

- Avoids “done deals” and “lip-service” consultation;
- Recognises airlines affordability and airport charges as a fundamental criteria;
- Avoids over-specifying and “gold-plating” investments;
- Allows planning to minimise operational disruption during build;
- Allocates project priorities - balancing operational requirements with airport commercial revenues; and, importantly,
- Considers alternate options to optimise the use of existing infrastructure and “do-nothing” scenarios.

As this is an approach accepted by EU Airport Regulators and enshrined in the ICAO principles of consultation and transparency[167], there is no reason why Australian regulators ought not to have the same expectations. Furthermore, ensuring that the implementation of a pathway to negotiate arbitrate is coupled with requirements for information disclosure and consultation will not only facilitate more effective commercial negotiations between airports and their customers but will minimise the chance of those negotiations failing and proceeding to arbitration.

[j] The guidance is included in IATA’s submission to the Productivity Commission

COSTS AND BENEFITS OF EFFECTIVE REGULATION

This section aims to address Information Request 2, Part 3: ***"The Commission is also seeking evidence on…the potential costs and benefits of changes to the regulatory regime".***

To assist us with the task of responding to this information request, A4ANZ engaged Frontier Economics to assess the potential costs and benefits of our proposed changes to the current system. The following section has been drafted using the outcomes of that analysis, and the full results are contained in ***Appendix B****: Economic Evaluation of an Alternate Approach to Airport Regulation*.

Proposed Remedy

For Frontier's assessment, they assumed that, in addition to a deeming provision, the new regulatory regime would involve three key modifications to the status quo:

- The introduction of an information transparency and disclosure regime to address informational advantages airports can leverage over airlines during negotiations.
- The introduction of a Final Offer Arbitration (FOA) regime to act as a threat of arbitration and therefore constrain an airports ability to exploit its market power during negotiations.
- Minor amendments to the ACCC monitoring regime to improve its effectiveness in identifying the misuse of market power.

Summary of Impact – Administrative Benefits

Input from both regulatory and economic experts showed that the proposed remedies will not increase administrative and compliance costs relative to the base case (which reflects the status quo). As Frontier Economics found, this is due to the fact that:

- The continuation of the ACCC's monitoring regime with some minor revisions in approach to better support negotiations will not impose any significant additional administrative costs on the ACCC. This is because the ACCC already collects much of the information required, and airports will continue to provide largely the same information to the ACCC. Frontier estimate that the minor amendments to the ACCC monitoring regime may create a one-off cost of $2m associated with the ACCC initially implementing the changes.[k]

- An information disclosure regime intended to facilitate bargaining and a negotiated outcome is also expected to involve minimal incremental costs. Costs associated with an enhanced information disclosure regime are not expected to be high: we estimate the net present value (NPV) of this additional administration cost to be $8.9 million.[l] However, an information disclosure regime will also decrease administrative cost for both airlines and airports by increasing the probability of an agreement being reached more efficiently. This may offset this additional cost.

[k] This would equate to the cost of 3 FTE staff working on implementing changes for 2 years, plus an additional 700k in consultancy services or government overhead costs.

[l] For costing purposes, Frontier have assumed that there are a total of 30 airport-airline negotiations occurring around Australia in any one year 4 of which involve a major city or regional airport and 26 of which relate to regional airports (based on information provided by A4ANZ). And that it initially costs an airport $80,000 to collate the necessary information for airlines at major city/regional airports and $40,000 for smaller regional airports. We have also assumed the processes for providing this information become streamlined over time such that the costs reduce by 40% after 3 years.

- When compared to time-unlimited negotiation, enabling access to FOA, in tandem with the information transparency and disclosure regime, is more likely to lead to more timely and therefore lower cost resolution of any disagreements than under the base case. If these reforms decrease the time spent on negotiations by 20%, Frontier estimate the administrative cost of negotiations would fall by $3.7 million per annum which equates to a total saving in NPV terms of $33.6 million.

- Frontier consider the proposed reforms are likely to reduce administrative and compliance costs by up to $22.7 million dollars on an NPV basis. While it could be argued that there are additional costs associated with enabling airlines and airports to access independent FOA arbitration, it is not immediately clear what these would be. As highlighted earlier, Frontier do not consider that direct access to an FOA regime will necessarily encourage parties to expeditiously seek arbitration and therefore increase administrative costs associated with the regime. Even taking the counter view, there would have to be a significant number of arbitrations under the new FOA regime to counteract the estimated administrative and compliance costs savings of $22.7 million dollars outlined above.[m] Furthermore, airlines and airports should – under the status quo – already be developing and presenting competing offers as part of the negotiation process.

Historically, it has been well-recognised that when airlines are able to reduce costs in any part of their business they have reinvested in improving the consumer experience.[168,169] A4ANZ members note that the reduction in the resources spent negotiating with airports would allow them to invest in:

- Building fleet capacity, instead of simply replacing aircraft;
- The preservation of essential regional air services;
- Collaborating with airports to progress innovations in customer experiences;
- Improving both domestic and international service levels; and
- Other new and important initiatives such as pilot academies.

Summary of Impact – Wider Benefits

In addition to administrative costs savings, the proposed reforms will enable better-informed negotiations that deliver more efficient outcomes than the base case. The threat of arbitration under an FOA regime is intended to redress the market power that airports would otherwise be able to exploit during negotiations with airlines and therefore lead to more efficient prices.

While it is challenging to reliably monetise all these benefits, it is reasonable to expect that under the proposed regulatory reforms the airports' ability to exploit their market power would be reduced, leading to lower airport prices, and potentially lower airline charges - increasing demand on existing routes, and potentially driving new or more frequent connections. As such, Frontier have identified the following benefits;

- **Consumer surplus**: On existing routes, this fall in airport prices and the additional travel generated creates additional welfare for consumers. Frontier estimate that this could result in an average annual increase in demand of up to approximately 1.9% which would lead to a gain in consumer surplus of around $650 million per annum.[n] This equates to almost $5.9 billion on an NPV basis – the vast majority of this consumer surplus is generated on domestic flights.

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[m] For example, if we assume each time limited FOA arbitrations cost airlines, airports and the arbitrator, $1 million in total then the regime would need to drive over 22 arbitrations in the next 15 years to outweigh the wider administrative and compliance cost savings it generates.

[n] This assumes the proposed remedies will lead to lower more efficient airport charges, which we have estimated by removing the excess profit identified in our companion analysis of profitability. We used these lower charges to estimate a percentage reduction in

- **Travel time savings:** These arise because some passengers, under the status quo, travel to their destination indirectly. The estimated improvements in connectivity, will enable some of these passengers to fly directly to their destinations leading to reduction in travel time. These savings have been valued at almost $90 million a year[o], or $819 million on an NPV basis.
- **Additional catalytic impacts on GDP:** Improved connectivity with the rest of the world could ultimately help facilitate extra trade and FDI, which together could boost GDP. The key aspects of this causal relationship between connectivity and economic value is supported by empirical evidence and is summarised in Frontier's full report. It is estimated that the total increase in GDP would be $1.2 billion annually which equates to an NPV benefit of $10.9 billion. Frontier estimate that this figure equates to around 7,000 jobs.
- **Tourism benefits** of around $250m outbound visitor spending and around $230m inbound visitor spending. This result is driven by the fact that Australia is a net importer of tourism – i.e. marginally more Australians fly abroad than visitors fly to Australia, hence the extra demand is assumed to be made up of the same mix of passengers.
- **Wider Economic Benefits Domestic:** Although difficult to quantify, Frontier note the potential for wider economic benefits (WEB) to result from incremental improvements in air connectivity. This could include agglomeration effects and additional welfare gains associated with creating more competitive markets.

These additional benefits have, in the past, been ignored on the assumption that the price elasticity of air travel is low. However, Frontier found that together these benefits are sizeable and should not be ignored, particularly given the proposed remedies are likely to lead to cost savings.

airfares, assuming this reduction in airports charges is fully passed through to air fares. Using commonly applied estimates of price elasticities of demand for air travel we estimated the consequential impact on passenger demand on every route from nine key Australian airports . The output of this analysis is the increase in demand (in % terms and in the absolute number of passengers) both on individual routes and in total.

[o] For each of the (feasible) new direct routes, we have used a fixed cruising speed (800kmh), a fixed take-off/landing time of around 40 minutes and a one our lay-over, then calculated the distance and time of a new direct route. Assumptions associated with the value of travel time savings, has come from the Australian Transport Assessment and Planning guidance documents.

CONCLUDING COMMENTS

Airlines, airports and the aviation sector more broadly provide vital services to the Australian community and are key drivers of Australia's economy. A4ANZ believes that in order to ensure that this vital sector is efficient, sustainable, and continues to foster innovation, there needs to be appropriate airport behaviour and operations, and efficient access to airport infrastructure.

This submission began by outlining the expectations of both the community and industry of airport regulatory oversight, concluding that current settings are not achieving policy objectives. Whilst airports may claim to place "passengers at the centre" of decision making[170], the prospect of change to these regulatory settings - through a more effective threat - has elicited a largely negative response from them, rejecting it as unnecessary. The reasons for resistance are apparent if we consider credit analysts' description of the current environment as reflecting the sometimes-conflicting interests of customers and shareholders.

The intent of the current regulatory model for privatised airports in Australia goes beyond a debate about shareholders and customers, however. It was introduced in 2002 with an expectation that it would: promote the economically efficient and timely operation, use of and investment in airports and related industries, minimise unnecessary compliance costs on airport operators and the Government; and facilitate commercially negotiated outcomes in airport operations.[171] Unfortunately, more than 15 years on, these objectives are not being met, and the regulatory model is no longer fit for purpose. There is a large and ever-growing body of evidence clearly showing that under the current light-handed regulatory system, airports across Australia have been able to exercise their market power to extract excessive profits from airport users, without demonstrable improvements in quality or efficiency.

These excessive profits have come at a cost to the Australian community, both financially and through lost opportunities for improving the quality and efficiency of airport services. Clearly, more effective regulatory pressure is required to prevent the steady and largely unjustified increase in airport charges and return more value to consumers and the economy. This is particularly the case with an unprecedented pipeline of investment in airport infrastructure anticipated over the next 15 years.

A4ANZ's proposal for the addition of a negotiate-arbitrate pathway to give credibility to the regulatory threat accords with earlier proposals from regulatory experts and the ACCC, the latter providing the main consumer voice. Arguments against change to the current regulatory model are founded in criticisms of heavy-handed regulation, such as price control. Statements about investor uncertainty and lack of investment appear to be drawn from an assumption that any change means a shift towards full regulation – however, this is not A4ANZ's proposed remedy, as should be clear from this submission. Regardless, our proposal for the introduction of final-offer arbitration has already prompted objections from airport operators, who clearly consider that there is much at stake. It must be said, however, that if airports are confident that they are operating and investing in a timely and efficient manner, and that they are able to engage in genuine commercial negotiations with airport users (which cannot depend on goodwill alone), then there is very little to fear from a credible regulatory threat.

Airports, and indeed airlines, ought to make a profit. Healthy, profitable businesses are vital to our economy, through job creation and innovation. It is clear, however, that one part of the sector is capturing the majority of the benefits that the growth in our sector is bringing. A4ANZ members are committed to building, maintaining and improving positive, constructive commercial relationships with airports; with a view to seeing airports, airlines and the whole aviation sector prosper. The financial analysis contained in this submission clearly shows that the changes proposed by A4ANZ are not only in the airlines' interests, but also their passengers' interests, and the long-term interests of the Australian economy.

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APPENDIX A

The market power of Australian airports

A REPORT PREPARED FOR A4ANZ

September 2018

The market power of Australian airports

The market power of Australian airports

Boxes

Figures

Tables

Executive summary

What is market power and why is it important?

Australia's current light-handed approach to the economic regulation of airports is based, in part, on the implicit assumption that Australian airports do not have significant market power.

We question this. The natural monopoly characteristics of airports mean that larger airports are typically able to deliver aeronautical services more efficiently than smaller airports. This necessarily limits the scope for competition among airports.

An airport with market power has the ability to sustain prices for its aeronautical services above efficient costs or deliver a poor quality of service. This can prevent people travelling either because the cost of air travel is higher than it needs to be or because airlines can no longer profitably provide some services.

This acts as a drag on the economy. Higher airfares, resulting from higher airport charges:

- raises costs for business, hampering their ability to compete in Australia and abroad;
- reduces face to face connections between families, friends and communities; and
- constrains growth in both international and domestic tourism.

This report considers what it is about airports that gives rise to market power and outlines a framework for further assessing the likelihood and extent of an airport's market power, by considering what competitive forces airports may face. This involves exploring the factors outlined in Figure 1 for the airport in question.

Using this framework, the report then explores whether there are any circumstances where Australian airports could face a material competitive constrain from other airports, other mode or other destinations.

In short, we find that there are very few circumstances where an Australian airport may face a significant competitive constraint on its market power.

Figure 1: Airport market power assessment framework

Source: Frontier Economics

Options are limited for passengers

The competitive constraints on an airport are driven by the degree to which passengers have alternative ways of satisfying their demand for travel. This could be through alternative airports, using other land-based modes or travelling to other destinations. Airports that face more significant substitution possibilities will face more price-sensitive demand (and hence have less market power).

It is important to note that the existence of choice does not equate to effective competition. To understand the extent to which alternative airports, modes and destinations act as a competitive constraint on an airport it is necessary to understand how many passengers would switch in response to rises in airport prices.

Competition between airports is not relevant in the Australian context

There are very few circumstances in Australia where a major population centres could be argued to be fully serviced by two or more airports. Even where there is

the prospect of choice, the literature shows that access time, and the frequency of air services from an airport, drive passenger decision making. For the majority of passengers, the additional travel time associated with getting to a more distant airport is high relative to any difference in airfare[1]. This means a passenger's preparedness to switch to a more distant airport in response to a change in air fares is extremely limited. Adding to this there are likely to be limits on an airlines ability to shift its services. For example, due to capacity or operational constraints at other airports and the high costs associated with switching.

In theory an airport may face competition from more distant hub airports if connecting passengers are able to choose alternative air travel routes between their origin and ultimate destination. However, this is not considered relevant in the Australian context. While connecting passengers represent between 30-60% of passengers using major hubs in Europe they represent only a small fraction of the overall passenger traffic using Australia's major city airports —less than 1%. This is unlikely to pose a material competitive constraint on an airport.

Modal substitution is unlikely to be material

For a select few Australian airports it may be possible for some passengers to use alternative modes of transport on some routes. However, the extent to which this act as a competitive constraint on an airport is limited by a number of factors:

- Airport charges constitute a small proportion of the cost of airlines — This as means these charges only increase air fares to a limited degree, which in turn dampens the demand response of passengers to any increase in airport charges, enhancing airport market power.
- Modal substitution will only be a relevant consideration for short haul routes— this means only a proportion of passengers serviced by an airport have any capacity to switch which increases the ability of an airport to profitably raise prices.
- Business travellers are relatively price insensitive — For airports servicing a high proportion of business travellers the demand response to any increase in airport charges will also be limited, further enhancing airport market power.

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1 The relative importance of these factors varies between different groups of passengers, with business travellers weighting access, time and flight schedules more heavily than non-business travellers, for whom airfares become more significant determinates of choice.

Destination substitution may be relevant, but only in specific circumstances

For passengers travelling for leisure a viable travel alternative maybe another destination —for example holiday marker may regard Port Douglas and Cairns as substitutes for the Sunshine Coast.

This will only constrain an airport's market power if it predominately services the inbound discretionary tourism market.

Airline countervailing power will not protect against airport market power

Countervailing power is a term used to describe the ability of large buyers in concentrated downstream markets to obtain price discounts or counteract the ability of a supplier to exercise its market power.

We do not consider airline countervailing power to be a relevant consideration. This is because a necessary condition for countervailing power is that airlines have a credible option to cease or postpone their purchase or take up other 'outside alternatives'. In other words, the risk of an airline switching is only relevant where there is another potentially competitive airport or destination that could be serviced. There are very few circumstances in Australia where this pre-condition would hold.

For an airline the cost of withdrawing or reducing its services would be high. Airlines suffer significant brand damage when they attempted to reduce services, this can also affect the configuration and reach of their network and ultimately their profitability.

1 What is market power and why is it important?

1.1 What is market power?

Market power and competition are essentially polar opposites. That is, a firm's market power is its freedom to set its prices and other conditions of dealing independently of the constraints which would otherwise be imposed by competitors.

An airport is subject to effective competition if it does not have the power to choose its level of profits by giving less and charging more.

In the absence of effective competition, an airport can be considered to have market power[2].

1.2 What about airports gives rise to market power?

The natural monopoly characteristics of airports suggest that, as a starting premise, they can be presumed to have market power in providing aeronautical services.

These natural monopoly characteristics suggest a single airport is likely to be able to deliver aeronautical services more efficiently than multiple airports operating in competition. However, this also means airports tend to be geographically spread and hence the scope for direct competition is limited.

The natural monopoly nature of airports stems from the high fixed and sunk costs involved, from their characteristics as a network and from the challenges associated with developing an alternative airport.

The existence of a natural monopoly does not necessarily indicate substantial market power. However, where a natural monopoly has substantial sunk costs and a location that cannot readily be replicated, the market power of the incumbent is likely to be substantial.

1.2.1 High fixed and sunk costs

Airport services are provided using facilities that require large capital investments much of which is fixed, irrespective of the number of airlines or passengers served. Services that involve high fixed and sunk costs tend to be natural monopolies.

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2 This is not the same as an airport having the ability to generate a competitive advantage. Rather, market power is the ability to sustain a competitive advantage because rivals (incumbents and potential entrants) are unable (in a commercial sense) to emulate the source of its competitive advantage.

Investments in runways and terminal facilities involve sunk costs because the facilities have no alternative use). They are also lumpy and do not vary with incremental increases in output until some significant threshold is reached. In other words, investments in airport expansions (or in a new airport) are indivisible and require a minimum level of demand to be viable.

Furthermore, it likely to be cheaper for the airport to invest in expansions rather than to duplicate airport facilities. This means, particularly in relation to runways, that one airport is likely to be able to provide aeronautical services at lower cost than two.

1.2.2 An airport as a network

An airport is a facility at which various transport routes (principally air transport) intersect to form a network. The network enables passengers and freight to transfer from one transport route to another.

Networks also tend to be natural monopolies.[3] That is, they provide services that can most efficiently be provided by one enterprise.

The intuition behind this is straightforward. For example, if passengers and freight arrive in Sydney by one means of transport and need to transfer to other transport routes, it saves time and expense if those other transport routes converge at the same point. As this is true of all routes by which passengers and freight arrive, airport services will have strong natural-monopoly characteristics. This has led to the development of hubs and bases which creates network benefits for both airlines and passengers (particularly in relation to international and long-haul flights).

1.3 Why we should care?

An airport with market power has the ability to sustain prices for its services above efficient costs. This a problem for a number reason.

First it can prevent some people from travelling (below what would otherwise be efficient). This could be because the cost of air travel is higher than it needs to be or because airlines can no longer profitably provide some services that they may otherwise have provided.

Second, it may divert travellers away from using aviation services even where they are the most efficient way to get from A to B.

3 William W Sharkey, *The Theory of Natural Monopoly,* Cambridge University Press, 1982, Ch 9.

Together these outcomes act as a drag on the economy. For example, higher airfares can affect business input costs and the ability of companies to compete in Australia and overseas.

Other consequences could include a decline in service quality or impacts on investment incentives.

Ex ante regulation is an appropriate response where competition is ineffective in promoting efficient outcomes. However, the regulatory process must commence with an assessment of whether airports possess significant market power such that they should be subject to regulation.

What is market power and why is it important?

2 Approaches to assessing Airport market power

2.1 Market power can be measured in a number of ways

"Market power can be defined as the ability of a firm to raise prices above the supply cost without rivals taking away customers in due time, supply cost being the minimum cost an efficient firm would incur in producing the product"[4]

Economic literature relies heavily on the structure-conduct-performance 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 result in 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.

There are significant challenges associated with assessing the conduct and performance of Australian airports, particularly for the vast majority of airports that are not subject to the ACCC's monitoring regime (see Box 1).

For this reason, we have focussed on assessing structural features of the market and how these can be used to draw conclusions about an airport's market power.

Box 1: The challenges associated with conduct and performance-based assessments of an airport's market power

Conduct and performance based assessments of market power rely heavily on examining the prices and profits of the firm in question. The ACCC has been monitoring airports for almost 20 years and has been reluctant to draw strong conclusions from monitoring data it

4 Queensland Wire, op. cit. note 1 at 189

has collected. This should come as no surprise as there are a number of challenges associated with undertaking price and profit based assessment of Australian Airports.

First, it is difficult to interpret and draw conclusions from an assessment of airport charges at a point in time. The pricing of services, to any particular airline at any point in time will almost certainly be driven by a wide set of issues associated with capacity, quality, level of service and the revenue generated through other complementary activities.

Second, while consideration of prices over a longer time period could provide some indication, this would need to be compared to some form of benchmark. Otherwise higher prices may arise from increases in factor costs, imposed new services or from exogenous shocks in demand. It is difficult to determine whether an airport is pricing efficiently in absence of knowing either:

- the efficient long-run cost base (to determine whether prices generate revenues that exceed costs overall) and/or
- reliable benchmarks of pricing by efficient comparators.

Obtaining the information necessary to articulate these benchmarks is challenging. Comparisons of prices, costs, profits and service levels between airports are complicated by differences in size, configurations, demand etc. which means that 'like-for-like' comparisons are challenging and potentially misleading.

Finally, an assessment of profitability must be done over long periods of time. Short run assessments of profitability struggle to distinguish between profits that are symptomatic of market power andthose which are due to high levels of efficiency. This makes unambiguously proving misconduct challenging.

Deriving meaningful results requires consideration of historic information, over a significant time period. Which has only just become feasible for those airports (Sydney, Melbourne, Perth and Brisbane) that have been subject to the ACCC monitoring regime. For all other airports data are not readily available to facilitate the use of profitability data to assess market power.

Source: Frontier Economics

3 A structural approach to assessing market power

3.1 Overview of key considerations

3.1.1 The purpose of the assessment

When developing a framework for assessment it is important to keep the purpose in mind. In this report we are primarily considering whether an airport has market power, over the bundle of services passengers use[5], which, absent regulation, it could potentially exploit[6].

It seems likely that airports may differ in their degree of market power. Therefore, the question becomes, which airports in Australia are likely to hold more significant market power.

3.1.2 Does an airport face elastic demand when pricing competitively?

A firm has market power if it can profitably charge prices significantly above the competitive level. For this to be possible, there must be relatively little substitution or switching to other travel options as the firm raises its prices above the competitive level. In other words, if passengers are unable or unwilling to choose an alternate travel option in response to an airport raising its prices above the competitive level (in a significant non-transitory way) then that airport would appear to have market power.

An empirical measure for this is the airport's own-price elasticity of demand. This is the percentage change in quantity (i.e. passengers) that results from a one percent rise in its price. Elasticities can provide an indication of a firm's degree of market power. High demand elasticities (elastic demand) reflect competition in a market. While low demand elasticities (inelastic demand) suggest the presence of market power — since the firm can increase its price without significant substitution.

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5 This report is considering how to assess the degree of an airport's overall market power. We have given limited consideration to freight. This is based on the assumption that most freight travels on passenger flights, which we are presuming are primarily driven by changes in passenger demand.

6 The framework does not attempt to separate the task of defining the market and assessing market power (on the basis of calculating market shares). As noted by Barker *"market definition may make little contribution to antitrust analysis, for example, when market boundaries are difficult to draw, making the resultant market concentrations statistics close to arbitrary"* (Source: Barker, J. (2007) *Market definition: an analytical overview,* Antitrust Law Journal, Vol 74, p131.)

Directly measuring an airport's own price elasticity is difficult and prone to misinterpretation for a number of reasons.

First, this measurement needs to be done at the competitive price level. It can be expected that if an airport has market power it may raise its prices to the point just below where substitution becomes likely. Therefore, measuring price elasticity at this price point will make it appear that the airport faces price-sensitive demand and hence has lower market power (see Box 2 for a more detailed explanation of this).

Second, demand for an airport's services are derived. In other words, an airport provides inputs that are used by airlines to provide a variety of aeronautical services to passengers. In fact, landing charges only represent a proportion of an airline's costs; and tracing how a change in aeronautical charges flows through to airfares is challenging. Airlines should not be expected to pass these costs through to all passengers equally, on all routes, if they are to minimise the extent to which they lose passengers. This means that while the response of passengers to changes in airfares can be measured the response of passengers to changes in airport charges cannot.

Box 2: Measuring own price elasticity and the *cellophane fallacy*

Commonly used formal market power tests require the competitive price level to be identified. However, there is a probability that an airport's existing charging structure already incorporates some exploitation of market power.

In other words, 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.[7]

Source: Frontier economics

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

3.1.3 How else can this be determined?

To understand market power you need to understand what passengers want to buy and what alternative ways they have of satisfying that demand? And, if the current alternatives appear limited, whether there are new ways that can be found to meet this demand.

By considering the possible substitution alternatives available to passengers (who use or could use an airport) it may be possible to draw inferences about the extent to which passengers respond to an increase in an airport's charges and the extent to which these constrain the airport.

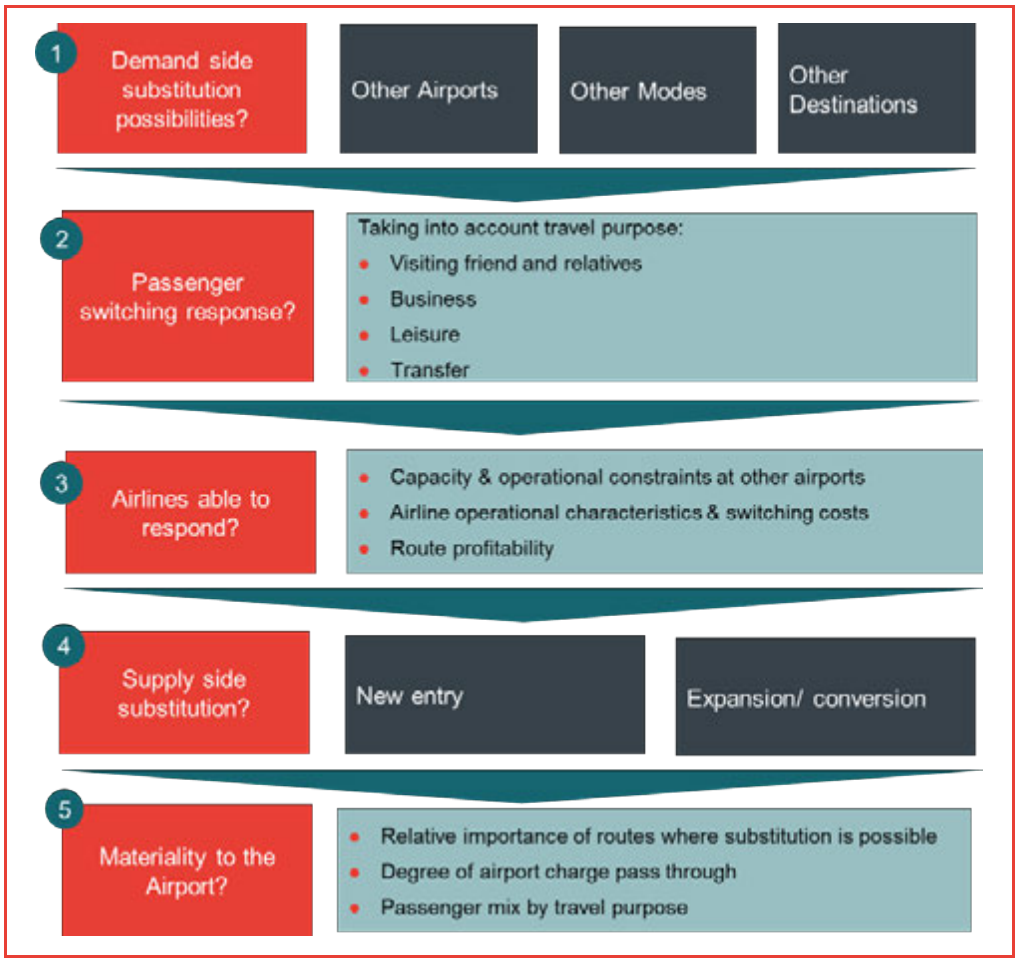
Since the demand for an airport's services is a derived demand, the elasticity facing an airport will be influenced by:

- The existence, or potential existence, of alternative **substitution possibilities** or travel options.
- **The likelihood of passenger switching** or the elasticity of demand for air travel to or from the airport in question and the proportion of airline costs accounted for by airport charges.
- The **responses of airlines** to passengers' preparedness to switch.
- The possibility of **supply side substitution** — the extent to which other airports can be developed or expanded to meet demand.
- The **materiality** of any overall switching response from the point of view of the airport.

All things being equal airports that face more significant substitution possibilities will face more price-sensitive demand (and hence have less market power).

Figure 2 below summarise these key considerations in assessing an airport's market power.

Figure 2: Key considerations when assessing airport market power



3.1.4 Market power should be assessed across the bundle of services supplied to users

Airports supply a range of services, making use of a range of different facilities. Some of these services are supplied directly to passengers and others are supplied to airlines or retailers, who in turn provide further services to passengers. The key services relevant to passengers, include:

- aeronautical services, associated with access to runways, terminals and other airside infrastructure facilities— these services are provided chiefly to airlines which provide services to passengers;
- landside access to the airport, via roads, parking and loading spaces — these services are provided directly to passengers, car hire companies, and transport providers (such as taxis); and
- retail tenancies — these services are provided to concessionaires which provide retail services to passengers.

In this report we are considering whether an airport has market power, over the bundle of services passengers use (either directly or indirectly). In this context it is inappropriate to assess the market power of an airport on a service by service basis. Rather the focus should be on the combined bundle of services consumed by passengers.

The demands for an airport's different services are interdependent. By way of example, the more flights to the airport, the more passengers; the more passengers, the more retail services consumed[8]. This interdependency means that airports may quite rationally charge prices for any one service that result in the under- or over-recovery of the incremental costs of that service, as this can increase their profits overall.

This means making inferences about an airport's market power by looking at outcomes (or price-cost relationship) associated with any one service may be misleading. Rather an airport's market power should be assessed with respect to their total operations.

A narrower approach to market power assessment (which accounts only for only aeronautical service) may be appropriate if an airport's other activities are constrained by competition. However, there is a material risk that substitution occurs because prices are already at levels reflecting the airport's exercise of market power (see explanation of 'the cellophane fallacy' in Box 2).

Furthermore, an airport has market power over bottleneck facilities required by its potential competitors which it can potentially leverage 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.

3.2 Demand side substitution possibilities

From the perspective of an airline passenger the broad categories of substitution, or alternative travel options available, could relate to:

- other airports,
- other modes of transport such as road or rail to get to their end destination and,
- for some passengers, other travel or holiday destination choices.

8 This suggests that an airport when structuring its charges would take account of the interdependencies among the demands of the various groups it serves. For example an airport would set its prices for retailers and airlines after considering the interdependencies in demand between these two groups of groups.

Assessing the extent to which these demand side alternates (other airports, modes or destinations) represent real choices for passengers will depend on a further set of considerations.

3.3 The likelihood and degree of passenger switching

If enough airline passengers are able and willing to choose an alternate travel option in response to an airport raising its prices above the competitive level (in a significant, non-transitory way) then an airport could be considered to face a competitive constraint.

The degree and likelihood of passenger switching in response to a price change will be affected by:

- the degree to which the airport's price rise is passed through to passengers; and
- passengers' price elasticities — which will be impacted by the purpose for which they were travelling.

3.3.1 How airport charges pass through to airfares

The extent and way in which airport charges are passed through to airlines and ultimately passengers is uncertain.

For example, the percentage increase in air fares (or costs facing passengers) that would result if an airport imposed a small, but significant increase in its aeronautical charges (i.e. 5-10%[9]) could vary.

Airlines adopt a yield pricing approach. This means that airfares for any scheduled flight vary over time and across ticket types in order to best utilise available capacity. This makes understanding the share of airport charges in typical air fares and, the extent to which any increases are passed through to passengers difficult.

This means that the elasticity of demand faced by airports is dampened by the response of airlines. Enhancing the prospect for market power.

3.3.2 Taking into account travel purpose

Understanding whether alternate travel options act as a constraint on an airport also requires developing an understanding of how likely passengers are to choose one option over the other given the service characteristics of these different alternatives; and their relative prices or price differentials.

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9 As per a SSNIP test. See Massimo Motta, Competition Policy, Theory and Practice, Cambridge University Press (2004) pp 102-104.

Factors that influence passenger decisions over travel alternatives include factors that affect the relative cost of each mode (both in financial terms and in convenience and the time taken to travel).

Different passenger segments also vary in their price responsiveness. This is likely to be driven by the value they place on time — which creates differences in respect of the substitutability of different airports and travel modes. Box 3 summarises the key outcomes of a literature review prepared for IATA on elasticity of air travel.

Overall, leisure travellers can be expected to have more elastic demand. This is because they may have more flexibility in their travel plans and the possibility for substitution is likely higher. By way of example, inbound passengers that are looking to travel to a particular airport to visit friends or relatives would not see alternative destinations as a substitute. While inbound passengers travelling for leisure may. A study by Morrison and Stewart found that short haul demand elasticities for air travel range from -0.7 for business travellers to -1.5 for leisure travellers.[10] This implies that a 1% increase in air fares will lead to a 0.7% fall in demand for air travel by business travellers and a 1.5% fall in demand for leisure travellers.

The demand elasticity for an airport's aeronautical services will be impacted by the weighted composite of the price elasticities of the different market segments it serves[11].

Therefore, in general, airports with a greater proportion of leisure traffic are likely to have more elastic demand, than those with a higher proportion of business passengers or inbound passengers visiting friends and relatives.

Box 3: Key factors affecting air fare elasticities

An extensive literature review by InterVISTAS Consulting on behalf of IATA 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).

10 Gillen, Morrison and Stewart (2002), Air Travel Demand Elasticities: Concepts, Issues and Measurements cited in IATA Air Travel Demand, Economic Briefing No. 9.

11 This assumes an airport does not have the capacity to price discriminate between different passengers. This is not wholly true as there may be some capacity for price discrimination by airline, or by time of travel.

A structural approach to assessing market power

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 1hour 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 air fares not airport charges. Given airport charges represent a small proportion of airlines costs, these elasticities imply a very small reduction in demand for air travel as a result of a rise in airport charges.

For example, if airport charges rise by 10% (and this represents 5% of an airlines costs) and this is proportionately passed through to all passengers, airfares would rise by 0.5%. An elasticity of -1.5 would imply demand for air travel would fall by 1.5%

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

3.4 The response of airlines

For passengers to exercise choice airlines must be able to facilitate that choice. To do so, airlines must be willing to develop a route or relocate enough of their services to another airport.

The extent to which passengers are prepared to substitute away from using a particular airport will influence the decisions made by airlines, by virtue of the impact on the profitability of affected route. However, there may be limits on an airline's ability to respond to any demand substitutability because of

- Operational constraints — In particular the capacity, price and quality of service provided by alternative airports. From the point of view of an airline its response to an increasing in charges will depend on the extent to which other airports represent viable substitutes.

- Switching costs—For airlines, switching costs involved in moving airports would include relocating equipment or staff, as well as the costs involved in marketing a new route (see Box 4).

Generally switching costs can be expected to be higher for airports that act as a base for an airline (i.e. where they utilise overnight hanger or parking spaces and other storage and maintenance facilities). This is because there will be:

- a larger number of routes affected, increasing marketing costs;
- higher contract cancellation costs as airlines are likely to have entered a larger number of contracts for maintenance, catering etc at the base airport; and
- costs for relocating crew that would not be incurred when switching destination airports.

Switching costs associated with moving from a hub airport are likely to be even higher than for base airports. This is because hub airlines benefit from the network externalities that hubs can create. In the case of switching a particular route from a hub airport, an airline may incur significant losses in network externalities.

Box 4: Airline switching costs

Switching airports is costly for airlines. Airlines may experience switching costs due to:

- relocation of assets at a new airport i.e. airline specific terminal facilities (check-in desks, airport lounges etc.) and maintenance facilities;
- staff costs including relocation, recruitment or redundancy;
- breaking long-term commitments;
- loss of economies of scale, for example if splitting operations across more than one airport.
- Airlines starting a new route will also need to incur significant marketing costs in promoting the routes to potential passengers in that catchment area and to generate awareness.

Source: IATA (2013), Airport Competition, Economic Briefing No. 11

3.5 Supply side substitution

The natural monopoly nature of airports (see section 1.2) limits the threat of new entry.

Entry into the market for supply of airport services encounters the challenge of securing access to land in a suitable location near major population centres (for a new airport or expansion) and getting permission to operate this as an airport. Land costs can be high, and the planning restrictions and approvals associated with airport development can create significant delays. As a result, in the short-term, incumbent airports have reasonable certainty that a rival airport cannot enter or expand capacity.

In the longer term, the potential for new entrants to provide aeronautical services, depends on the extent of barriers to entry or expansion such as:

- the extent of sunk costs;
- the impact of planning regulations including environmental legislation;
- the extent of airline lock in; and
- the indivisibility of investment.

3.6 Assessing materiality

What level of passenger switching would be material to an airport's pricing decisions? To analyse the strength of the response of passengers, it is necessary to consider:

- the routes or connection for which substitution is possible and their relative importance in the airport's overall traffic mix;
- the degree to which an increase in airport charges (say by 5-10%) will be passed on to these different passengers through airfares on these routes;
- the relative breakdown of passengers by travel purpose;
- the demand elasticity of passengers 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 (the critical loss).

4 Competition from other airports

The most obvious choice for passengers exists when a catchment is served by more than one airport. But the extent to which one airport represents a viable alternative to another is a matter of degree. In this chapter we consider how to apply the framework described above when looking at the possibility of an airport facing competition from another airport.

Given the natural monopoly characteristics (discussed in section 1.2) there are very few major population centres in Australia that could be argued to be serviced by two or more airports. The exception being the Brisbane/Sunshine Coast/Gold Coast region and to a lesser extent Sydney/Canberra region.

As discussed in chapter 3, understanding whether and to what extent one airport acts to constrain another involves developing an understanding of the likelihood of passengers switching, airlines being able to respond to the change in passenger preferences and the materiality of this change from the perspective of the airport.

4.1 Passenger switching response

From the point of view of airlines and their passengers other airports in the vicinity could provide substitutable, but differentiated, offerings.

4.1.1 Location, location, location

The substitutability of other, potentially competing, airports will depend primarily on their location, relative to the airport in question and passengers' origin/destination.

A common finding of studies looking at airport choice (in areas served by multiple airports) is that airport access time and the frequency of air services are the main determinates of the choice of airport[12]. Often the additional travel time and expense associated with getting to a more distant airport can be high relative to any difference in airfare.

The relative importance of these factors varies between different groups of passengers, with business travellers weighting access, time and flight schedules more heavily than non-business travellers, for whom airfares become more significant determinates of choice.

12 See Rogier Lieshout, (2012) *Measuring the size of an airport's catchment area,* Journal of Transport Geography 25 (2012) 27–34; Paliska. D, et al (2016) *Passengers' airport choice and airports' catchment area analysis in cross-border Upper Adriatic multi-airport region*, Journal of Air Transport Management 57 (2016) 143-154.

In the past, sector regulators have attempt to look at competition between airports by defining geographic catchment area for airports based on 'acceptable' drive times and looking for potential overlaps in these catchment areas. But this approach reveals nothing about the appropriateness, relevance or significance of these overlaps and whether the airports are acting as a competitive constraint.

First, it relies on an assumption about how far a passenger might be prepared to travel to reach an airport. This assumption is commonly made without basis and without accounting for a passenger's actual sensitivity to prices, travel time or route availability at different airports.

Second, the fact that some passengers have access to two airports within a certain travel time does not tell you the likelihood of a passenger choosing to switch away from their closest airport as a result of a change in airport charges. As a result, this approach does not help answer a question about the market power of an airport.

Consistent with the wider literature, analysis by Frontier Economics in Europe has shown that passenger preferences for travelling from their closest airport is extremely strong (see Box 5). The analysis focussed on assessing the competition faced by Stansted Airport. It suggested that a 10% reduction in airport charges at Stansted (fully passed through) might be needed to persuade a passenger to incur an additional 1% travel time.

Box 5: Importance of distance to a passengers' choice of airport

In 2013 the UK sector regulator the CAA was required to take a view on whether Stansted airport faced a competitive constraint from other airports in the south-east of the UK.

Using real customer data from easyJet's booking system which consisted of more than three million bookings on both holiday routes (e.g., to Malaga and Palma) and business or mixed routes (e.g., to Glasgow and Edinburgh) Frontier Economics Europe was able to build a detailed model of the determinants of passenger choices. From this it was possible to estimate the extent to which the price of a flight (for a certain route with a similar schedule) from an alternate airport would need to decrease to compensate the passenger from any increase in travel distance they face.

Using the passenger's post code, it was possible to estimate the drive time for each passenger to every relevant airport. It was also possible to compare the price paid at the time of booking by the booking passenger and by passengers choosing the nearest equivalent flight at an alternative airport. As a result, it was possible to identify own-price and cross-price effects on passengers' choices.

The modelling showed that passengers' preference for travelling from the closest airport is extremely strong. For every 1% increase in distance, the likelihood of them flying from that airport declines on average by 4%.

It must be remembered that price influences this choice. On average, for every 1% increase in distance, a 1% change in relative prices would be needed to persuade passengers to travel to the more distant airport. Assuming airport charges make up only about 10% of total ticket prices a 10% reduction in airport charges, fully passed through, might be needed to persuade a passenger to incur an additional 1% travel time.

This modelling can also be used to simulate the loss of passengers from moving a route to a new airport. By way of example, below shows the effect on demand of easyJet moving an existing service currently operating out of Stansted to East Midlands Airport (which was initially considered to have an overlapping catchment with Stansted Airport). The results

of this simulation show that easyJet's loss in passengers from such a move, while holding prices constant, would be very significant.

Table 1. Results of a simulation of easyJet moving a service from Stansted to East Midlands

	% loss in passengers
International flights	30-50%
Domestic flights	60-70%

These results show that a simple drive-time analysis is misleading. The isochrones around airports may appear to overlap, but the likelihood of a passenger choosing to switch between a close airport and a distant airport as a result of a change in airport charges is negligible. And the strength of this local preference traps airlines, making their relocation of services in response to an increase in landing charges extremely unlikely.

Source: Frontier Economics Europe

4.1.2 Passenger travel purpose

The importance of distance will in turn be affected by the nature of the passengers who use the airport. In particular airports with a large proportion of businesses travellers can be expected to face a less elastic demand which will dampen the extent to which other airports act as a competitive constraint.

With this in mind, it is possible that airport access time may be more important driver for passengers (using most Australian airports) than what might be indicated by the Stansted analysis (see Box 5).

The reason for this is that relatively few passengers using Stansted are understood to be travelling for business purposes — only 14% of outbound and inbound passengers.[13] The proportion of business travellers using Australia's key airports is likely to be much higher (between 30-60%).[14] This difference in passenger type suggests that passenger preference for the closest airport is likely to be even stronger in the Australian context.

4.2 Competition for connecting passengers

A recent report for the Airports Council International Europe (ACI Europe) noted that airports may face a competitive constraint from more distant airports. This

13 CAA Passenger Survey 2012 (source: CAA (2013) *Market power determination in relation to the passenger market at Stansted Airport –statement of reasons, CAP 1135 Appendix* F, p12)

14 Based on % of overnight visitors travelling for business purposes to Australian capital cities (source: Productivity Commission 2011, Economic Regulation of Airport Services, Inquiry Report no. 57, Canberra.)

may arise if connecting passengers are able to choose alternative viable air travel routes between their origin and ultimate destination. The theory being that if a journey is available through multiple airports it is likely that more distant airports will be in competition with one another for these connecting passengers.

This is unlikely to be relevant in the Australian context. While connecting passengers represent between 30-60% of passengers using major hubs in Europe they represent a very small percentage of passengers using Australia's major city airports (see Table 2).

Given connecting passengers represent only a small fraction of the overall passenger traffic through the airport the possibility of more distant hub airports acting as a competitive constraint is highly unlikely.

Table 2: Proportion of connecting passengers at different international airports

Airport	Proportion of connecting passengers
Frankfurt Airport	61%
Amsterdam Schiphol	38%
London Heathrow	30%
Sydney Airport	<1%*
Melbourne Airport	<1%*
Brisbane Airport	<1%*

*Source: OXERA (2017) The continuing development of airport competition in Europe, prepared for ACI Europe and *ACCC Airport monitoring report 2015-16, Supplementary Spreadsheet B - Indicators and statistics used (note. These figures include only transferring international passengers.*

5 Competition from other modes

From the point of view of passengers, alternative modes of travel could provide substitutable, but differentiated offerings.

However, this is only likely to be true for certain routes serviced by an airport. For example, driving may be a viable alternative for travelling from Sydney to Canberra, but not from Sydney to Perth.

A passenger decision over alternative travel modes would be influenced by the cost of travel on their chosen route (i.e. from their origin to destination) compared with alternative modes (taking into account both financial cost and travel time differences).

Other factors such as convenience, reliability and the number of people travelling together would also affect decision making. For example, (in respect to road transport) some travellers would place a high value on the convenience of having their car available at their destination.

Based on individual preferences, passengers will rank their transport options differently. It should be expected that different passengers vary in respect of whether they see alternative modes as potential substitutes and in their price responsiveness. 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.

Modal competition was considered by the PC to be an important constraint on Adelaide and Canberra's market power (see Box 6). The PC based this conclusion on the fact that a relatively large proportion of overnight visitors to ACT and SA arrived by private vehicle.

However, this tells you very little about market power. 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.

None of the previous PC Inquiry reports have presented evidence on the likelihood of passenger substitution for airports such as Canberra or Adelaide. For example, passengers have not been surveyed and there has been no attempt to estimate the degree to which airports consider alternative transport modes as competition — i.e. by looking at whether airports have raised (or lowered) prices in response to increases (or decrease) in the costs of potential competing modes.

The degree to which modal competition creates a credible constraint on an airport will depend on:

- how important short haul routes are for the airports profitability; and
- the price sensitivity of passengers on this route.

International evidence on price elasticities for air travel suggests that for short haul routes (less than 1hour travel time) elasticities may be on average 10% higher[15].This undoubtedly reflects the increasing importance of modal competition on these routes.

As discussed in chapter 4 airports with a larger proportion of business travellers will face dampened elasticity even where there are potential modal substitutes.

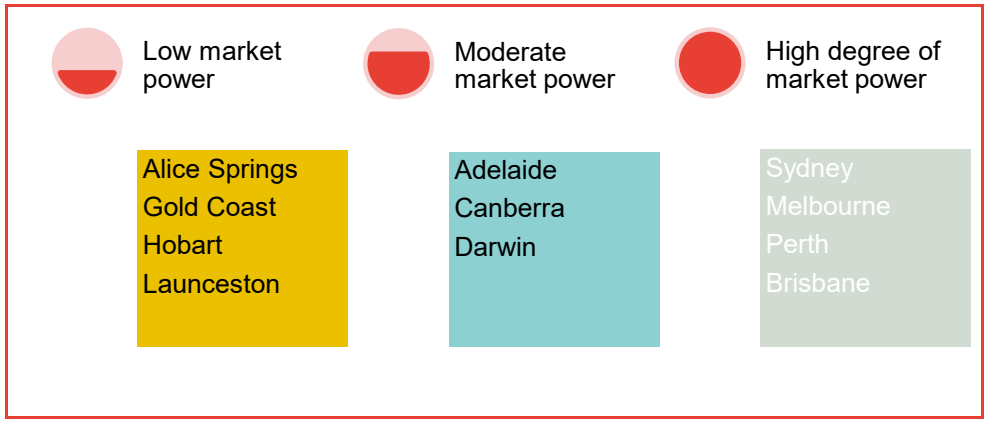
Box 6: Productivity Commissions past assessments of Airport Market Power

In 2001-2, 2006 and 2012 the Productivity Commission undertook reviews of airport economic regulatory arrangements. These included assessments of the ability of airlines or passengers to substitute away from the services provided by the airport (towards another airport, destination or other mode of transport).

The Productivity Commission's findings were used to determine those airports that should be subject to the light-handed regulatory regime: Sydney, Melbourne, Perth and Brisbane.

The Productivity Commission's most recent assessment (as shown in Figure 3) suggests that market power is strongest for Sydney, Melbourne, Perth and Brisbane airports.

Figure 3: Market power of the Australian airports, past findings



Source: Productivity Commission 2011, Economic Regulation of Airport Services, Inquiry Report no. 57, Canberra.

Source: Frontier Economics

15 *Estimating Air Travel Demand Elasticities, Final Report*, InterVISTAS on behalf of IATA, December 2007

6 Competition from other destinations

The most obvious choice for passengers exists when a catchment is served by more than one airport. But for some passengers a viable alternative maybe another destination. The extent to which this choice is relevant will depend on the passenger's purpose of travel and their origin[16].

Business travellers and those visiting friends and relatives will have limited discretion over their choice of destination (and hence airport), as will a passenger wishing to depart from the airport in question.

However, leisure traffic may be significantly more flexible as many destinations may be broadly seen as substitutes. For destinations to be seen as substitutes they do not necessarily have to be geographically close but they must have similar characteristics. For example, holiday travellers may regard Port Douglas and Cairns as substitutes for the Sunshine Coast.

To illustrate, it is helpful to think about an island served by a single airport (the island's only point of access). This airport is the only viable means of access to an island; however, it may not have significant market power if:

- the population base of the island is low, such that the majority of its traffic is inbound, and
- the island is primarily an optional destination for discretionary tourism.

If alternatively, the population base on the island is large such that a large number of passengers originate on the island, these passengers would have no alternative to the airport.

16 This choice will not be relevant to passengers wishing to depart from the airport in question. While they can choose an alternative destination, this will not affect their choice of departing airport.

7 Relevance of countervailing power

7.1 What is countervailing power?

The countervailing power of airlines is sometimes cited as a factor reducing an airport's ability to exploit its market power. Countervailing power is a term used to describe the ability of large buyers in concentrated downstream markets to obtain price discounts or counteract the ability of a supplier to exercise its market power.

7.2 Countervailing power is a misconception

Airline countervailing power is unlikely to be a relevant consideration in the Australian context. This is because a necessary condition for countervailing power is that airlines have a credible option to cease or postpone their purchase or take up other 'outside alternatives'. In other words, the risk of an airline switching is only relevant where there is another potentially competitive airport or destination that could be serviced. There are very few circumstances in Australia where this pre-condition would hold.

Considering this issue more generally it is clear that countervailing power is only relevant at the margin of any market power assessment and its relevance would depend on the relative bargaining power of airlines and airports.

Assuming airlines have some scope to withdraw their services, the relevant factors to assess are the relative costs airlines and airports face as a result of any break-down in bargaining.

The **cost to an airline** of withdrawing or reducing its demand equate to the costs (including opportunity costs) of switching its services or routes to another airport. It is worth highlighting that airlines would face significant brand damage if they attempted to reduce services. It would also affect the quality of their overall service. As discussed in section 3.4 switching costs will be higher, such that the countervailing power of an airline will be negligible where:

- the passengers or demands serviced by the airport in question are relatively inelastic;
- the airline has limited ability to access landing slots at other airports that meet the needs of the passengers; and
- the airport is significant to the airline in terms of either its profitability or as a result of the configuration of the airline's network.

The **costs to an airport** of ceasing to supply a specific airline will depend primarily on whether they have an alternative other than selling their services to the airline in question. This will vary depending on:

- the capacity of the airport, and whether it is presently capacity-constrained
- the intensity of airline competition or the existence of other airlines which are able to service demand for air services to and from the airport; and
- whether the airport is credit constrained or faces cash-flow problems such that it cannot reduce supply for any extended period of time.

The fact that an individual airline may threaten to withdraw its services is not sufficient to conclude that the airline has countervailing buyer power. If services from that airport remain profitable and there are alternative airlines able to provide services from that location, then the threat of withdrawing services are not credible and so would not constrain an airport.

For countervailing power to be at all relevant in relation to an assessment of market power any costs from a break-down in bargaining need to be predominantly borne by the airport. Therefore, what is important is the balance of the factors listed above.

To illustrate this, it is worth exploring a number of different scenarios.

First, assume there are a number of airlines using an airport and competition in the airline market is strong. If any individual airline unilaterally threatened to cease demand this would impose limited costs on the airport. This is because there is a high probability that another airline could take the place of the protesting airline. In this circumstance airlines are unlikely to exert significant countervailing power on the airport.

Second, consider two scenarios associated with a single airline being serviced by an airport. In these circumstances the possibility of countervailing power arising depends on the combination of the factors discussed above.

- Where an airline services a one-company mining town, the mine will be the main customer for flights from and to the airport. Any threat by the airline (or mining company) to stop using the airport might not be credible as it may lead to a significant drop in profits if workers cannot get in or out of the mine in a timely fashion. Therefore, assuming the airport has no short-term cash constraints, it is unlikely that the airline will have significant countervailing power.
- It is possible that an airline which services a small isolated airport and carries mostly tourists may have some countervailing power. A small private airport may not have sufficient cash flow to sustain it over the period it takes to get a new airline to service this route. However, this would rely on the airport in question being a destination airport rather than a base or central hub for the airline's network and not representing a major source of profit for the airline.

In summary, countervailing power will only be relevant to airports with less significant market power where there remains some scope for the airlines to

withdraw their services. In these circumstances the extent of countervailing power will vary from airport to airport.

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APPENDIX B

3 SEPTEMBER 2018

ECONOMIC EVALUATION OF AN ALTERNATIVE APPROACH TO AIRPORT REGULATION

REPORT PREPARED FOR A4ANZ

Frontier Economics Pty Ltd is a member of the Frontier Economics network, and is headquartered in Australia with a subsidiary company, Frontier Economics Pte Ltd in Singapore. Our fellow network member, Frontier Economics Ltd, is headquartered in the United Kingdom. The companies are independently owned, and legal commitments entered into by any one company do not impose any obligations on other companies in the network. All views expressed in this document are the views of Frontier Economics Pty Ltd.

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EXECUTIVE SUMMARY

A4ANZ has asked Frontier Economics to undertake an economic evaluation of its proposed reforms to the airport regulatory regime to inform its submission to the Productivity Commission's, July 2018 issues paper on the *Economics regulation of airports*. This report presents the outcomes of our analysis.

Many Australian airports possess and exploit market power

There is now convincing evidence that Australian airports have market power and have been exploiting this in their dealings with airlines. Frontier Economics' companion report on airport market power found that there were very few circumstances where Australian airports face any material competitive constraints.[1]

Furthermore, our analysis of airport profitability provides evidence that the monitored Tier 1 Australian airports have been exploiting this market power to earn excessive returns.[2]

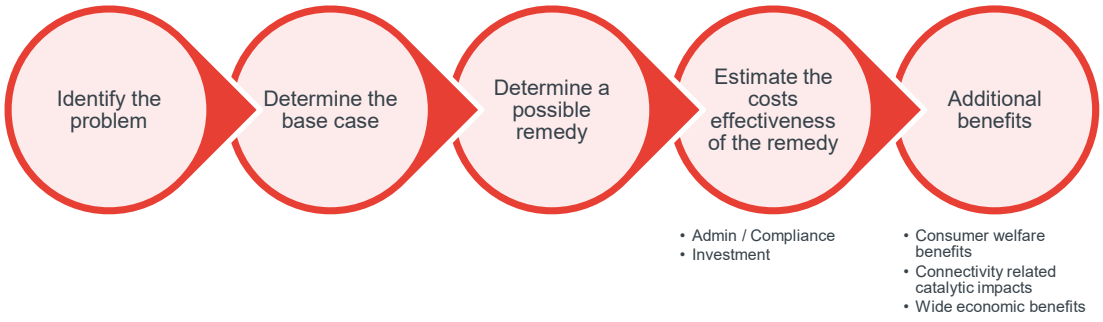
The excessive returns earned by airports prevents people travelling; either because the cost of air travel is higher than it needs to be, or because airlines can no longer profitably provide some services. This acts as a drag on the economy. Higher airfares, resulting from higher airport charges:

- raises costs for business, hampering their ability to compete in Australia and abroad;
- reduces face to face connections between families, friends and communities; and
- constrains growth in both international and domestic tourism.

In this report, we evaluate the economic costs and benefits of a set of regulatory reforms addressing these issues. This involves the key steps outlined in **Figure 1** below, the key elements of which are:

- **A cost effectiveness analysis** which considers whether the proposed remedies impose incremental administrative and compliance costs on industry and governments agencies relative to the base case.
- An analysis of the **incremental consumer and wider economic benefits** of the proposed remedies— focussing on consumer welfare and the catalytic impacts relative to the base case.

Figure 1: Evaluation of alternative regulatory approach



[1] Frontier Economics (2018) "The market power of Australian airports", prepared for A4ANZ

[2] Frontier Economics (2018) "The profitability of Australian price monitored airports", prepared for A4ANZ

Existing arrangements for mitigating airport market power are ineffective

Australia's current approach to the economic regulation of airports is light handed. It is intended to deter the exercise of market power through *ex post* evaluation of pricing and other conduct. Airports enter into bilateral negotiations with airlines on prices, terms and conditions under a purported threat of re-regulation.

However, when looking forward, the mechanisms intended to create this 'threat' look increasingly ineffective. Airports now face a much lower threat of government action to address their market power than they did in the past.

To be effective, an *ex post,* deterrent regime relies on a credible threat of effective punishments or suitably high penalties. The deterrent, in the current regime, is intended to be derived from the threat of:

- declaration of services under the *Competition and Consumer Act 2010* (Part IIIA); and
- re-regulation based on ACCC monitoring and regular reviews of economic regulatory arrangements by the Productivity Commission.

Our analysis suggests that the risk of airline-initiated action under Part IIIA of the CCA is now likely to be small. Recent amendments to declaration criterion (a) reduce airlines' ability to obtain declaration, and ultimately arbitration of terms, under Part IIIA (see Annex A). Furthermore, the risk of government-initiated action has also declined over time, given a history of inaction in response to airline and ACCC concerns, and past Productivity Commission recommendations.

The combined effect of these arrangements represents a 'deterioration of the threat' of arbitration/regulation meaning that airlines will face limited and declining bargaining power when dealing with airports into the future. This is the base case for this assessment.

The proposed remedies will not increase administrative and compliance costs

Our evaluation considerers the impact of the following key amendments to the existing arrangements governing airports:

- The introduction of a Final Offer Arbitration (FOA) regime to act as a threat of arbitration and therefore constrain an airports ability to exploit its market power during negotiations.
- The introduction of information transparency and disclosure requirements on airports to address informational advantages airports can leverage over airlines during negotiations.
- Minor amendments to the ACCC's existing monitoring regime to complement the information disclosure regime by helping airport users identify if they are receiving a 'good offer'.

Our analysis suggests that these proposed remedies will not increase the administrative and compliance costs relative to the status quo (base case). In fact, we think there is sufficient evidence to suggest that these remedies will lower administrative and compliance costs by $22.7 million on a net present value (NPV) basis (see **Table 2**).

This is primarily because, when compared to time-unlimited negotiation, enabling access to FOA, in tandem with the information transparency and disclosure regime, is more likely to lead to timelier, and therefore lower cost, resolution of any disagreements than under the base case. If we assume these reforms decrease the time spent on negotiations by 20%, we estimate the administrative cost of negotiations would fall by $3.7 million per annum which equates to a total saving in NPV terms of $33.6 million.

This cost saving well and truly offsets the additional increment costs that may be incurred by the ACCC in implementing a revised monitoring regime and the airports in complying with additional information disclosure requirements.

We do not consider that direct access to an FOA regime will necessarily encourage parties to expeditiously seek arbitration and therefore increase administrative costs associated with the regime (see section 5.2.2). Even taking the counter view there would have to be a significant number of arbitrations under the new FOA regime to counteract the estimated administrative and compliance costs savings of $22.7 million dollars outlined above[3].Nor do we consider there is any reason to assume the proposed remedies will have a detrimental effect on investment by airports which should be factored into the evaluation (see section 5.3). Theory would suggest that under the base case — with airports with monopoly power, subject to no regulation— you are likely to get inefficient investment compared to the social optimum. In fact, the proposed remedies are likely to have a beneficial impact on airline investment and therefore connectivity. Where an airport's market power limits the ability of airlines to enter into long-term arrangements airlines may be reluctant to make the necessary complementary investments to expand their network, for fear that an airport will be able to expropriate the value of any sunk investments.

Therefore, it seems reasonable to assume the proposed remedies will not harm investment incentives relative to the status quo.

Table 1: Summary of outcomes of the cost effectiveness analysis

Costs	NPV of Costs[4]
Cost to the ACCC of implementing minor amendments to its monitoring approach	$2 million
Cost to Airports from the introduction of an information transparency and disclosure regime	$8.9 million
Improved timeliness of negotiation	Saving of $33.6 million
Costs associated with arbitrations	Unvalued assumed to be low
Total	**Saving of $22.7 million**

Source: Frontier Economics

Additional benefits of the proposed reform are likely to be material

In addition to administrative costs savings, the proposed remedies will enable better-informed negotiations that deliver more efficient negotiated outcomes than the base case. This is primarily because the threat of arbitration under an FOA regime should redress the market power that airports would otherwise be able to exploit during negotiations with airlines.

[3] For example, if we assume each time limited FOA arbitrations cost airlines, airports and the arbitrator, $1 million in total then the regime would need to drive over 22 arbitrations in the next 15 years to outweigh the wider administrative and compliance cost savings it generates.

[4] Assuming a 15-year evaluation period, and real discount rate of 7%.

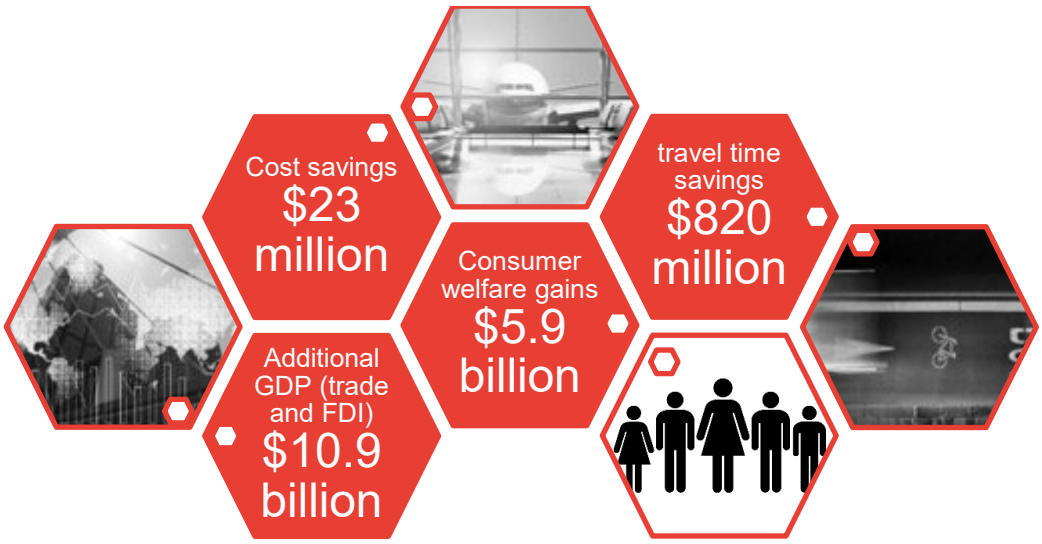
All thing being equal, this is expected to lead to more efficient prices for airport services which, in turn, will lower airline charges and therefore increase demand for air travel.

On existing routes, this additional travel can be valued in terms of the consumer welfare it generates. In addition, this increase in demand for air travel may also drive new direct or more frequent connections, which in itself may generate additional benefits.

These benefits have, in the past, been ignored on the assumption that the price elasticity of air travel is low. However, we find that together these benefits are sizeable (see **Figure 2**) and should not be ignored. Particularly, given the proposed remedies are likely to lead to cost savings.

Further details on these additional benefits follow.

Figure 2: Summary of benefits of the proposed remedies (NPV, value over 15 years)



Source: Frontier Economics

Consumer surplus on existing connections

Under the base case, Australian airports with market power can be expected to set aeronautical charges above the competitive level. We consider that with the proposed remedies, the airports' ability to exploit their market power would be reduced. All thing being equal, this would lead to lower airport prices, and therefore lower airline charges on existing routes. We estimate that this could result in an average annual increase in demand of approximately 1.9% which could lead to a gain in consumer surplus of around $650 million per annum.[5] This equates to almost $5.9 billion on an NPV basis.

The vast majority of this consumer surplus is generated on domestic flights. This is unsurprising given domestic air travel, under the status quo, would be more heavily affected by higher Australian airport charges (given these charges are incurred on both ends of the journey).

[5] This assumes the proposed remedies will lead to lower more efficient airport charges, which we have estimated by removing the excess profit identified in our companion analysis of profitability. We used these lower charges to estimate a percentage reduction in airfares, assuming this reduction in airports charges is fully passed through to air fares. Using commonly applied estimates of price elasticities of demand for air travel we estimated the consequential impact on passenger demand on every route from nine key Australian airports. The output of this analysis is the increase in demand (in % terms and in the absolute number of passengers) both on individual routes and in total.

It should be noted that this estimated consumer surplus represents both allocative inefficiencies (or dead weight loss) and the transfer of producer surplus to consumers (i.e. benefits that were previously captured by airports).

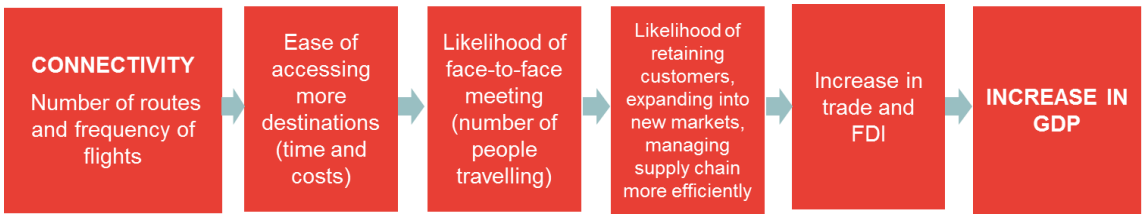
Potential benefits from improved connectivity

Lower airfares can be expected to drive new direct airline connections or, on existing routes, more frequent connections.

Our analysis suggests that there could be up to 35 new bi-weekly connections (centred on Asia) that might become feasible with lower airport charges (see Box 1: . This improved connectivity would drive the following benefits, relative to the base case.

- **Travel time savings.** These arises because some passengers, under the status quo, travel to their destination indirectly. The estimated improvements in connectivity, will enable some of these passengers to fly directly to their destinations leading to reduction in travel time. We value these savings at almost $90 million a year[6], or $820 million on an NPV basis.
- **Additional catalytic impacts on GDP.** Improved connectivity with the rest of the world could ultimately help facilitate extra trade and FDI, which together could boost GDP. The key aspects of this causal relationship between connectivity and economic value is supported by empirical evidence and is summarised in **Error! Not a valid bookmark self-reference.**. We estimate the increase in GDP to be $1.2 billion annually which equates to an NPV benefit of $10.9 billion.

Figure 3: Relationship between connectivity and economic growth



Source: Frontier Economics

[6] For each of the (feasible) new direct routes, we have used a fixed cruising speed (800kmh), a fixed take-off/landing time of around 40 minutes and a one our lay-over, then calculated the distance and time of a new direct route. Assumption associated with the value of travel time savings, has come from the Australian Transport Assessment and Planning guidance documents.

Box 1: Estimating new connections

To establish the extent of new connections that might emerge from lower airport charges, we consolidate 'beyond' demand. A beyond passenger is one that flies from the origin airport in question to the final destination via a hub – or in other words, either an 'indirect' passenger or a 'multi stop' passenger.

The analysis identifies routes where no direct connection currently exists today, but where there could now be enough beyond passengers to satisfy specific thresholds.[7] We found that there could be up to 35 new bi-weekly connections that might now be feasible with a reduction in airport charges[8]. These new connections primarily centre on direct flights to destinations in Asia.

Source: Frontier Economics

Other wider economic benefits

It also seems reasonable to conclude that improved domestic connectivity would generate productivity improvements by facilitating easier interactions between Australian firms and across supply chains. Given domestic travel represents the vast majority of flights taken from Australian airports this could be significant.

Although difficult to quantify, we note the potential for wider economic benefits (WEB) to result from incremental improvements in domestic air connectivity. This could include:

- **Agglomeration effects:** Efficiencies can be expected to arise when businesses and people are located more closely together.[9] This could be considered to occur when there is a reduction in travel time/cost arising from connectivity improvements. For example, this may increase productivity by providing firms with greater access to specialised or deeper labour markets, a larger choice of suppliers and/or facilitating the provision of specialised inputs more efficiently by virtue of reducing transportation time/costs.
- **Welfare gains associated with creating more competitive markets:** In markets for which transport is a significant input, lowering costs or increasing the timeliness of transport may enable businesses to expand into new product or geographical markets, in turn increasing competition in these downstream markets.

7 Based on the assumption of a bi-weekly flight with an assumed number of seats and load factor.

8 While our analysis suggests some of these new routes may be feasible in the absence of the reduction in airport charges, we are assuming that wider operational constraints may be preventing them from being developed and that these wider constraints may be more easily overcome with the estimated demand increase.

9 Productivity Commission (2017), Realising the productive potential of land, Supporting paper no 10, p3.

1 THE PROBLEM

Many Australian airports possess and exploit market power

There is now convincing evidence that Australian airports have market power and have been exploiting this in their dealings with airlines.

The high fixed and sunk costs associate with airport investment means that larger airports are commonly able to deliver aeronautical services more efficiently than smaller airports. This characteristic, along with the efficiencies that can arise when transport routes and connections converge at the one point, leads airports to be geographically spread and necessarily limits the scope for competition.

Our companion report on airport market power found that there were very few circumstances where Australian airports face any material competitive constraints.[10] Furthermore, our analysis of airport profitability provides evidence that the monitored Tier 1 Australian airports have been exploiting this market power to earn excessive returns.[11]

Airports also have informational advantages over airlines. These can be exploited during negotiations: airports know more about their own assets (including its costs, utilisation and capacity) than airlines. This gives airports an additional advantage during negotiations.

The combination of market power and informational advantages gives airports a bargaining edge over airlines. Airports can sustain prices for aeronautical services above efficient costs, even while delivering a poor quality of service or undertaking investment that is not in the interests of passengers.

This can prevent people travelling either because the cost of air travel is higher than it needs to be or because airlines can no longer profitably provide some services. This acts as a drag on the economy. Higher airfares, resulting from higher airport charges:

- raise costs for business, hampering their ability to compete in Australia and abroad;
- reduces face to face connections between businesses, families, friends and communities; and
- constrains growth in both international and domestic tourism.

In this report, we evaluate the economic costs and benefits of a set of reforms to the regulatory regime governing airports aimed at addressing these two issues — airport market power and information asymmetry in negotiations with users.

[10] Frontier Economics (2018) "The market power of Australian airports", prepared for A4ANZ

[11] Frontier Economics (2018) "The profitability of Australian price monitored airports", prepared for A4ANZ

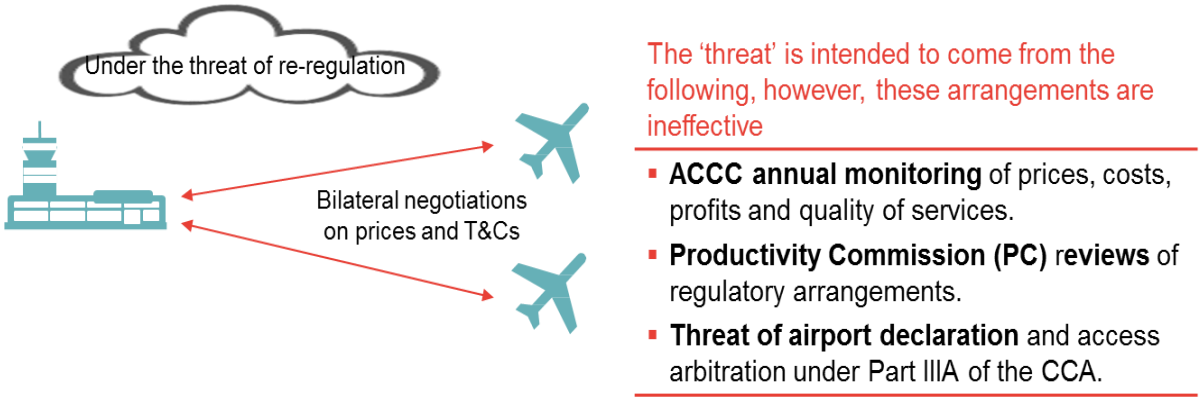
2 THE BASE CASE

Existing arrangements for mitigating market power are ineffective

Australia's current approach to the economic regulation of airports is light handed and intended to be an *ex post* (deterrent) regime. Airports enter into bilateral negotiations with airlines on prices, terms and conditions under a purported threat of re-regulation (see **Figure 4**).

However, when looking forward, the mechanisms intended to create this 'threat' look increasingly ineffective. So much so that we consider airports now face a much lower threat of government action to address their market power than in the past.

Figure 4: Australia's light-handed approach to regulation



Source: Frontier Economics

Firstly, to act as an adequate deterrent, an *ex post* regime relies on the ability to **identify, demonstrate and measure misconduct**. The ACCC annual monitoring of prices, costs profits and quality of aeronautical services and car parking at the four largest leased airports is intended to be the main mechanism for this.

However, the ACCC has not been able, or willing, to articulate whether and at what price or profit level an airport is exploiting its market power. The ambiguity around outcomes comes partly from the fact that the monitoring regime:

- Primarily tracks movements in indicators of costs, profits, prices and quality of service over time. This approach is not well suited to identifying abuse of market power. For further exploration of specific issue relating to indicators and the information underpinning them refer to a submission by Margaret Arblaster.[12]

[12] Margaret Arblaster (2018) *Report on the policy framework for economic regulation of airport services in Australia for Airlines for Australia and New Zealand (A4ANZ)*, August 2018

- Focussed on assessing specific charges, which can be driven by a wider set of considerations and may not relate directly to aeronautical costs.
- Assesses profitability only in the short term.
- Does not clearly articulated benchmarks against which to assess an airport's performance. (i.e. against the airport's weighted-average cost of capital or based on efficient comparators to that airport).

Furthermore, its assessments relate to aeronautical services and so are done on a 'dual till' basis. This means it does not consider the full suite of passenger related activities of an airport (with the exception of car parking). This is problematic. An airport services many complementary markets and its charges for aeronautical and non-aeronautical services are interdependent. Monitoring on this basis would not necessarily replicates how a competitive airport sets its prices (see **Box 2:**) and requires cost allocation between aeronautical and non-aeronautical activities that hampers the effectiveness of the ACCC monitoring regime.

Secondly, to be effective, an *ex post* regime relies on a **credible threat** of unavoidable, sufficiently high, effective punishments or penalties to act as a discouragement. The deterrent, in the current regime, is intended to be derived from:

- the threat of airlines taking legal action under CCA (through Part IIIA); and
- the threat of re-regulation based on ACCC monitoring and regular reviews of economic regulatory arrangements by the Productivity Commission.

The likelihood and consequence of an airport being penalised via these channels is not suitably high to act as a deterrent under current arrangement. And, in fact, the risk has been declining over time.

Our analysis suggests that the risk of airline-initiated action under Part IIIA of the CCA is now likely to be small. Putting aside the costly and time-consuming nature of Part IIIA, recent amendments to declaration criterion (a) will affect an airline's ability to obtain declaration, and ultimately arbitration of terms, under Part IIIA. This is because airlines will have to demonstrate to decision-makers that airports are imposing terms and conditions that they disrupt or threaten airline competition. This is further explained in Annex A.

The risk of government-initiated action has also declined over time, which may be observed from:

- the lack of a formal, periodic review process for Productivity Commission reviews (as there is no legislative requirement).
- there is now a history of government inaction in response to ACCC concerns and past Productivity Commission recommendations.

The combined effect of these arrangements means airlines have less bargaining power in negotiations with airports than at the time of deregulation in 2002.

The base case for this economic evaluation is continuation of the status quo — continuation of ACCC monitoring with Part IIIA acting as a weak constraint. We consider this represents a 'deterioration of the threat' meaning that airlines will face declining bargaining power when dealing with airports into the future.

Box 2: The "dual till" perspective to monitoring

The dual till approach to monitoring in Australia contains two major flaws. The first is that it does not correctly capture the full scope of activities over which the airports have market power. The second is that it ignores the interdependency between the monitored and non-monitored services, which largely invalidates the results. We discuss these flaws and why they matter in this box.

In our companion report, we described how airports have market power over the bundle of services passengers' use (either directly or indirectly)[13]. That is, monopoly is not just restricted to aeronautical services that are acquired by the airlines. Of most significance is that an airport is likely to have market power over bottleneck facilities required by its potential competitors which it can potentially leverage 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.

This might suggest that monitoring could be extended to other services. However, there is an additional complication - the demands for an airport's services are interdependent. By way of example, the more flights to the airport, the more passengers; the more passengers, the more retail and car parking services consumed. This interdependency means that airports may quite rationally charge prices for any one service that result in the under- or over-recovery of the incremental costs of that service, as this can increase their profits overall.

The dual till approach to monitoring or pricing ignores this interdependency and means we must treat any inferences made about an airport's profitability or prices by looking at outcomes (or price-cost relationship) carefully. A better approach would be to monitor with respect to airports' total 'passenger related' operations (sometimes referred to as a hybrid till approach).

While an argument could be made that a narrower 'dual till' approach to monitoring (which accounts only for only aeronautical service) may be acceptable if an airport's other activities are constrained by competition. We do not think this is relevant; substitution in an airport's non-aeronautical activities mostly seems to occur because prices may already be at levels reflecting the airport's exercise of market power (sometimes referred to as the 'cellophane fallacy').

Source: Frontier Economics

[13] Frontier Economics (2018) "The market power of Australian airports", prepared for A4ANZ

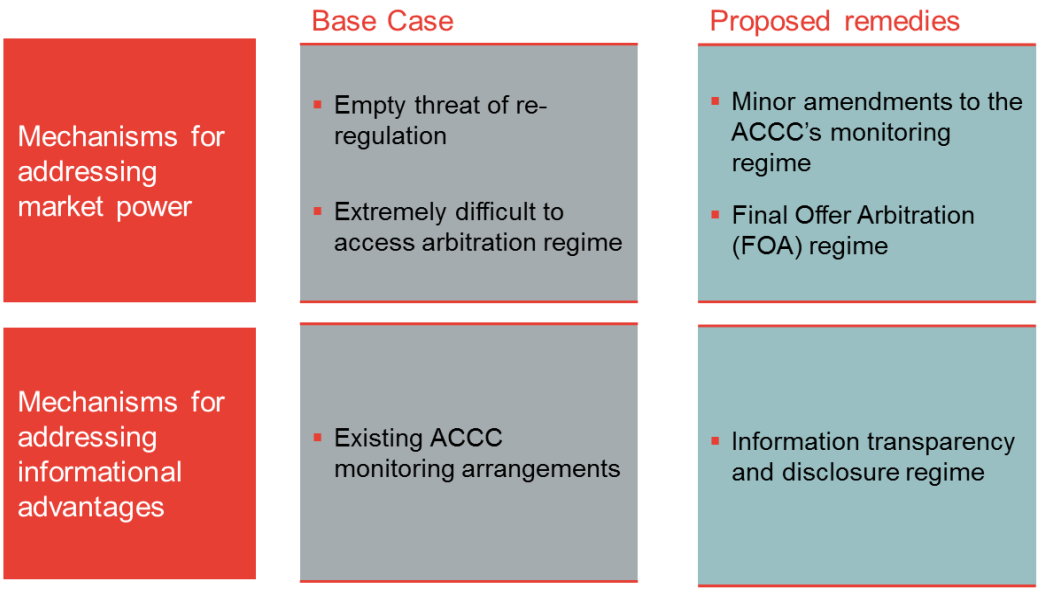
3 PROPOSED REMEDIES

For the purposes of our assessment, we assume that the new regulatory regime would involve three key modifications to the status quo consistent with A4ANZ proposal outlined in its submission to the Productivity Commission's issues paper. Namely:

- The introduction of a Final Offer Arbitration (FOA) regime to constrain an airports ability to exploit its market power during negotiations.
- The introduction of an information transparency and disclosure regime to address informational advantages airports can leverage over airlines during negotiations.
- Minor amendments to the ACCC monitoring regime to improve its effectiveness in identifying the misuse of market power and to complement the information disclosure regime.

Figure 5 below illustrates how the proposed regulatory remedies differ from the base case in respect to the key objectives for the reform, namely addressing market power and addressing informational advantages.

Figure 5: Summary of differences between the proposed reforms and counterfactual



Source: Frontier Economics

3.1 Final offer arbitration regime

Under the proposed regime, if a negotiated agreement cannot be reached within a reasonable timeframe, parties can access a 'final offer' arbitration (FOA) regime[14]. A FOA regime involves an independent arbitrator choosing one of the parties' proposals on each (or perhaps all) disputed issues. This differs from arbitration under Part IIIA where the parties present evidence and the arbitrator acts as

[14] A4ANZ's proposal for implementing this involves amending the *Airports Act 1996 (Cth)* by introducing a new s.192.

fact-finder and crafts an award. Unlike conventional arbitration, under FOA, the arbitrator is not permitted to 'split the difference' or compromise the offers of each side.

One side or the other 'wins' by getting its offer accepted.[15] This is designed to encourage genuine pre-arbitration negotiation where each party 'seeks security in agreement' to avoid the risk that the arbitrator could choose the other party's offer.[16]

Possibly because an FOA regime places less of a requirement on the arbiter to undertake its own investigations they typically include a short time frames for arbitration of the dispute.

FOA has been applied in labour disputes in various states within the United States,[17] including negotiations over major league baseball players' contracts.[18] It is also the legislated approach used in Canada to facilitate the resolution of rate and service disputes between carriers and shippers.[19] Under the *Canadian Transportation Act, 1996*, arbitration must be completed within 60 days.

3.2 Information disclosure and transparency regime

The purpose of an information disclosure regime, in the context of a negotiate-arbitrate regulatory model, is to address information asymmetries between the provider and the user, of the facility or service, so as to facilitate a negotiated outcome between the parties. Where airlines seek to negotiate with an airport over the provision of airport services, a key difficulty is obtaining information from the airport that enables airlines to verify whether the terms offered are reasonable.

Possible feature of an information disclosure and transparency regime could include:

- A general requirement for the airport to negotiate in good faith and to use reasonable endeavours to accommodate the requirements of users.
- A defined structure for the pricing model and potentially more clearly defined specific pricing and costing rules.
- Obligations relating to record keeping and information provision — For example reporting on the following in a timely fashion:
  - Details of proposed capital expenditure — including clearly articulated drivers for, and benefits of, investment, demand assumptions, alternatives explored, detailed scope and costings for key investments to a sufficient level of detail to enable the airline to assess its prudency / efficiency and hold the airport accountable for its delivery.
  - Details on historic capital expenditure (at a project level) compared to forecast estimates.
  - Operating costs — including a more detailed breakdown to allow benchmarking and identification of any assumed escalation rates.
  - Aeronautical and non-aeronautical splits and allocation methodology adopted.

15 Brams, S.J. and S. Merrill, III, "Equilibrium Strategies for Final-Offer Arbitration: There is No Median Convergence", *Management Science*, Vol. 29, No. 8, (August 1983), pp.927-941 (Brams and Merrill (1983)).

16 Stevens, C.M., "Is Compulsory Arbitration Compatible With Bargaining?", *Industrial Relations*, Vol. 5, No. 2 (February, 1966), pp.38-52.

17 Konchon, T.A, "Dynamics of Dispute Resolution in the Public Sector", Chapter 5 in *Public-Sector Bargaining*, Benjamin Aaron, Jospeh R. Grodin and James L. Stern (eds), Industrial Relations Research Series, The Bureau of National Affairs, Inc. Washington, D.C. (1979).

18 Chelius, J.R. and J.B. Dworkin, "An Economic Analysis of Final-Offer Arbitration as a Conflict Resolution Device", *The Journal of Conflict Resolution*, Vol. 24, No. 2 (June 1980).

19 Under Part IV of the *Canadian Transportation Act, 1996*

  - Other assumed inputs to the building block model— such as the WACC, opening asset base, and depreciation.
- Guidance around the negotiation process and timeline (e.g. when information will be provided) will improve transparency and certainty during the negotiation process and reduce unnecessary delays or protract contract negotiations.
- Requirements to improve contract transparency and certainty.
- Requirement for agreement terms to include service KPIs or requirements, and compensation payments/rebates for failing to meet KPI's related to the level of service funded by airlines.

3.3 Minor modifications to the ACCC's monitoring regime

The ACCC's current airport monitoring regime was intended to identify abuses of market power. Under the proposed remedies this regime would be maintained, with some amendments to better promote negotiated outcomes between airports and airport users.

The current regime is ineffective in assisting users to determine whether the offers they receive from airports are reasonable. This is because, for example, pricing models used by airports produce a return on capital using a weighted-average cost of capital multiplied by the asset base. This is a major component of the return for a capital-intensive business. However, the ACCC's monitoring provides no guidance on reasonable values for either of these elements in the return on capital calculation for future years. As a consequence, airports use different methodologies when a standardised approach would clearly offer distinct benefits in terms of the costs of negotiations.

A more effective monitoring regime could complement the information disclosure regime by helping airport users identify if they are receiving a 'good offer'. An overarching monitoring regime can assist in this, as it can draw together consistent and comparable information, across airports and over time, (albeit with limitations). This can create an important data source for airport users.

That is, we envisage that the regime would:

- Continue to look at the trends in indicators of costs, profits, prices and quality of service for each Airport over time in order to articulate whether outcomes are improving or declining.
  - Some minor legislative amendments should address limitations associated with the consistency of data and the basis on which some assessments are made (i.e. profitability should be assessed more holistically than just reporting on aeronautical services, with car parking as an adjunct).
- Continue to compare performance across airports, again with minor amendments.
- Articulate benchmarks which an airport user can use to assess an airport's performance and its offer; for example, appropriate methods by which an airport could estimate an efficient return on capital.

These revisions would enhance the utility of the regime without imposing significant further cost on airlines, airports or the ACCC.

4 APPROACH TO THE ASSESSMENT

This chapter described the framework that has been used to assess the proposed remedies described in Chapter 3. The approach taken in this analysis is consistent with the requirements in the Australian Government Guide to Regulation, and more specifically the Office of Best Practice Regulation (OBPR) guidance note for cost-benefit analysis.[20]

The core of the assessment is contained in Chapters 5 and 6. This involves:

- **A cost effectiveness analysis** which considers the extent to which the proposed remedies impose incremental costs on industry and governments agencies associated with administering and complying with the proposed remedies, relative to the base case (see Chapter 5)
- An analysis of the **additional benefits** of the proposed remedies— focussing on incremental increases in consumer welfare and the catalytic impacts on GDP relative to the base case (see Chapters 6).

It is important to highlight that the analysis does not seek to measure the impact of the proposed remedies versus no regulation at all. Rather, it assesses the *incremental impact* of the proposed remedies (outlined in Chapter 3) against the base case (outlined in Chapter 2).

4.1 Categories of impacts

The primary groups affected by the proposed remedies will be:

- The industry — both airlines and airports who may be subject to new or different obligations or may find the nature of their negotiations changes, and
- Government agencies with relevant regulatory or policy making responsibilities— such as the ACCC and/or federal departments who might be charged with implementing changes to the regulatory arrangements, and
- The public at large because of any change in airport pricing and quality of service which may in turn affect their ability to use and fly to/from Australia's airports.

We have attempted to identify and monetise the costs and benefits affecting all these groups.

4.1.1 Costs

The key costs associated with the proposed remedies are contained in Chapter 5 and have been categorised as follows.

- **Industry administrative costs** — For industry the administrative costs of complying with the proposed remedies will reflect the costs incurred in dealing or negotiating with their counterpart (airline or airport) relative to what is required under the base case). This may change because of:
  - any investments that need to be made to modify or develop new reporting and information disclosure systems; and/or employ additional staff to manage these systems in order to demonstrate compliance;

[20] Office of Best Practice Regulation (2014) *Cost-benefit analysis Guidance Note*, July 2014 & https://www.cuttingredtape.gov.au/sites/default/files/documents/australian_government_guide_regulation.pdf

- a change in the time involved in negotiating agreements; and/or
- the costs incurred in dealing with the regulator/arbiter through any additional processes (i.e. over and above what is required under the base case). This will depend on the likelihood of any remedies leading to arbitration.

- **Regulator/policy makers administrative costs** — The proposed remedies could result in additional:
  - one-off costs for the regulator or policy maker associated with recruiting, educating and training existing staff, developing new systems, and working with industry to bring them up to speed on the new requirements.
  - additional ongoing costs associated with the need for additional staff to audit and monitor compliance as well as educate other staff, to inform and maintain records. However, this would be the case if the amount of record keeping required actually increases under the proposed remedies.
- **Impact on the efficiency of industry investment** — With any regulatory remedy there is always the prospect of impacting on investment in the sector. For airports this could arise if a remedy impacts on an airport's expectations about the future recovery of capital expenditure. For airlines this can arise if a remedy impacts on the risk an airport might expropriate the value associated with any sunk complementary investments it makes, such as on developing and marketing new routes or landside facilities.

4.1.2 Benefits

The key additional benefits associated with the proposed remedies are considered in Chapter 6 and have been categorised as follows.

- **Impact on consumer welfare** — This captures the extent to which lower airport charges, resulting from the proposed remedies redressing market power, may lead to lower airfares which in turn may increase air travel. On existing routes, this additional travel can be valued in terms of the consumer welfare it generates.
- **Connectivity related catalytic impacts on GDP**—An increase in air travel may also drive new direct airline connections or, on existing routes, more frequent connections. This Improved connectivity with the rest of the world could ultimately help facilitate extra trade and FDI, which together could boost GDP, relative to the base case.
- **Connectivity related travel time savings**— Some passengers travel to their destination indirectly (multi-stop passengers). Improvements in connectivity, may enable some of these passengers to fly directly to their destinations leading to reduction in travel time.
- **Wider economic benefits** —Incremental improvements in air connectivity could also drive further efficiencies in the economy as a result of reducing travel time/costs. For example, this may be agglomeration effects which increase productivity by providing firms with greater access to specialised or deeper labour markets, a larger choice of suppliers and/or facilitating the provision of specialised inputs more efficiently by virtue of reducing transportation time/costs.

4.2 Quantifying the impacts

The approach taken in this report is consistent with the requirements set out in the Australian Government Guide to Regulation, and the OBPR's guidance note for cost-benefit analysis.[21]

[21] Office of Best Practice Regulation (2014) *Cost-benefit analysis Guidance Note*, July 2014 & https://www.cuttingredtape.gov.au/sites/default/files/documents/australian_government_guide_regulation.pdf

Administrative and compliance costs associated with the proposed remedies have been monetised where possible. For this we relied on data from airline stakeholders on the time and number of staffs involved in negotiating with airports. Where other assumptions have been made and these are described in the relevant sub-section.

Valuing the benefits associated with the proposed reforms is far more challenging for the following reasons:

- To estimate the scale of some benefits a number of assumptions to be made. While these are fully described in the relevant sub-sections we note that this will inherently make the estimates less reliable than the administrative and compliance cost estimates.
- For some benefits it was only possible to quantify the value of the additional output generated (i.e. GDP). These estimates cannot be directly incorporated into a CBA as they do not take account of the change in inputs required to deliver these outputs. For example, in estimating the benefit associated with increased connectivity we are not able to estimate all the incremental costs associated with providing these additional routes.

Because of these limitations, we have undertaken a cost effectiveness analysis. This focuses on the costs associated with the implementing, administering and complying with the proposed reforms. We complement this with an indicative analysis of additional impacts to explore the extent to which there are likely to be sizeable additional benefits that further support regulatory reform.

Based on relevant guidelines[22], the following parameters have been adopted for all valuations:

- An annual real discount rate of seven per cent for the central case in determining the net present value of different costs and benefits. Sensitivity testing was conducted using real discount rates of three and ten per cent respectively.
- A fifteen-year evaluation period has been adopted. Sensitivity testing was conducted using an evaluation period of 10 and 20 years.
- The base year for presenting all impacts is 2018.
- Any upfront costs associated with implementing the new policy are assumed to be incurred in 2019.

[22] OBPR (2014), Cost-benefit analysis guidance note, July 2014.

5 COST EFFECTIVENESS OF THE PROPOSED REFORMS

The proposed remedies will not increase administrative and compliance costs, nor impose material burdens on investment

5.1 Summary of impacts

We find that the proposed remedies will not increase administrative and compliance costs relative to the base case (which reflects the status quo).

- **First**, the continuation of the ACCC's monitoring regime with some minor revisions in approach to better support negotiations will not impose any significant additional administrative costs on the ACCC. This is because the ACCC already collects much of the information required, and airports will continue to provide largely the same information to the ACCC[23]. We consider the minor amendments to the ACCC monitoring regime may create a one-off cost of $2m associated with the ACCC initially implementing the changes[24].
- **Secondly**, an information disclosure regime intended to facilitate bargaining and a negotiated outcome is also expected to involve minimal incremental costs. The incremental costs associated with an enhanced information disclosure regime are not expected to be high. This is because airports are expected to already collect this information in order to inform their own negotiations. Hence, the only additional cost would be in collating this information to enable it to be readily understood by airlines. We estimate the net present value (NPV) of this additional administration cost to be $8.8 million.[25] However, an information disclosure regime will also decrease administrative cost for both airlines and airports by increasing the probability of an agreement being reached more efficiently. This may offset this additional cost.
- **Thirdly**, when compared to time-unlimited negotiation, enabling access to FOA, in tandem with the information transparency and disclosure regime, is more likely to lead to timelier and therefore lower cost resolution of any disagreements than under the base case. If these reforms decrease the time spent on negotiations by 20% we estimate the administrative cost of negotiations would fall by $3.7 million per annum which equates to a total saving in NPV terms of $33.6 million.

23 The ACCC already receives information directly from Airports as a result of its price monitoring function under Part VIIA of the CCA and under Part 7 of the Airports Act 1986. The Airports Act requires specified airport operators to produce separate accounts for their aeronautical and non-aeronautical businesses and provide these to the ACCC it also contains other provisions relating to the preparation of the accounts, and auditing.

24 This would equate to the cost of 3 FTE staff working on implementing changes for 2 years, plus an additional 700k in consultancy services or government overhead costs.

25 For costing purposes, we have assumed that there are a total of 30 airport-airline negotiations occurring around Australia in any one year — 4 of which involve a major city or regional airport and 26 of which relate to regional airports (based on information provided by A4ANZ). And that it initially costs an airport $80,000 to collate the necessary information for airlines at major city/regional airports and $40,000 for smaller regional airports. We have also assumed the processes for providing this information become streamlined over time such that the costs reduce by 40% after 3 years.

- **Finally**, while it could be argued that there are additional costs associated with enabling airlines and airports to access independent FOA arbitration, it is not immediately clear what these would be. We do not consider that direct access to an FOA regime[26] will necessarily encourage parties to expeditiously seek arbitration and therefore increase administrative costs associated with the regime (see subsection 5.2.2 below). Furthermore, airlines and airports should under the status quo already be developing and presenting competing offers as part of the negotiation process.

In summary, we consider the proposed reforms are likely to reduce administrative and compliance costs by up to $22.7 million dollars on an NPV basis (see **Table 2**).

Table 2: Summary of administrative and compliance costs

REMEDY	NPV OF COSTS[27]
Cost to the ACCC of implementing minor amendments to its monitoring approach	$2 million
Cost to Airports from the introduction of an information transparency and disclosure regime	$8.9 million
Improved timeliness of negotiation	Saving of 33.6 million
Costs associated with arbitrations	Unvalued assumed to be low
Total	**Saving of $22.7 million[28]**

Source: Frontier Economics

We also consider whether the alternative regime may have detrimental effect on investment by airports or airlines which should factor into the evaluation. We find that:

- With monopoly airports and no regulation, you are likely to get underinvestment or inefficient investment compared to the social optimum.
- With a monopoly and heavy-handed regulation, you can get over-, under- or the social optimum investment – but it will depend on the incentives imposed by regulation. Internationally, there is evidence that the greater problem is over-investment and gold plating.
- A negotiate-arbitrate model has few good comparators to draw on, so it is difficult to be definitive about how optimal investment would be. That said, there is no basis for believing it will be a material cost from a move to this system in comparison to the existing system of monopoly with no regulation.

Further details on the key assumptions underpinning these estimates follows in the sections below.

26 Or indeed other negotiate-arbitrate regimes that are supported by well-designed information disclosure and transparency provisions and that place much of costs of arbitrations on parties to the dispute would also discourage reliance on arbitration.

27 Assuming a 15 year evaluation period, and real discount rate of 7%.

28 This ranges between a saving of $16 million assuming a 10-year evaluation period and a 7% real discount rate and $30.7 million assuming a 20-year evaluation period and 3% real discount rate.

5.2 Administrative and compliance costs

5.2.1 Improved timeliness of negotiations

As the base case largely precludes any form of arbitration, it is difficult to come to a firm conclusion as to whether FOA will lead to a more timely and cheaper resolution of airport service negotiations. However, it seems reasonable to assume that the threat of arbitration will truncate the time spent negotiating if the arbitration regime is time-limited in nature. For example, under the *Canadian Transportation Act 1996* that applies to certain transport disputes, arbitration must be completed within 60 days.[29] This would be the case under an FOA or other forms of time limited negotiate-arbitrate regimes.

Under the base case, the administrative costs of negotiation incurred by airlines and airports are high.

Using estimates provided by A4ANZ on the number of full time equivalent (FTE) staff in airline negotiation teams we estimate that the airlines and airports are likely to be collectively spending $18 million per annum negotiating with each other.[30] Airlines have indicated that negotiations involving major city airports typically take around 1.5 years to complete while with smaller airports this is typically between 1-6 months[31]. If we assume information transparency and threat of arbitration decreases the time spent on negotiations by 20% then the cost of negotiations would fall by $3.7 million per annum which equates to a total saving in NPV terms of $33.6 million.

We do not consider this saving will come at the expense of costs associated with arbitrations. Rather, we assume that access to arbitration may reduce the incentive of an airport to engage in delaying tactics as this would increase the risk of arbitration. We also do not consider this saving will come at the expense of more efficiently-negotiated outcomes. This is because the marginal benefit of continuing to negotiate past a certain point is likely to be low.

5.2.2 An FOA regime will not decrease commercial incentives to negotiate or increase the costs associated with arbitration

We do not consider that direct access to an FOA regime will necessarily encourage parties to expeditiously seek arbitration and therefore increase administrative costs associated with the regime.

The literature is inconclusive on whether or not a FOA regime is more or less likely to lead to parties seeking arbitration than other more conventional forms of arbitration. In determining whether any arbitrations are likely to arise, it is therefore reasonable to look back at arbitrations under Part IIIA when they were more accessible to airlines (noting the base case for this assessment assumes arbitration under Part IIIA is no longer readily accessible). In fact, since the introduction of Part IIIA, there has only ever been two notifications of a dispute relating to airport services by an airline. Both were ultimately resolved outside the formal arbitration processes.[32] This suggests there is no *prima facie* evidence for access to arbitration leading to spurious and high levels of arbitration.

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29 See https://otc-cta.gc.ca/eng/publication/final-offer-arbitration-a-resource-tool (accessed 31 July 2018).

30 For costing purposes, we have used estimated staff numbers in airline negotiation teams from A4ANZ and salary estimates from Hays Salary Guide for FY17/18 and assumed Australian airports spend an equivalent amount on negotiations.

31 Based on information from airline members provided by A4ANZ

32 In 2005, upon application for review by Virgin Blue, the airside services at Sydney Airport were declared by the Australian Competition Tribunal for a period of five years: In January 2007, Virgin Blue notified the ACCC of an access dispute with Sydney Airport Corporation Limited. However, following negotiated commercial settlement, the dispute was withdrawn in May 2007 (source: ACCC Media release No. 130/07). In 2014 Tiger Airways applied to the NCC to have domestic terminal facilities declared on the basis that it was having difficulties negotiating increased access to terminal

It could be argued that the historically, low level of airport related access disputes under Part IIIA is a function of the fact that seeking declaration (and therefore arbitration) is costly. In its 2006 inquiry the Productivity Commissions pointed to this fact when it raised concerns that:

> *"A readily accessible airport-specific arbitration mechanism would fundamentally undermine incentives for the parties to negotiate outcomes…."*[33]

In supporting this conclusion, it implied that a high bar was needed to prevent excessive arbitration. It also pointed to experiences in telecommunications where sector-specific arbitration was heavily used.[34]

We consider an industry-specific FOA regime will act to enhance negotiations rather than leading to an excessive reliance on arbitration, for three main reasons.

First, the regime is intended to encourage parties to compromise and settle on the basis that an extreme offer will be less likely to be chosen by the arbitrator. In a review of the FOA regime applying to Canadian railways it was noted that:[35]

The Panel believes that the FOA provisions have two important hallmarks of effective economic regulation: First, the arbitration process encourages parties to reach commercial settlement of their disagreement by its all-or-nothing approach.

Secondly, the information disclosure and transparency provisions will play an important role in actually reducing the scope and likelihood of any possible arbitration. This will be particularly enhanced if, for example, a building block structure for a pricing model and more clearly defined specific pricing and costing rules are developed.

In contrast to the Commission's earlier view, it was not the mere existence of a sector specific access regime which led to numerous access arbitrations in the telecommunications sector (see Box 2). Rather, there were two coincident factors that stymied that regime – Telstra's vertical integration meant that it had a strong incentive to delay negotiations, and no coherent, updateable pricing model was ever established.

Thirdly, impeding access to arbitration is entirely unnecessary to reduce reliance on arbitration. Under an FOA regime airlines and airports will clearly have easier access to arbitration; however, the costs associated with arbitration will be predominately incurred by the parties. This is because under a FOA regime, the arbiter will necessarily be relying on the information and evidence provided by parties to make a compelling case for their offer. This (and the short timeframes imposed on the arbiter) will keep the additional analysis the arbiter is required to do to a minimum. It will also mean the majority of costs

facilities. One month after the application was submitted an agreement was reached with Sydney Airport and the application for declaration was withdrawn. Looking more widely there have been at least six cases where airport users have made an application to have services provided on airports declared. Arbitration was commenced, but not completed, following declaration in only the Virgin Blue Case (source: Margaret Arblaster (2018*) Report on the policy framework for economic regulation of airport services in Australia for Airlines for Australia and New Zealand (A4ANZ*), August 2018).

33 Productivity Commission (2006), *Review of Price Regulation of Airport Services*, Report no. 40, Canberra.p.61.

34 Productivity Commission (2006), p. 96 and Productivity Commission (2011), *Economic Regulation of Airport Services,* Inquiry Report no. 57, Canberra, p XL which states that "The Productivity Commission's concerns, however, remain that: …. under the access regime for telecommunications, the ACCC has conducted nearly 100 arbitrations in the five years to 2009-10."

35 Cited in a report prepared by InterVISATS for Air New Zealand on Issues regarding the regulation of New Zealand's Gateway airports, section 5.5 Final Offer Arbitration: The Case of Canada's Railways and Maritime Sector

associated with arbitration will be incurred by the negotiating parties suggesting they will only be incentivised to seek arbitration when a party feels like it is being significantly disadvantaged. Furthermore, if parties have to undertake the work required to develop a considered offer to present to the arbiter then they will be better able to reach a view about the expected net benefits of arbitration.

For these reasons we do not consider that direct access to an FOA regime will encourage parties to seek arbitration as a "default" and therefore increase administrative costs associated with the regime. Other negotiate-arbitrate regimes that are supported by well-designed information disclosure and transparency provisions and that place the majority of costs of arbitrations on parties to the dispute would also discourage reliance on arbitration.

Even if this view were incorrect, there would have to be a significant number of arbitrations under the new FOA regime to counteract the estimated administrative and compliance costs savings of $22.7 million dollars outlined above. For example, if we assume each time limited FOA arbitrations cost airlines, airports and the arbitrator, $1 million in total then the regime would need to drive over 22 arbitrations in the next 15 years to outweigh the wider administrative and compliance cost savings it generates.

On this basis we conclude that the proposed remedies will not increase administrative and compliance costs.

Box 3: Experiences with arbitration in telecommunications can easily be misinterpreted

In its 2011 report the Productivity Commission raised concerns with sector specific arbitration mechanisms on the basis that *"…under the access regime for telecommunications, the ACCC has conducted nearly 100 arbitrations in the five years to 2009-10"*[36].

These arbitrations occurred under an access regime introduced in 1997 under Part XIC of the *Trade Practice Act 1974.* The access regime applied to 'declared' services; essentially, those services which had monopoly or bottleneck characteristics. In the first instance, prices for these services were to be negotiated between access providers and access seekers. The ACCC was able to intervene at the request of parties, for example by issuing a final determination in access dispute.

In selecting an access pricing approach for fixed line services, the ACCC decided that access prices should be set at no more than the total-service long-run incremental cost (TSLRIC) of providing the relevant access services.[37] This was an attempt to set prices at the efficient forward-looking costs of supply.

However, the practical problems associated with implementing a TSLIRIC approach to pricing, as outlined below, effectively prevented pre-arbitration negotiations from being successful.

- Estimating TSLRIC requires a number of assumptions to be made around approach and a general lack of agreement about how to implement a TSLRIC led to a proliferation of estimation models. This significantly increase the scope of negotiations and prospect for differential positions.
- When compared with other pricing approaches based on the depreciation of actual costs incurred, TSLRIC modelling is highly speculative and requires a greater degree of foresight (well beyond five years). In particular long-term forecasts of future asset price changes and assumptions about obsolescence of assets. These assumptions are highly speculative particularly in the presence of rapid technological change.
- In addition to the contention that surrounded setting TSLRIC-based prices for the first time a greater challenge emerged from how to update the costs and prices over time. In particular this required an estimation of a 'modern equivalent asset' that would be built to provide service today and into the future. It is an imaginary cost of an imaginary network, and, that being the case, it can be imagined in different ways.

As a result of the above access seekers and providers struggled to agree a set of modelling principles and inputs and ultimately a mechanism for updating prices over time to produce predictable and stable prices. In our view, this provides valuable lessons for the design of an appropriate airports regulatory regime.

Source: Frontier Economics

36 Productivity Commission (2011) p XL

37 ACCC (1997) cited in Davis, Warwick. 2011. 'From futility to utility – recent developments in fixed line access pricing'. Telecommunications Journal of Australia. 61 (2): pp. 32.1 to 32.16.

5.3 Costs to investment

5.3.1 Airport investment

We do not consider that an FOA regime will compromise **investment by airports**. Indeed, we expect the opposite to be true – that is, an FOA regime (or other forms of negotiate-arbitrate) will incentivise airports to undertake efficient investments.

Like any monopoly business, we expect airports to make investment decisions that will maximise their profits. Rent-seeking behaviour by airports may result in inefficient outcomes. For example, airports will have an incentive to create scarcity rents by not undertaking (or delaying) efficient expansions in airport capacity, such as building new terminals or gates, where the cost of these investments is matched by consumers' willingness to pay. Underinvestment in capacity expansions will have the effect of bidding up the price of (scarce) airport capacity above the level that would be expected to result in a competitive market. This would increase the profitability of the airport – at the expense of consumers, who would pay higher prices for the same services – and create welfare loss.

There is an extensive 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.[38] Dobbs notes that under inelastic demand, the level of under investment can be substantial.

In the airport sector, Zhang and Zhang (2003) showed that a profit-maximising airport is less inclined towards capacity expansions than a welfare maximising airport, noting that:[39]

> *… capacity expansion improves the quality of the service by reducing the congestion, which results from heavy use of the existing airport. The socially optimal time for capacity expansion is the time when the benefits of the additional capacity, which include benefits to both passengers and the airport, just outweigh the cost of the capital investment. However, since the private airport does not care for the consumer surplus but needs to bear the cost of the capital for the expansion, the benefits to the airport would be insufficient at the social optimum. The private airport will therefore add capacity only when congestion is heavy enough such that the benefits to the airport alone outweigh the cost of capital… [T]he private airport tends to add capacity "too late" from a social point of view.*

Otherwise, airports may be incentivise to make investments that may not be of direct benefit to airlines and attempt to pass these costs through to airlines.

In addition, firms that do not face competition or a strong threat of entry do not have a strong incentive to innovate. Unlike in a competitive market, where market participants are encouraged to innovate in order to acquire a competitive edge over their rivals and survive, a monopoly faces no risk that another supplier will take its customers. This can stymie innovation in the industry – specifically, airports face little incentive to invest in new services and technologies that would improve the quality of service offered to airlines. As a related point, the lack of competition means that airports will also face little incentive to

[38] Dobbs (2004), *Intertemporal Price Cap Regulation under Uncertainty*, The Economic Journal Vol. 114, No. 495 (2004) 421-440

[39] Zhang and Zhang (2003), *Airport charges and capacity expansion: effects of concessions and privatization*, Journal of Urban Economics 53 (2003) 54-75, at. 65.

pursue cost efficiencies. Over time, this would result in airport costs (and prices) being higher than they otherwise would have been under competition.

From these points, we conclude that there is little evidence to support the proposition that monopolies will undertake efficient investment decisions.

The criticism levelled at regulation and its potential to generate unintended consequences for investment generally arises in the context of heavier-handed, price or revenue cap regulation. Due to information constraints and limitations on the regulator's ability to foresee all potential eventualities, their decisions may distort infrastructure investment incentives. For example, setting a capital expenditure allowance or regulated rate of return that was either too high or too low (vis-à-vis the outcomes that would arise in a competitive market) would lead to a level of investment that was either greater or less than the efficient level. In addition, uncertainty in the application of the regulatory framework may increase regulatory risk which, if not accounted for in the regulated rate of return, may have a chilling effect on investment.

These criticisms do not apply to the FOA framework. The proposed framework remains a relatively light-handed approach to regulating airport behaviour. First and foremost, it encourages parties to reach an agreement on new investment. Direct regulatory intervention is limited to extreme cases where a party feels that it would be substantially better off by going to arbitration. In these cases, a robust arbitration framework, with clear objectives and obligations, will mitigate the risk that arbitrators make decisions that compromise efficient airport investment, and encourage confidence in the regulatory framework (i.e. reduce regulatory risk).

Finally, we note that there is no evidence from other jurisdictions that a negotiate-arbitrate framework will hinder investment in the airport sector. Evidence from other sectors and overseas suggests that, of the spectrum of regulatory approaches that are typically adopted, a negotiate-arbitrate model has the potential to produce the most efficient outcome. The various approaches we considered are:

- An unregulated monopoly – in this case, the service provider has an incentive to underinvest as this would allow the service provider to increase profitability by charging scarcity rents. As noted above, this reduces consumer surplus and results in welfare loss for society.
- A monopoly regulated under a heavy-handed framework – depending on the nature of the regulatory framework and how it is implemented, the level of investment in this case may be either above, below or equal to the efficient (competitive) level. Evidence from other industries and jurisdictions suggests that heavy-handed regulation (such as price and revenue caps) often gives rise to concerns relating to overinvestment and gold plating. In these regimes, regulators generally allow service providers to recover a guaranteed return on its capital expenditure. This creates an incentive for the business to increase the value of the asset base to which the regulated rate of return is applied (by overinvesting or gold plating), and thereby increase the revenue that it may earn.
- A monopoly subject to a negotiate-arbitrate regime – it is difficult to be definitive about how optimal investment will be under this framework, due to the absence of good comparator regimes in other industries or jurisdictions. Notwithstanding, in our view, there is no basis for believing that investment will be less efficient than the current regime of price monitoring.

5.3.2 Airline investment

A pre-occupation with the impact of the proposed remedies on airport investment, also risks ignoring that the proposed remedies may have a beneficial impact on airline investment and therefore connectivity.

In order, to establish new routes airlines often make sunk investments in landside assets (i.e. airline specific terminals and maintenance facilities), and incur costs associated with marketing the route to potential passengers and reconfiguring their flight schedules.

As noted by Daryl Biggar[40], in the absence of conventional price regulation, airlines would look to protect these investments through long-term secure arrangements with airports. Where market power limits the ability of airlines to enter into these long-term arrangements airlines may be reluctant to make the necessary complementary investments, for fear that an airport will be able to expropriate the value of any sunk investments.

Assuming an FOA regime enhances an airlines ability to form effective long-run contracts this may have a positive impact on airline investment, particularly in relation to expanding new routes, which would in turn enhance connectivity (see section 6.3).

[40] Biggar, D. (2011) *Why regulate airports> A re-examination of the rationale for airport regulation,* 27 January 2011

6 ADDITIONAL BENEFITS OF THE PROPOSED REFORM

The additional benefits of the proposed reform are material

6.1 Summary of impacts

In addition to administrative costs savings, the proposed reforms will enable better-informed negotiations that deliver more efficient outcomes than the base case. This is primarily because the threat of arbitration under an FOA (or other accessible negotiate-arbitrate) regime should help redress the market power that airports would otherwise be able to exploit during negotiations with airlines.

All thing being equal, this is expected to lead to more efficient prices for airport services which, in turn, will lower airline charges and therefore increase demand for air travel. While it is challenging to reliably estimate and monetise all the benefits that arise from this, our analysis suggests that the proposed regulatory reforms could:

- **Increase consumer surplus and remove deadweight loss**. On existing routes, this fall in airport prices and the additional travel generated creates additional welfare for consumers. We estimate that this could result in an average annual increase in demand of up to 1 million round trips per year (approximately a 1.9% increase in demand) which would lead to a gain in consumer surplus of around $650 million per annum. This equates to around $5.9 billion on an NPV basis — around $72 million of this relates to capturing the 'deadweight loss' which currently exists today.[41] The vast majority of this consumer surplus is generated on domestic flights.

In addition, this increase in demand for air travel may also drive new direct, or more frequent connections, which may generate additional benefits. Again, while challenging to reliably estimate, our analysis suggests that this improved connectivity could facilitate the following benefits.

- **Travel time savings.** These arises because some passengers, under the status quo, travel to their destination indirectly. The estimated improvements in connectivity, will enable some of these passengers to fly directly to their destinations leading to reduction in travel time. We value these savings at almost $90 million a year[42], or $820 million on an NPV basis.

41 This assumes the proposed remedies will lead to lower more efficient airport charges, which we have estimated by removing the excess profit identified in our companion analysis of profitability. We used these lower charges to estimate a percentage reduction in airfares, assuming this reduction in airports charges is fully passed through to air fares. Using commonly applied estimates of price elasticities of demand for air travel we estimated the consequential impact on passenger demand on every route from nine key Australian airports. The output of this analysis is the increase in demand (in % terms and in the absolute number of passengers) both on individual routes and in total.

42 For each of the (feasible) new direct routes, we have used a fixed cruising speed (800kmh), a fixed take-off/landing time of around 40 minutes and a one our lay-over, then calculated the distance and time of a new direct route. Assumption associated with the value of travel time savings, has come from the Australian Transport Assessment and Planning guidance documents.

- **Additional catalytic impacts on GDP.** Improved connectivity with the rest of the world could ultimately help facilitate extra trade and FDI, which together could boost GDP. We estimate the increase in GDP to be $1.2 billion annually which equates to an NPV benefit of $10.9 billion.
- **Wider Economic Benefits (WEB) on domestic routes.** Although difficult to quantify, we note the potential for WEB to result from incremental improvements in air connectivity. This could include agglomeration effects and additional welfare associated with creating more competitive markets.

These additional benefits have, in the past, been ignored on the assumption that the price elasticity of air travel is low. However, we find that together, and over time, these benefits could be sizeable and should not be ignored. Particularly, given the proposed remedies are likely to lead to cost savings.

6.2 Welfare impact from addressing airport monopoly pricing

Under the base case, Australian airports with market power can be expected to set aeronautical charges above the competitive level. This ultimately results in lost consumer surplus and a dead weight loss for the community (see **Box** 4: for further explanation of this) when compared to a situation where airport market power is constrained as is assumed under the proposed remedies.

We have estimated the possible increase in consumer surplus at around $650 million per year. This equates to around $5.9 billion on an NPV basis[43]. This is based on:

- an estimated reduction in average airport charges, assuming airport market power is fully constrained under the proposed remedies. This is based on converting the excess profit identified in our companion profitability analysis[44] into a percentage fall in airport charges which was applied to estimates of average aeronautical revenue per passenger at each airport considered in the analysis.[45]
- an estimated reduction in ticket fares following the reduction in airport charges. We have made a high-level assumption that a decrease in airport charges would be passed through to passengers in full in the form of lower ticket fares[46]. We have applied the reduction to ticket fares on each individual route at each airport considered in the analysis. We have used data on ticket fares at the route level from OAG Traffic Analyser.
- an estimated increase in demand on each individual route using established price elasticities of demand. We have assumed inputs of -0.7 for passenger flying to short haul destinations and -0.8 for passenger flying to long haul destinations. This is based on the IATA economic briefing on air travel demand elasticities[47], which provides similar estimates to ones previously used by the Productivity Commission.[48] We have used data on passenger volumes (by route) from OAG Traffic Analyser.

43 This figure is based on the 'mid-point' estimate of the potential reduction in airport charges an evaluation period of 15 years and a real discount rate of 7%. We note this figure is sensitive to various assumptions. For example, it would reduce to $3.9 billion using the lower bound estimate of the potential reduction in airport charges and assuming a 10-year evaluation period and 7% discount rate and increase to $8.8 billion assuming the upper bound estimate of the potential reduction in airport charges and assuming a 15-year evaluation period and 3% discount rate.

44 Frontier Economics (2018) "The profitability of Australian price monitored airports", prepared for A4ANZ

45 Our analysis has produced a 'mid-point' estimate of the reduction in airport charges at each individual airport based on profitability analysis. We have also produced an upper bound and a lower bound estimate. The main results presented in this section are based on the mid-point estimate. (See Annex B for further details).

46 The exact amount of pass through will depend on the nature of demand and the competitiveness of the air travel on any route. However, even where pass through to fares is very low this would still lower airline costs on any route i.e. the fall in airport charges will either reduce the fixed costs of airlines, making routes more viable; or reduce airfares, increasing demand and therefore making routes more viable. Given route viability is the primary purpose of this analysis any fall in airport charges could be viewed as beneficial to passengers. Therefore, to simplify the analysis we have assumed 100% pass through.

47 IATA (2008) "Economics Briefing No. 9", https://www.iata.org/publications/economic-briefings/air_travel_demand.pdf

48 Productivity Commission (1998) "Report No. 2 International Air Services"

Box 4: An example of consumer welfare loss under monopoly pricing

Suppose an airport experiences a constant marginal cost C per passenger it serves.

Also suppose the airport faces a demand function P=a-bQ, where P is the price it charges airlines per passenger and Q is the number of passengers. A and b are constants representing the price (a) which will reduce demand to zero, and the sensitivity of demand with respect to price (b).

According to economic theory, if the airport is functioning in a competitive market or is constrained from charging monopoly prices (as is assumed under the proposed remedies), it will set a charge per passenger at Prem = MC (marginal cost), which will result in the demand Qrem = (a - C)/b.

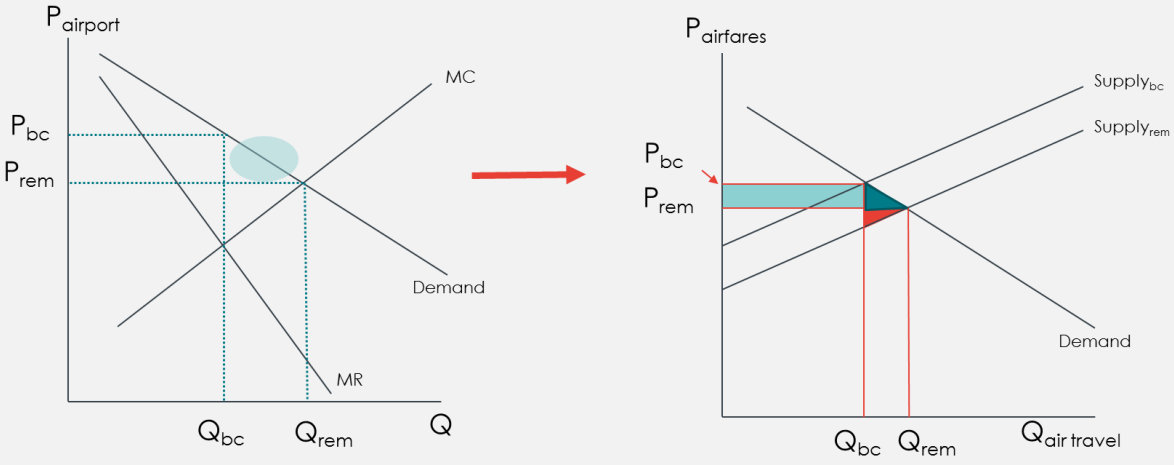
On the other hand, if the airport is an unconstrained monopolist, its profit maximising price is to charge Pbc = (a + C)/2 (by equating price with marginal revenue (MR)), which results in demand Qbc = (a - C)/2b, which is half the level of output in the competitive case.

This situation is illustrated in the left side of the figure below.

Assuming this difference in airport charges is passes through into airfares, when an airport is no longer charging monopoly pricing (as is assumed under the base case) this will results in a gain of consumer surplus. This is made up of two parts:

- Removed overcharge – this is the light blue shaded area in the right side of the figure below. This represents that passengers who were still choosing to fly even with the excessively high charges will now pay less to fly than they would have.
- Removed deadweight loss – this is the shaded dark green triangle. This represents that some passengers who could not afford to fly when the prices are set at the monopoly level can now afford to fly with the price set at the competitive level (as assumed under the proposed remedies).

In reality, airports also incur fixed costs which need to be recovered from consumers; this means that under effective competition or regulation, the price and quantities would be between these two extremes.



Source: Frontier Economics

It should be noted that the potential gain in consumer surplus represents both allocative inefficiencies (or dead weight loss) and the transfer of surplus (i.e. benefits that were previously captured by airports) to consumers. The estimate can be a split between these two component parts:

- the removed 'overcharge' – i.e. the light blue shaded area in the right side of the figure in Box 4: above. This represents the extra charges that passengers, who would still choose to fly even with the excessively high charges, now no longer pay under the proposed remedies.
- the removed 'deadweight loss' – i.e. the dark green shaded triangle in the right side of the figure in Box 4: above This represents that some passengers who could not afford to fly with prices set at the monopoly level can now afford to fly with the price set at the competitive level (as assumed under the proposed remedies).

See Annex 1 for further details.

Table 3 below summarises our results.

Table 3: Estimate of the potential gain in consumer surplus on an annual basis under the proposed remedies

AIRPORT	TOTAL O/D ROUND TRIPS 2017 (M)*	INCREASE IN DEMAND (%)	INCREASE IN DEMAND ('000S)	TOTAL INCREASE IN CONSUMER SURPLUS ($M)	- OF WHICH OVERCHARGE $M)	- OF WHICH DEADWEIGHT LOSS ($M)
Sydney	18.0	2.5%	449	$259	$255	$4
Melbourne	15.4	2.2%	335	$185	$182	$2
Brisbane	9.6	1.3%	124	$61	$61	$1
Perth	6.1	0.8%	49	$42	$42	$0
Adelaide	4.0	1.6%	62	$30	$29	$0
Gold Coast	3.1	2.6%	80	$29	$29	$1
Cairns	2.3	1.1%	25	$16	$16	$0
Canberra	1.8	1.4%	26	$15	$15	$0
Hobart	1.2	2.2%	26	$11	$11	$0
Total	**61.6**	**1.9%**	**1,176**	**$648**	**$639**	**$8**

*Source: Frontier Economics based on data on passenger volumes and ticket fares from OAG Traffic Analyser. *We have considered the number of departing O/D passengers at each airport and have assumed that they make a return journey.*

The results show that the reduction in consumer surplus could be around $650 million per year. The impacts are greatest at Sydney at Melbourne. This is because:

- they are the largest airports in the analysis meaning that more passengers are impacted negatively by the excessively high airport charges; and
- we estimate that the overcharge on a $ per passenger basis is greatest at those airports.

The vast majority of this consumer surplus is generated on domestic flights. This is unsurprising given the relative significance of domestic air travel and that under the status quo, would be more heavily affected by higher Australian airport charges (given these charges are incurred on both ends of the journey).

The results presented in **Table 3** are based on our 'mid-point' estimate of the potential reduction in airport charges at each airport. Based on our upper and lower bound estimates, the total consumer surplus figure ranges between $550 million and $740 million on a per annum basis.

6.3 Potential benefits from improved connectivity

Lower airfares will also drive new direct airline connections or, on existing routes, more frequent connections.

6.3.1 Estimating new routes and connections

To establish the extent of new connections that might emerge from lower airport charges we undertook analysis to consolidate 'beyond' demand. A beyond passenger is one that flies from the origin airport in question to the final destination via a hub – or in other words, an 'indirect' passenger or a 'multi stop' passenger.

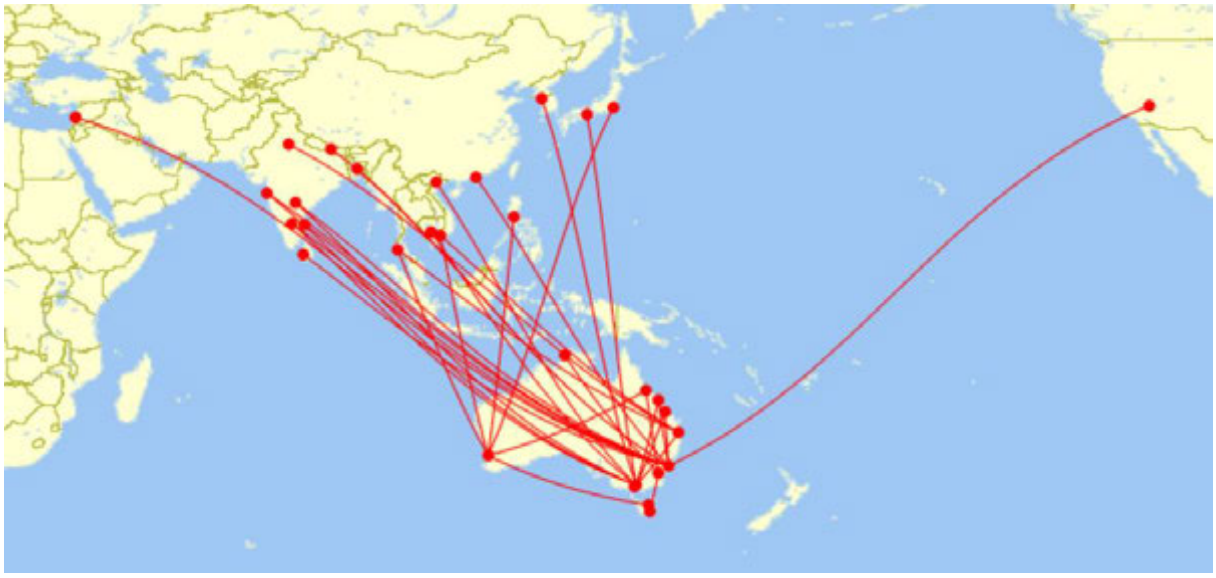
The analysis identifies routes where no direct connection currently exists today, but where there could be enough beyond passengers flying indirectly to the destination to potentially justify adding a new direct connection. We have identified routes which pass the following passenger threshold tests:

- Short haul: We have set the passenger threshold at 15,600 departing passengers per annum. This equates to a twice weekly connection with an average load of 150 passenger.
- Long haul: We have set the passenger threshold at 20,000 departing passenger per annum. This equates to a twice weekly connection with an average load of 190 passengers.[49] We have also applied a distance threshold to rule out very long haul flights. There is currently a direct connection between Heathrow and Perth, which is around 7,800 nautical miles. We only consider potential new connection below this threshold.

We have identified 35 new connections in total that pass these threshold tests. The map below summarises our results:

[49] For short haul, this is based on assuming an A320-200 with 180 seats and a load factor of 83%. For long haul, this is based on assuming a B787-9 with 236 seats and a load factor of 81%. The load factors for short haul and long-haul flights are taken from the Qantas Annual Review 2017 for Jetstar Group and Qantas International respectively.

Figure 6: Results of connectivity analysis



Source: Frontier Economics analysis using gcmap.com.

The results show that there could be enough demand to significantly improve domestic connectivity, as well as to add a number of new direct connections to destinations in Asia, and India in particular.

Our results should be interpreted with caution. As described in the previous subsection, the modelled reductions in airport charges could be expected to boost demand by around 2% on average. Many of these potential new connections already pass the passenger thresholds even before the modelled reduction in airport charges. However, the reductions in charges provide a demand boost which could be enough to produce a critical mass of passengers sufficient for an airline to consider operating a direct connection for the first time. The lumpy decision whether to operate a new direct connection can be impacted by small changes on the margin. We also consider this approach to be conservative because we have not factored in that new connections would induce extra O/D demand - i.e. in the absence of a direct connection, some passenger may choose not to fly, but would fly if there were to be a direct connection. Also, at the larger airports where airlines operate hub and spoke models, the new connections would also likely attract transfer passengers, further adding to total demand and boosting viability.

6.3.2 Travel time savings

New direct connections are quicker and more convenient than flying indirectly. We have estimated the number of hours that could be saved by beyond passengers currently flying indirectly to these destinations.

We have assumed that the direct connections would cut out 1 hour of transfer time connecting at a hub airport along the way, which we consider to be a very conservative assumption. And we have also estimated the reduction in flight time that would arise by being able to fly on one single direct connection rather than on two connections, which involves an extra landing, take-off and indirect flight path – resulting in an average time saving of 2 hours. (We have also multiplied these figures by two to capture that the benefit is felt on both the outbound and inbound flights).

Finally, to monetize these figures we have multiplied the estimate of hours saved by an estimate of the monetised value of time, assumed at $15 per hour. This is based on Australian Transport Assessment and Planning guidance travel time values[50].

Table 4 below summarises our results.

Table 4: Results of connectivity analysis

AIRPORT	POTENTIAL NEW CONNECTIONS	HOURS SAVED (M)	TIME SAVINGS ($M)
Sydney	12	2.2	$34
Melbourne	9	1.6	$24
Perth	6	0.9	$13
Brisbane	4	0.8	$12
Canberra	3	0.4	$6
Hobart	1	0.2	$2
Total	**35**	6.0	**$90**

Source: Frontier Economics

The analysis shows that the new routes could save passengers around 6 million hours per year. This could be worth around $90 million per year in terms of the monetised value of time, or $820 million on an NPV basis[51]. Again, we note that this approach is conservative because we do not factor in the time savings for the extra passengers that would also use the connections.

6.3.3 Catalytic impacts for GDP

Improved connectivity with the rest of the world could ultimately help facilitate extra trade, FDI and tourism spend, and this in turn would boost productivity and GDP. We estimate the increase in GDP to be $1.2 billion annually which equates to an NPV benefit of $10.9 billion[52].

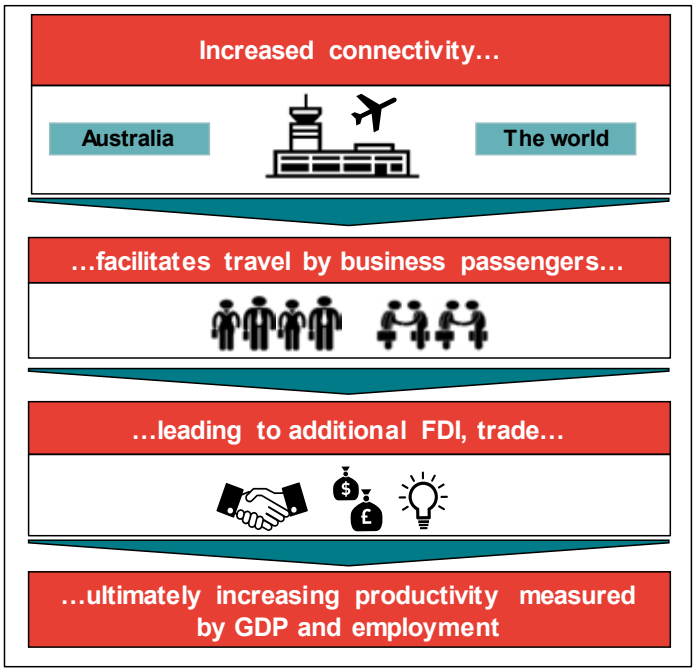
The figure below provides a high level overview of our approach, where we link an increase in demand to increases in outputs based on various elasticities.

50 Since there are no figures for air travel available, we have conservatively used the figure for Heavy Bus passengers. Furthermore, the values are as at 2013, and would be likely to have increased since then with inflation and wages. Full statistics are available here: https://atap.gov.au/parameter-values/road-transport/3-travel-time.aspx

51 This figure is based on the 'mid-point' estimate of the potential reduction in airport charges an evaluation period of 15 years and a real discount rate of 7%. It would reduce to $632 million assuming a 10-year evaluation period and 7% discount rate and increase to $1.1 billion assuming a 15-year evaluation period and 3% discount rate.

52 This figure is based on the 'mid-point' estimate of the potential reduction in airport charges an evaluation period of 15 years and a real discount rate of 7%. It would reduce to $8.4 billion using assuming a 10-year evaluation period and 7% discount rate and increase to $14.3 billion assuming a 15-year evaluation period and 3% discount rate.

Figure 7: Overview of approach to estimating catalytic impacts



Source: Frontier Economics

We have modelled these links quantitatively using various data inputs such as estimates of tourism spending, trade and FDI flows at the level of individual partner countries and GDP. See Annex C for further details on our approach.

The table below summarises our results:

	SPENDING ($M)			GDP ($M)			
	Outbound	Inbound	Net	From trade	From FDI	TOTAL	Jobs
Sydney	$138	$135	-$3	$294	$416	$710	4,140
Melbourne	$69	$62	-$7	$138	$172	$310	1,810
Brisbane	$9	$8	-$1	$17	$27	$45	260
Perth	$30	$19	-$11	$41	$48	$89	520
Adelaide	$3	$2	-$1	$6	$9	$15	90
Gold Coast	$3	$3	$0	$6	$7	$13	80
Cairns	$2	$1	-$0	$5	$8	$14	80
Canberra	$0	$0	-$0	$1	$2	$2	10
Hobart	$0	$0	-$0	$0	$1	$1	10
Total	**$254**	**$232**	**-$22**	**$509**	**$691**	**$1,200**	**7,000**

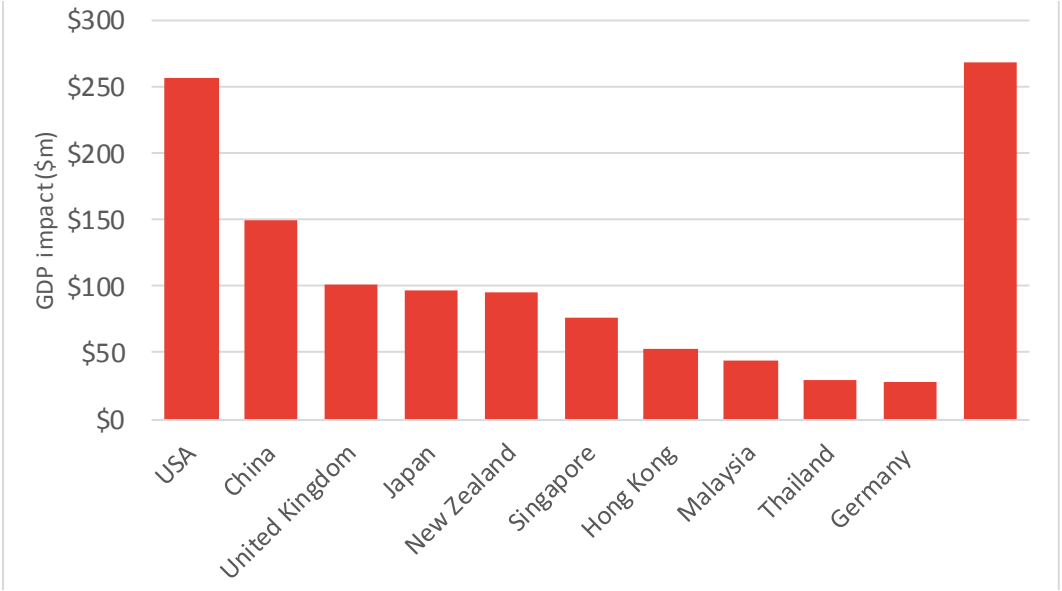
We estimate that the increase in demand brought about by the reduction in airport charges, could ultimately facilitate:

- Around $250m of outbound visitor spending and around $230m of inbound visitor spending. This result is driven by the fact that Australia is a net importer of tourism – i.e. marginally more Australians fly abroad than visitors fly to Australia. Therefore, we have assumed that the extra demand would be made up of the same mix of passengers.
- Around $1.2bn of additional GDP, brought about by productivity gains through increases to trade and FDI. We estimate that this figure equates to around 7,000 jobs.

The results suggest that the impact is greatest at Sydney, again largely owing to the fact that it is the largest airport considered in the analysis with the largest assumed reduction in airport charges.

The chart below shows a breakdown of the GDP benefit by partner country for the top 10 largest countries in the analysis by GDP impact.

Figure 8: Breakdown of total GDP figure by partner country



Source: Frontier analysis

The results suggest that a large proportion of the benefits arise from increased business flows with the USA, China and the United Kingdom

The GDP impact estimated at $1.2 billion annually relates to our 'mid-point' estimate of the reduction in airport charges. Based on our upper and lower estimates, the GDP impact could lie within the range of $1 billion per annum (c6,000 jobs) to $1.4 billion (c8,000 jobs).

6.4 Other wider economic benefits

We note that we have only estimated the catalytic impact with respect to the increase in *international* travel. However, domestic travel represents the vast majority of flights taken from Australian airports.

Therefore, it seems reasonable to conclude that improved domestic connectivity would generate productivity improvements by facilitating easier interactions. This could be categorised as a wider economic benefit (WEB).

WEBs are welfare improvements resulting from transport improvements that are not easily captured in a traditional economic cost-benefit analysis.[53] WEBs arise because of market failures, or market imperfections, which mean economic agents cannot capture the entire benefits of their actions.[54] WEBs are therefore distinct from, and additional to, the benefits estimated above, which do not have regard to whether the proposed remedies would help address market failures.

In this section we provide an overview of WEBs and discuss their relevance to airport pricing in Australia. Further detail is provided in Annex D.

6.4.1 What are wider economic benefits?

Although the estimation of WEBs related to transport improvements is relatively recent in Australia, it has been common practice in the UK since the early 2000s. Guidelines have been published in various jurisdictions to assist in the identification and valuation of WEBs.[55]

We consider the WEBs of most relevance to incremental improvements in connectivity arising from the proposed remedies to be:

- **Domestic agglomeration effects:** Efficiencies can be expected to arise when businesses and people are located more closely together.[56] This could be considered to occur when there is a reduction in travel time/cost arising from connectivity improvements. Closer connections enable firms and workers to increase productivity by taking advantage of location specific economies of scale.[57] Services sectors for which face-to-face contacts are important, such as finance, insurance, real estate and consulting services, are most amenable to agglomeration effects. The main sources of agglomeration effects are:
  - **Knowledge transfer:** Improvements in transport connections can increase interaction between firms and workers and therefore facilitate learning and knowledge transfers or spillovers.
  - **Access to labour:** Better transport linkages can improve productivity by providing firms with better access to specialised or deeper labour markets.
  - **Input effects:** Better air travel connections could also increase productivity by facilitate the provision of specialised inputs more efficiently, providing firms with a larger choice of suppliers and improved capacity to select the input type required for each specific production process.
- **Welfare gains associated with creating more competitive markets:** In markets for which transport is a significant input, lowering costs or increasing the timeliness of transport may enable businesses to expand into new product or geographical markets, in turn increasing competition in these downstream markets.

53 Australian Transport Assessment and Planning Guidelines, T3 Wider economic benefits, August 2016, p2.

54 Anthony Venables (2016), Incorporating wider economic impacts within cost-benefit appraisal, Discussion paper 2016-05, International Transport Forum, OECD, p6 The main sources of market failure include externalities, public goods, market power and incomplete information. Sources of market failure may provide a role for government intervention, including for example, more effective economic regulation of airports.

55 See, for example, Australian Transport Assessment and Planning Guidelines (2016), T3 Wider economic benefits, and United Kingdom Department for Transport (2018), TAG unit A2-1 wider economic impacts appraisal.

56 Productivity Commission (2017), Realising the productive potential of land, Supporting paper no 10, p3.

57 Eddington (2006), Agglomerations in the UK and the role of transport policy, Eddington Review: Research Annex 1.3.

6.4.2 Application to Australian airports

The magnitude of any wider economic benefits will depend on the nature of the intervention, the attributes of the economy (for example, the skills of the local workforce); the nature of competition in air transport-using industries and the response of labour to changes in the cost and availability of flights.[58]

WEBs can account for a material proportion of the economic benefit of a transport improvement. For example, in the UK WEBs were found to increase the estimate of conventional measures of benefits by 5% in the context of the South Yorkshire Bus Subsidy to 44% for London's Crossrail project.[59] In Australia WEBs have been estimated to account for between 9% and 28% of total benefits for major transport infrastructure projects.[60] The potential benefits associated with any change to the airport regulatory regime is likely to be smaller than these estimates, recognising the incremental nature of this intervention.

The measurement of WEBs is not straightforward, and there is limited data to facilitate their estimation.[61] We have therefore not attempted to monetise the WEBs from reforms that better constrain airport market power. Rather, we address these more qualitatively as additional benefits, beyond those described, likely to flow from the proposed reforms.

[58] See United Kingdom Department for Transport (2018), TAG unit A2-1 wider economic impacts appraisal, p1 for further discussion of this.

[59] Duncan Kernohan and Lars Rognlien (2011), Wider economic impacts of transport investments in New Zealand, NZ Transport Agency Research Report number 448, p75.

[60] Patrick Tsai (2016), Wider economic benefits: debunking the myths, p4.

[61] Productivity Commission (2015), PC Productivity Update, p42; Australian Transport Assessment and Planning Guidelines (2016), T3 Wider economic benefits, and United Kingdom Department for Transport (2018), TAG unit A2-1 wider economic impacts appraisal.

7 SUMMARY OF EVALUATION

Our analysis suggests that the proposed remedies outlined in Chapter 3 are cost effective.

They are unlikely to increase the administrative and compliance costs relative to the status quo (base case). In fact, we think there is sufficient evidence to suggest that these remedies will lower administrative and compliance costs by $22.7 million on a net present value (NPV) basis when compared to the current regime (see **Table 5** for a breakdown of this figure).

This is primarily because, when compared to time-unlimited negotiation (under the base case), enabling access to FOA, in tandem with the information transparency and disclosure regime, is more likely to lead to timelier, and therefore lower cost, resolutions of any disagreements.

We do not consider that direct access to an FOA regime will necessarily encourage parties to expeditiously seek arbitration and therefore increase administrative costs (see section 5.2.2). Nor do we consider there is any reason to assume the proposed remedies will have a detrimental effect on investment which should be factored into the evaluation (see section 5.3).

Table 5: Summary of outcomes of the cost effectiveness analysis

Costs	NPV of Costs[62]
Cost to the ACCC of implementing minor amendments to its monitoring approach	$2 million
Cost to Airports from the introduction of an information transparency and disclosure regime	$8.9 million
Improved timeliness of negotiation (assuming reforms decrease the current costs of airport/airline negotiations by 20%)	Saving of $33.6 million
Costs associated with arbitrations	Unvalued assumed to be low
Total	**Saving of $22.7 million**

Source: Frontier Economics

All thing being equal, the proposed remedies are expected to lead to more efficient prices for airport services which, in turn, will lower airline charges and therefore increase demand for air travel. The benefits that may arise from this have, in the past, been ignored on the assumption that the price elasticity of air travel is low.

However, we find that these benefits could be sizeable (see **Figure 2**) and should not be ignored.

We estimate that this a fall in airport prices (as a result of removing excess profits) would lead to an average annual increase in air travel demand of approximately 2% which would lead to a gain in

[62] Assuming a 15-year evaluation period, and real discount rate of 7%.

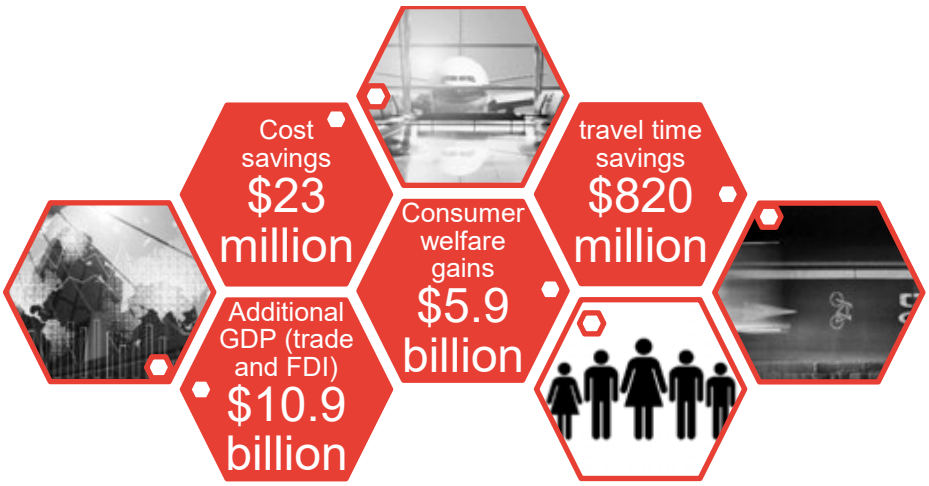
consumer surplus of around $650 million per annum.[63] This equates to around $5.9 billion on an NPV basis. The vast majority of this is generated on domestic flights. It should be noted that this estimated consumer surplus represents both allocative inefficiencies (or dead weight loss) and the transfer of producer surplus (i.e. benefits that were previously captured by airports) to consumers.

In addition, this increase in demand for air travel may also drive new direct or more frequent connections, which may generate further benefits. Our analysis suggests that there could be up to 35 new bi-weekly connections (centred on Asia) that might become feasible with lower airport charges.

This improved connectivity would create:

- **Travel time savings.** These arises because some passengers, under the status quo, travel to their destination indirectly. The estimated improvements in connectivity, will enable some of these passengers to fly directly to their destinations leading to reduction in travel time. We value these savings at almost $90 million a year[64], or $820 million on an NPV basis.
- **Additional catalytic impacts on GDP.** Improved connectivity with the rest of the world could ultimately help facilitate extra trade and FDI, which together could boost GDP. We estimate the increase in GDP to be up to $1.2 billion annually which equates to an NPV benefit of $10.9 billion.
- **Wider Economics Benefits:** Although difficult to quantify, we note the potential for wider economic benefits (WEB) to result from incremental improvements in domestic air connectivity. In particular agglomeration effects.

Figure 9: Summary of benefits of the proposed remedies (NPV, value over 15 years)



Source: Frontier Economics

63 This assumes the proposed remedies will lead to lower more efficient airport charges, which we have estimated by removing the excess profit identified in our companion analysis of profitability. We used these lower charges to estimate a percentage reduction in airfares, assuming this reduction in airports charges is fully passed through to air fares. Using commonly applied estimates of price elasticities of demand for air travel we estimated the consequential impact on passenger demand on every route from nine key Australian airports. The output of this analysis is the increase in demand (in % terms and in the absolute number of passengers) both on individual routes and in total.

64 For each of the (feasible) new direct routes, we have used a fixed cruising speed (800kmh), a fixed take-off/landing time of around 40 minutes and a one our lay-over, then calculated the distance and time of a new direct route. Assumption associated with the value of travel time savings, has come from the Australian Transport Assessment and Planning guidance documents.

A THE ECONOMICS OF APPLYING THE REVISED CRITERION (A) IN PART IIIA PROCEEDINGS

Summary

Recent amendments to the Part IIIA national access regime have created uncertainty about the effectiveness of declaration as a constraint on airports' behaviour. The Productivity Commission's Issues Paper to the Inquiry specifically invites feedback in relation to the 2017 changes to Part IIIA of the *Competition and Consumer Act 2010* (CCA).

In this annex, we examine, from an economic perspective, the possibility of airlines seeking declaration of services supplied by airports under Part IIIA.

Our main finding is that the new wording of criterion (a) has served to make declaration more unlikely — and therefore less of a constraint on airports' behaviour — as declaration would only promote competition in limited and unusual circumstances. Part IIIA's limited application means it could only rarely (if ever) be the mechanism of 'last resort' for resolving serious and protracted disputes as the Productivity Commission originally intended.

A summary of the reasoning for this finding is as follows:

- The criterion (a) test requires that the decision maker – whether this be the NCC, Minister or the Tribunal – be satisfied that declaration of an airport service would promote competition in a dependent market.
- The most obvious hurdle to airport service declaration is that the primary concern relating to abuse of an airport's market power is likely to be uniformly high prices. However, there is usually not a clear anti-competitive motive for high prices, and nor do high input prices of themselves ordinarily have a material effect on competition in downstream markets.
- It is conceivable that high prices (whether uniform or discriminatory) could lessen competition in a dependent market, and that declaration leading to more reasonable terms of access could promote competition. However, as we will discuss, these circumstances will be rare.
- The addition to criterion (a) that declaration would provide access on "reasonable terms" may have been intended to address detriments from monopoly pricing, but it is unlikely to provide any additional utility to criterion (a) in relation to airports.

We explain this reasoning with respect to the analysis in the *Virgin Blue*[65] and *Glencore*[66] access applications and decisions of the National Competition Council, the relevant minister, and the Australian Competition Tribunal. The requisite special circumstances were present in the Virgin Blue application, but the later Glencore case reinforces that decision makers will generally take a sceptical approach to claims that competition can be promoted by lower access charges.

Background

Section 44CA of the *Competition and Consumer Act 2010* now reads:

65 *Virgin Blue Airlines Pty Limited* [2005] ACompT 5 (Virgin Blue)

66 *Application by Glencore Coal Pty Ltd* [2016] ACompT 6 (Glencore)

> *(1) The declaration criteria for a service are:*
>
> *(a) that access (or increased access) to the service, on reasonable terms and conditions, as a result of a declaration of the service would promote a material increase in competition in at least one market (whether or not in Australia), other than the market for the service…*

This new wording clears up the ambiguity about the competing interpretations of the appropriate with-and-without comparison that have characterised the history of Part IIIA since its introduction in 1995. The relevant comparison is not between competition "with and without access to the service" but instead between competition "with and without declaration of the service".

At face value, this new criterion is obviously a higher threshold than the "with and without access" approach. Few, if any, would contend that the "with or without access" approach is a higher threshold, particularly in light of the Glencore decision (which is discussed later in this note).[67] It remains to be seen whether the declaration-based approach to criterion (a) means that the threat of the application of Part IIIA to airports is now effectively neutralised.

In the past, the Productivity Commission has relied on the "backstop" of Part IIIA to prevent the exploitation of market power by airports:

> *… Part IIIA was always intended to be an operative part of the light-handed approach for oversighting airport behaviour — in essence, a mechanism of 'last resort' for resolving serious and protracted disputes.*[68]

We have been asked by A4ANZ to analyse the revised or clarified criterion (a) test to see whether it still meets this objective: that is, to identify the circumstances in which economics would support the declaration of an airports service because it would promote competition in a relevant downstream market in which the airlines compete.

In this note, we set out:

- The elements of the new criterion (a) test
- the meaning of competition and how it can be promoted by declaration
- the circumstances under which declaration could be expected to promote competition in markets for services supplied by airlines
- whether the additional requirement that access be on reasonable terms changes these conclusions

[67] Indeed, the Productivity Commission reached that same view in its 2006 review. See Productivity Commission, *Review of Price Regulation of Airports Services*, No. 40, December 2006, p. 52.

[68] Ibid., p. 47.

Elements of the criterion (a) test

Criterion (a) has a number of elements. Four elements follow from the wording:

- the test must take a "with and without declaration" approach to the assessment of competition
- declaration must promote an increase in competition
- competition must be promoted in a market that is not the market in which the airport holds market power from the ownership of the facility
- the conditions of competition in that identified market must be promoted to a material extent

Access (or increased access) to the facilities provided by an airport promotes competition, because (a) the facilities are clearly a bottleneck to which access must be obtained to provide an airline service, and (b) there are no general rights of access to airports.

The new wording of the test emphasises that it is access because of declaration that matters. So, we must ask when and how might access "on reasonable terms and conditions" that results from declaration promote competition in the markets in which airlines compete?[69]

The relevant markets in an application

The first step in considering criterion (a) is to identify the market or markets in which competition is likely to be promoted to a material extent (the dependent market). This dependent market is separate to the market in which the airport holds market power.

In our view, finding a relevant dependent market is not likely to be a particularly contentious issue in any application for declaration by an airline. The Tribunal's finding in Sydney Airport was that the relevant dependent market was the carriage of domestic air passengers into and out of Sydney.[70] This was not challenged. While it is possible that other markets – including for international passengers – might also be contemplated, it is clear that airlines compete to provide passenger transport services from an airport. This will form the basis of the market in which competition must be promoted.

What does it mean to "promote competition"?

The next step would be for the applicant for declaration to demonstrate how declaration could promote competition in the dependent market identified – for passenger transport services.

As has been noted by the Australian Competition Tribunal on several occasions, competition is a multi-faceted and rich concept that defies a simple exposition.[71] Perhaps most succinctly, the Tribunal has described the process of competition as follows:

[69] With vertical integration, declaration will tend to promote competition if it lowers access prices towards efficient costs. This is because it will enable more effective competition between the vertically-integrated firm (which obtains access to the bottleneck at marginal cost) and competitors in the dependent market.

[70] Virgin Blue, at 128.

[71] See generally *Application by Chime Communications Pty Ltd* (No 2) [2009] ACompT 2 (27 May 2009)

> *1050 …competition may be described as rivalry that amounts to a process that leads to an increase in economic efficiency.*[72]

In our opinion, this correctly links competition with a process that leads to economic efficiency and therefore is socially beneficial.

The starting point for economic analysis of (the state of) competition is conventionally the polar cases of perfect competition and monopoly. The reason this is important is that, in the polar cases, the answers on whether declaration would promote competition are relatively straightforward:

- with perfect competition, there is little prospect that declaration could promote competition because if all suppliers in the dependent market act as price takers, the upstream firm cannot affect prices or quantities in the dependent market.
- with monopoly, there will usually be a strong case that declaration could promote competition (if access to the bottleneck input is essential to compete and declaration would improve access).

Beyond the polar and extreme cases of perfect competition and monopoly, there exists a range of more or less competitive markets and competitive market models. Most relevant to criterion (a) analysis is the intermediate case of workable or effective competition, and of competition's antithesis, market power.

Most definitions of effective or workable competition draw on the "structure-conduct-performance" paradigm that has been widely used in industrial economics for many years.[73] In particular, when making judgments about the effect of a thing on competition, one will look to the effects of that thing on the structure, conduct and performance of the relevant market(s). The key points derived from this framework include that effective competition:

- is strongly dependent on the structure of the market, including the number of competitors and barriers to entry
- signifies rivalry between a number of actual and potential competitors
- prevents or strongly inhibits the exercise of market power which allows firms to 'give less and charge more'
- is associated with higher output and lower prices compared to a less competitive market.

This approach is supported by the decision of the Tribunal in *Chime No. 2*:

> *48 What, then, do we draw from the various models for studying a market to determine its competitiveness and for assessing how the market may behave in the future? In the Tribunal's view a market is sufficiently competitive if the market experiences at least a reasonable degree of rivalry between firms each of which suffers some constraint in their use of market power from competitors (actual and potential) and from customers. The criteria for such competition are structural (a sufficient number of sellers, few inhibitions on entry and expansion), conduct-based (e.g. no collusion between*

[72] *In the matter of Fortescue Metals Group Limited* [2010] ACompT 2 (Fortescue)

[73] Often associated with the work of Scherer, see for example, F M Scherer and David Ross, *Industrial Market Structure and Economic Performance*, Houghton Mifflin, 3rd edition, 1990, p 5.

firms, no exclusionary or predatory tactics) and performance-based (e.g. firms should be efficient, prices should reflect costs and be responsive to changing market forces).[74]

This provides the foundation for an analysis of how declaration could improve the prospects of, or environment for, competition. Competition will be promoted where pricing or other behaviour with declaration: changes market structure with the effect of increasing rivalry between enterprises, reduces market power, allows for increased differentiation of services, or otherwise could be shown to result in higher output and lower prices – consistent with a downstream market that is (without declaration) not effectively competitive.[75]

The circumstances in which access on reasonable terms and conditions could promote competition

Given the discussion on the promotion of competition, it appears difficult, yet not impossible, to conceive of circumstances in which declaration could promote competition. An obvious pointer towards those circumstances are the arguments used in the *Virgin Blue* application, as we go on to discuss.

More broadly, we would expect that airlines may be able to pursue the argument that declaration could promote competition in a downstream market for passenger transport services where:

- an airport denies access to an airline to its facilities
- the airport is engaging in a degree of price discrimination by airline, or directed at an airlines' passengers where the airline targets supply to those passengers (e.g. tourists)
- increases in charges have been sufficient to lower existing airlines' output (e.g. fewer planes or passengers) and/or raise prices in downstream markets, or to raise barriers to entry to new airlines.

Criterion (a) in *Virgin Blue*

The Virgin Blue case remains a relevant benchmark for the role of Part IIIA in relation to airports, because it was decided (later judged incorrectly) by applying a very similar version of the current criterion (a) test.

In October 2002 Virgin Blue applied to the NCC for declaration of an "airside service" at Sydney Airport. In November 2003 and January 2004, the NCC and Treasurer respectively recommended and decided not to declare the airside service. On review, the Competition Tribunal declared the service on the basis that the criterion (a) test was satisfied.

The approach of the Tribunal was similar to that faced by a Tribunal, NCC or Minister at the current time:

516 In order for the Tribunal to declare the Airside Service on the basis of a finding that increased access to the Airside Service would promote competition in the dependent market, it is necessary to establish that, in the counterfactual, SACL's use of monopoly power in relation to use of the Airside

74 Application by Chime Communications Pty Ltd (No 2) [2009] ACompT 2 (27 May 2009)

75 Noting that the Tribunal said in Fortescue that: "The position we take is that if a dependent market is already effectively competitive, intervention is not called for." At [1068].

Service would have an adverse impact on competition in the dependent market which would not exist in the factual with declaration.[76]

On appeal to the Full Federal Court, the Tribunal's decision was upheld but a different application of the criterion (a) test was applied which directly consider the implications of "access" on competition rather than "declaration" – which has now been amended.[77]

The pertinent findings of Virgin Blue's application to the Tribunal were that:

- SACL sought to change its charging structure to increase the proportion of variable charges
- this change in charging structure would have favoured Qantas, at the expense of Virgin Blue
- this new charge was not more cost reflective than the old, and so would not be justified on the grounds of economic efficiency.

The Tribunal considered the question of whether a non-vertically integrated monopoly, like an airport, could have an incentive to deny access, and so lessen competition. It found that a monopolist may have incentive to do so when the downstream market is characterised by a small number of large buyers:

…We accept the proposition that, while a monopolist would ordinarily have no incentive to deny access to its facilities to downstream customers where there is strong competition between its customers, this situation does not hold where the market is characterised by relatively few large customers and strategic behaviour is possible…each of the airlines might want to cut a special deal with SACL, and SACL may be able to use a divide-and-conquer strategy.[78]

In simple terms, the Tribunal is observing that where a monopolist is forced to charge a single (linear) price, it has no incentive to deny access. However, whether the monopolist sets different prices to different users (and can "price down the demand curve" through individual negotiations), it must be wary of buyers behaving strategically and delaying purchases to achieve lower prices. Denying access can be profitable and rational behaviour in those circumstances, even if it lessens downstream competition. This is because it makes its threat to not lower prices or increase output more credible.

The Tribunal did not just consider economic theory in determining that declaration would promote competition. Nor did it focus specifically on the example cited above – as there was no evidence of a denial of access. Rather, it relied on evidence from SACL directly relating to changes in tariff structure (in the form of a strategy paper and oral evidence) that SACL knew that its tariff changes would favour Qantas to make out the theoretical propositions.[79]

The Tribunal accepted the notion that competition has many dimensions, and that there are many ways in which those dimensions of competition can be affected. Virgin Blue's expert, Dr Williams, pointed out some of these ways:

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76 Virgin Blue, at 516.

77 *Sydney Airport Corporation Limited v Australian Competition Tribunal* [2006] FCAFC 146

78 Virgin Blue, at 305.

79 ibid, at 307.

The principal ways in which declaration of the Airside Service would promote competition in the dependent air services market are:

a) it would be less likely to deny access to potential entrants into the air services market;

b) it would be less likely to raise the level of the price of the Airside Service in such a way as: (i) to reduce the range of price/service options offered by airlines, and (ii) to reduce the incentive for (new or established) airlines to commit capacity to fly to and from Sydney; and

c) it would be less likely to structure the price of the Airside Service in such a way as to soften competition and favour full service over low cost carriers.[80]

This analysis demonstrates that, as a general proposition, declaration can promote competition in a market served by a non-vertically integrated supplier. However, the circumstances in which it is likely that declaration would be likely to promote competition are likely to be limited. The evidentiary burden is only likely to be discharged if there is strong evidence than an airport has behaved in ways that have obvious and demonstrable effects on downstream competition — with many behaviours that are also detrimental to competition likely to be easy to mask as being directed at no outcome other than high prices.

To summarise, the key finding was that SACL's change in charging methodology was an example of where declaration could promote competition. A number of other grounds under which competition might be lessened were also raised. However, these grounds also point to the general limitation in relying on criterion (a) – as one needs evidence that access had been denied, that prices or other conditions on the market in which the airlines supply restrict additions to capacity or new services, or that prices are effectively sufficiently discriminatory that they lessen competition.[81]

Criterion (a) in *Glencore Coal (Port of Newcastle)*

The Glencore Coal (Port of Newcastle) case[82] is another pertinent benchmark for the application of the new criterion (a) test. Although the ultimate finding was that the "with and without access" approach was the relevant benchmark for (the existing version of) criterion (a), the Tribunal also had a great deal to say about how it should be applied in the alternative (that is, post 2017) construction.

As a matter of principle, the Tribunal seemed less disposed to the approach of the earlier Tribunal in Virgin Blue. The Tribunal cited the findings of the Hilmer Inquiry that unless there is vertical integration, competition is not necessarily affected.[83]

80 ibid, at 518.

81 Noting that this can also mean charging the same price to carriers in very different circumstances, as per the Virgin Blue example.

82 *Application by Glencore Coal Pty Ltd* [2016] ACompT 6

83 Ibid, at 133.

The reason is that the effect of monopoly pricing is simply to raise the price of one of myriad input prices. When one of an industry's costs goes up, there is no presumption of an adverse effect on competition.

That said, the facts in the Glencore case were slightly different to Virgin Blue. Coal is an export commodity, and the market for seaborne coal is widely accepted to be effectively competitive. That is, there are many suppliers of seaborne coal and coal producers are price takers in a world market.[84]

In this situation, considerations of the kind explored by the Tribunal are less relevant for airports, for two reasons.

- The Port's pricing is much less likely to affect downstream pricing and output decisions.
- Changes in price structure are not likely to produce a softening of competition in the downstream market as per the *Virgin Blue* case – because of price taking behaviour.

The Tribunal first dismissed "sweeping" statements that monopoly should be "presumed" to lessen downstream competition, as this did not clearly identify the relevant markets nor the mechanisms by which higher prices would reduce competition. This approach was certainly consistent with that of the earlier Fortescue Tribunal, which said that:

"The position we take is that if a dependent market is already effectively competitive, intervention is not called for.[85]

The Tribunal considered Glencore's specific arguments that:

- Some mines were "marginal" – in the sense that material increases in port charges could result in them no longer supplying the world market
- Uncertainty over tariffs would deter investment in related markets due to the potential for expropriation of rents.

On the first proposition, the Tribunal found that RBB (Glencore's expert) had not shown that small changes in marginal costs will affect output and prices. It had established theoretical propositions only.[86]

We understand the argument raised by Glencore in the following way: price is determined in the world market where the supply curve for global-exporting coal mines intersects demand. Within the group of mines that supply at the world price, some mines will be the marginal price-setter, and others will be infra-marginal (so earn some economic rents).

In the **left** panel, where domestic producers are low cost, an increase to the monopoly charge by an input supplier such as the port means they will make less money. However, by assumption they are not marginal mines. There is no impact on the world price or quantities consumed. In the **right** panel, we assume that the marginal producer is a domestic mine or mines. If port charges were to increase

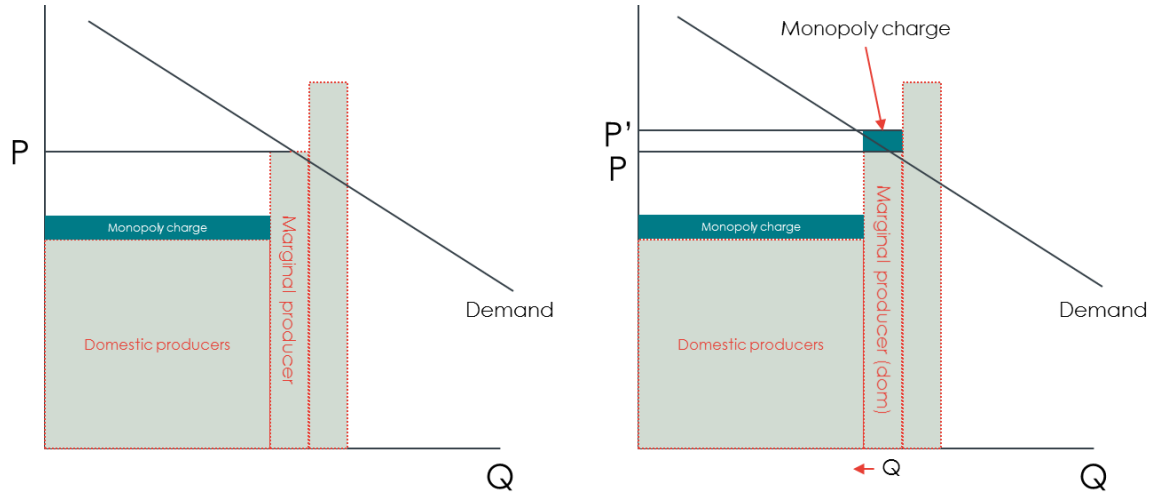
84 Ibid., At 116 and 141.

85 Fortescue, at 1068.

86 Glencore at 144.

significantly, then it could have the effect of increasing the world price and lowering world output (p=>p' and Q=>Q').

Figure 10: Impact on monopoly port charges on the downstream world market for seaborne (export) coal



Source: Frontier Economics

The Tribunal found that, in fact, port charges were only a small component of costs, and output prices had varied dramatically over the preceding years. This looked more consistent with the left panel – if the demand curve was regularly shifting, then it would not be changes in charges that made mines marginal, or would otherwise only have an insignificant impact on profitability.

The Tribunal also found that Glencore's case about a detriment to future investment presumes that increases in price will be such they affect total future output. But, it said, this would not explain why the monopoly would do that. This would not maximise its profits:

> *PNO is in a position to leverage its charging structure, so long as it does not do so to the extent that the coal export market does not diminish, and ideally increases.*[87]

As a consequence, the Tribunal concluded that even high prices caused by exploitation of monopoly could be defended on grounds that it might not reduce output:

- even though it had an expectation that a natural monopoly provider of a bottleneck service (like PNO) "will charge a price higher than the "efficient" price for that service, which is often thought of as the competitive price, at least in the non-natural monopoly setting"[88]

87 ibid., at 153.

88 ibid., at 147.

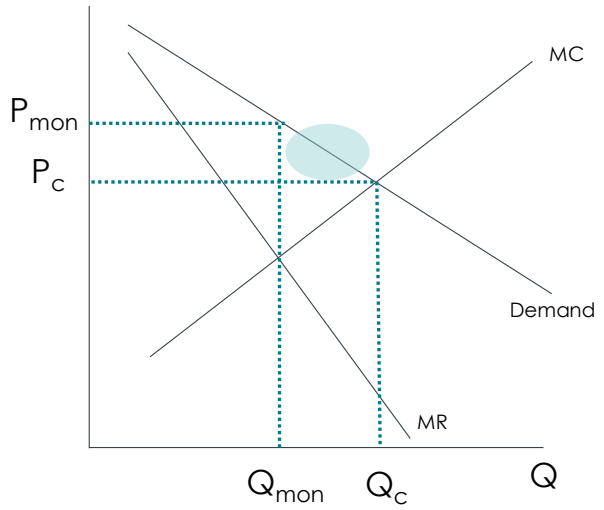
- "it does not necessary follow from an ability to increase prices that there will be a reduction in coal production that impacts competition in the coal export market because PNO has the commercial motivation to ensure that the Service supports the ongoing coal export market and its expansion."[89]

In other words, PNO would be expected to charge high prices, but in ways that would not lessen output (which is quite compatible with miners earning economic rents).

Could the Tribunal's analysis be challenged?

As a matter of economics, the point made by the Tribunal that PNO would "not diminish" output is not necessarily true.[90] This is because a monopolist such as PNO may indeed find it worthwhile to lose some units of output that are only marginally profitable to make more profit on its remaining output. This follows from profit maximising conditions where a firm sets a single (linear price), as shown in **Figure 11**. A monopolist sets a linear price at P_{mon} (where marginal costs equal marginal revenues). However, this always leaves some profitable deals 'on the table', i.e. where price is below the monopoly price, but higher than marginal cost (shaded circle).

Figure 11: Do monopolists maximise output?



Source: Frontier Economics

The cheap deals can only be accessed if the monopolist can price discriminate between customers, with some customers paying the higher price and some the lower.[91] This will only be possible in some—very limited—conditions, such as where the monopolist has a clear insight into the production costs of the firms in dependent markets. Where such insight is not feasible, then the monopolist will not be able to achieve Q_c – the maximum possible output – and will charge higher prices and reduce output.

[89] ibid., at 155.

[90] The ACCC has recently submitted to the NCC a similar argument – that declaration might promote competition because it reduces a potential hold up problem caused by uncertainty about whether the Port of Newcastle might expropriate a mine's investments. This would reduce investment and output, although whether this is true in the relevant market is less clear. See http://ncc.gov.au/images/uploads/Australian_Competition_and_Consumer_Commission_8_August_2018.pdf

[91] This is also shown in the right panel of **Figure 10** – the output loss could only be avoided by charging a very low price to the marginal producer, but with no price discrimination, this would forgo all of the benefits from the monopoly charge to inframarginal users.

With that said, we understand that the Tribunal's main point remains; a rise in input costs that applies to all firms cannot be presumed to lessen competition and a clear theoretical and empirical case would need to be adduced.

As we have indicated, the Glencore case ultimately resulted in declaration on the basis that access would promote competition. The Port has subsequently applied to the NCC for a revocation of the declaration under section 44J, which will take account of the new Part IIIA wording (section 44CA). This will provide a further test for criterion (a) – but based on the decisions of the Tribunal (and, following that, the Full Federal Court) – a significant change in approach to criterion (a) would be required for the Minister to not revoke the declaration.

The addition of reasonable terms and conditions to declaration is not likely to assist decision-makers

The terms of the new criterion add in an extra feature which may assist with the inquiry into whether declaration promotes competition. This feature that that declaration is presumed to give rise to "reasonable terms and conditions" of access.

The formulation might *appear* to invite an inquiry into what the terms of access would be under declaration; however, the Government's explanatory memorandum to the changes states that:

> *12.21 What are reasonable terms and conditions is not defined in the legislation. This is an objective test that may involve consideration of market conditions. It does not require that the Council or Minister come to a view on the outcomes of a Part IIIA negotiation or arbitration. The requirement that access is on reasonable terms and conditions is intended to minimise the detriment to competition in dependent markets that may otherwise be caused by the exploitation of monopoly power.*[92]

From this statement, it appears that the Government has in mind that declaration that reduces the exploitation of monopoly power can reduce detriments to competition in dependent markets. This is line with the analysis we have presented. That is, it would not be a defence for a bottleneck monopolist to say: we charge high prices to all so competition *cannot* be affected.

Unfortunately, while we might agree with the sentiment expressed, it is likely to be very difficult for the NCC, Minister or Tribunal to conclude that the current terms of access are unreasonable, and to specify what more reasonable terms and conditions might look like. This is so even for airports that are subject to monitoring using regulatory accounts.

An obvious issue is the value to place on an airport's assets, and the rate of return that an airport could reasonably earn on those assets. The ACCC has concluded in relation to its monitoring of airports that:

[92] Explanatory Memorandum to the *Competition and Consumer Amendment (Competition Policy Review) Bill 2017*, at 12.21.

A4.3.1 Monitoring information cannot be used to assess the appropriateness of the level of prices and profits

When assessing the level of prices and profits, it is common regulatory practice to undertake an assessment of the firm's economic returns against their efficient long-run costs for providing services. This may involve a public process to rigorously determine an economic value of the firm's asset base (i.e. the regulatory asset base (RAB)) and the firm's required rate of return on capital (i.e. the weighted average cost of capital (WACC)). In the case of airports, however, the benchmark for efficient long run costs has not been set. Instead, the airports' asset values under monitoring are based on their accounting values rather than their economic value. Importantly, the accounting value of assets may include revaluations that have been undertaken at the airports' discretion and that can distort assessments of airports' performance.[93]

To take a further example, airports are multi-service enterprises that use a common set of assets, such as terminals and landside areas. How airports allocate their common costs between services can result in very large price differences – which may or may not be reflective of unreasonable terms.

We conclude that, without detailed regulatory accounting and guidance on key pricing parameters, the burden of showing that prices are not reasonable – and so should engage a comparison with lower reasonable prices - is likely to prove an overwhelming burden for applicants and decision-makers.

93 ACCC, *Airport monitoring reports 2016-17*, Appendix A, p. 189.

B CONVERTING EXCESS PROFITS INTO LOWER AIR FARES

An assumption underpinning the analysis of the consumer welfare and the catalytic impacts of improved connectivity is the difference in airport charges under the proposed remedies and the base case.

Under the base case, our analysis assumes that Australian airports with market power can be expected to set aeronautical charges above the competitive level consistent with their pricing in the past. This is compared to pricing under the proposed remedies where it is assumed airport market power is constrained.

The estimated reduction in average airport charges, under the proposed remedies, is based on a number of steps and assumptions:

- First, converting the excess profit identified in our companion analysis of profitability[94] into a lower airport charge (as a percentage).
- Second, this percentage reduction has then been applied to ACCC estimates of average aeronautical revenue per passenger at each of the nine airports considered in the analysis.
- Third, the consequential reduction in ticket fares is estimate as a result of this reduction in airport charges. We have made a high-level assumption that a decrease in airport charges would be passed through to passengers in full in the form of lower ticket fares. We have applied the reduction to ticket fares on each individual route at each airport considered in the analysis. We have used data on ticket fares at the route level from OAG Traffic Analyser.

Converting excess profits into a percentage reduction in airport charges

In our companion analysis of Airport profitability[95], the main method used to calculate an airport's excess profits involved calculating an internal rate of return (IRR) and comparing this with an estimated opportunity cost of capital (WACC) based on taking a conservative view of a regulators likely approach to estimating this.

For example, for Sydney Airport we calculated a difference of 3.8% between the IRR and an (average) WACC (pre-tax, nominal) over the period 2002-2016. Under the proposed remedies we are assuming that an airports prices will be reduced to the point where its prices (and revenue) now deliver an IRR in line with the WACC.

There are potentially a range of alternative price paths that could have produced the IRR equal to the WACC[96]. The simplest approach for estimating the percentage price change, and the one adopted in this analysis, is to calculate the percentage by which the positive annual (and final) cash flows would need to reduce to produce an IRR consistent with earning the opportunity costs of capital. It should be noted that this implicitly assumes charges do not impact on volumes – so that at the assumed lower price path, revenues and cash flows would fall by the same amount as prices.

A secondary method on which we have relied is to estimate the Tier 1 Airports' return on assets (EBIT / total assets). We have computed this annually from 2007. If we chose a recent year, we could compute the reduction in revenues necessary so that earnings are consistent with a return on assets equal to the cost of capital. Again this would assume that, in the alternative, prices would fall by the same as

94 Frontier Economics (2018) "The profitability of Australian price monitored airports", prepared for A4ANZ

95 ibid

96 Note the IRR is calculated using cash flows rather than prices, and we do not have volumes by which we could simply back out price changes (that is, cash flows are a function both of prices and volumes).

revenues. The results of these two calculations for the four airports subject to monitoring – over the period 2002-16 (Sydney) and 1998-2016 (Melbourne, Brisbane, Perth) is presented in **Table 6**.

Table 6: Implied range of price reductions to achieve return = WACC

SUMMARY	PRICE REDUCTION (IRR) – UPPER BOUND	PRICE REDUCTION (ROA) – LOWER BOUND
Sydney	31%	37%
Melbourne	43%	24%
Brisbane	10%	9%
Perth	15%	13%

Source: Frontier Economics analysis

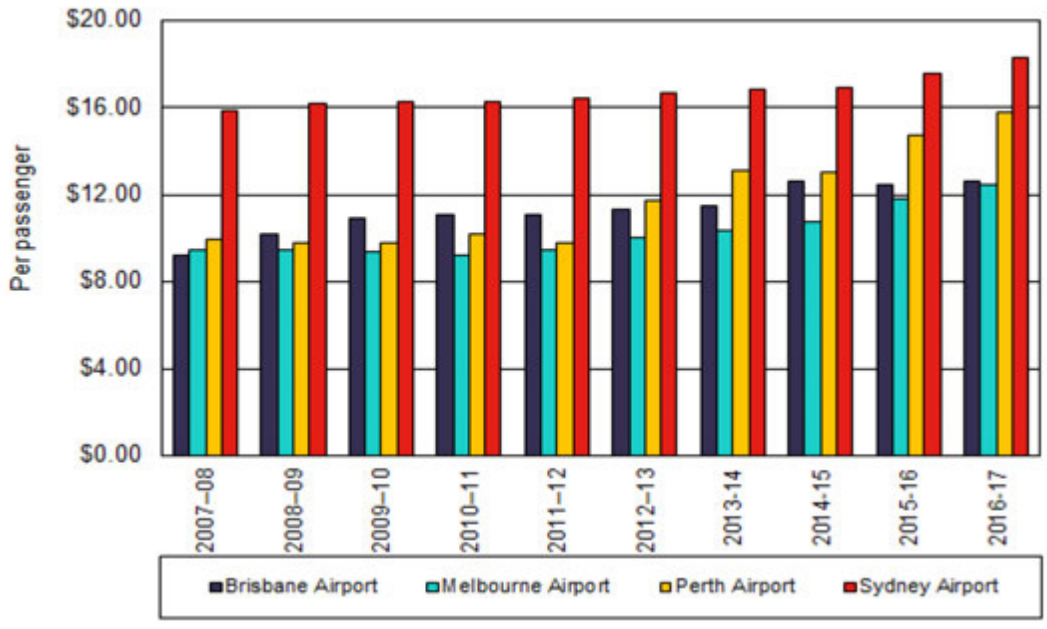
By way of example for Sydney:

- A 31% reduction in revenues/prices across the period 2002-2017 would result in Sydney's IRR = WACC.
- A 37% reduction in revenues/prices in the 2017 year would result in Sydney's ROA = WACC.

Converting the percentage reductions into absolute reductions

We then applied these percentage reductions to the most recent estimates of average aeronautical revenue per passenger at the four airports above. This is based on the figure below from the ACCC.

Figure 12: Aeronautical revenue per passenger in real terms: 2007–08 to 2016–17



Source: ACCC: Airport Monitoring Report 2016–17 April 2018. Figure 2.3.1

Based on the range of percentage price reduction estimates provided in **Table 6** above we have produced a range for of the reductions in absolute terms in **Table 7** below.

Table 7: Reduction in aeronautical revenue per passenger

SUMMARY	LOWER BOUND	UPPER BOUND	MID-POINT
Sydney	$5.6	$6.7	$6.2
Melbourne	$3.0	$5.3	$4.2
Brisbane	$1.1	$1.3	$1.2
Perth	$2.0	$2.4	$2.2
Minimum	$1.1	$1.3	$1.2

Source: Frontier Economics analysis

We have assumed that these reductions in aeronautical revenue per passenger would lead to an equivalent reduction in airport charges per passenger. We have assumed that the minimum estimate reported in **Table 7** above would also apply at the five other airports included in the analysis. Namely Adelaide, Gold Coast, Cairns, Canberra and Hobart.

Next, we have assumed that these reductions in airport charges would be passed through to passengers in full in terms of lower ticket fares. In reality, airports tend to charge airlines on the basis of departing passengers only. As a result, the figures in **Table 7** need to be converted in average revenue per departing passenger. Assuming there are half as many departing passengers as total passengers then the to deliver the reductions in *average revenue per passenger* presented above there would need to be a reduction *average revenue per departing passenger* of twice the size. For example, we assume that the airport charge for a passenger departing Sydney would fall by $12.40 using our mid-point estimate (i.e. 2 x $6.2). Therefore, a passenger making a return journey between Sydney ($12.40) and Perth ($4.40) would see the return ticket fare fall by $16.80.

In our connectivity and catalytic impact analysis we have used the 'mid-point' reduction to produce our base case set of results, and have used the upper and lower bound estimates as a sensitivity to produce a range.

Converting reductions in airport charges into airfares

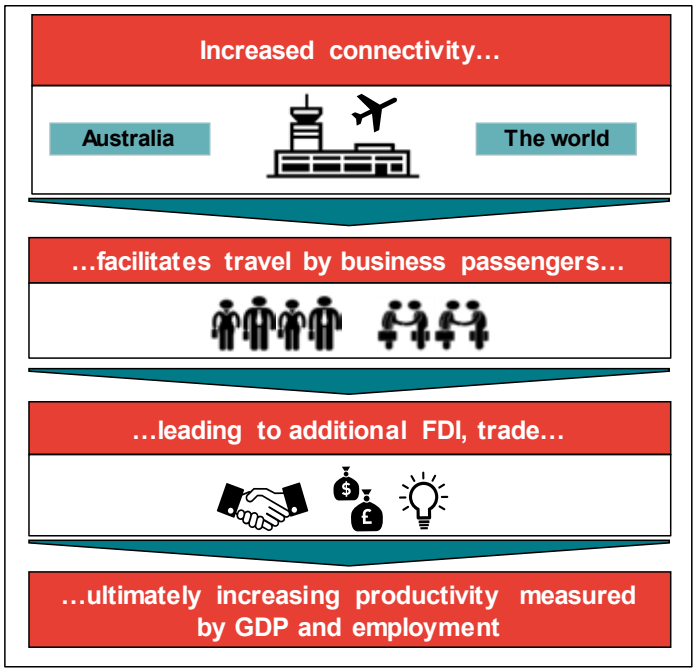
We have then applied these reductions in average airport charges to estimates of average ticket fare per passenger for each individual route at the airports considered in the analysis. This is based on ticket fare information from OAG Analyser. The data from OAG already includes airports charges within the estimate of ticket fare. However, it does not include taxes. We have therefore added on GST (ad valorem tax of 10%) for passengers flying to short haul destinations, and have added $60 for passengers flying to long haul destinations (the 2017 Passenger Movement Charge[97]).

[97] https://www.homeaffairs.gov.au/trav/ente/goin/departing/passenger-movement-charge-(PMC)

C ESTIMATING THE CATALYTIC IMPACT

The illustration below provides a high-level overview of our approach to estimating catalytic impacts, which we describe in more detail below.

Figure 13: Overview of approach to estimating catalytic impacts



Source: Frontier Economics

The starting point of the analysis is the estimate of the increase in demand on individual routes following the reduction in airport charges, described in section 6.2. First we express this increase in demand as an increase at the country level – e.g. not expressed at the level of Sydney to Los Angeles, but Australia to the USA. This is relevant in the context of trade and Foreign Direct Investment (FDI) statistics being reported at the national level[98].

In the following sections we describe how the increase in passenger volumes links to increased FDI, trade and tourism, and consequently how these impact on productivity, GDP and jobs.

In this annexe, we describe the link between passenger volumes and FDI, trade and tourism as follows:

- Relationship between face-to-face meetings and trade and FDI
- Relationship between leisure passengers and tourist spending.

We then describe the relationship between trade and FDI and GDP.

Relationship between face-to-face meetings and trade and FDI

Face-to-face meetings increase the likelihood of closing business deals which has a positive impact on trade and FDI. Face-to-face meetings are also important to manage increasingly globalized supply

[98] For example, the statistics collected by the OECD http://www.oecd.org/corporate/mne/statistics.htm

chains. This relationship is strongly supported by qualitative literature, but it is difficult to quantify the relationship.

Concept

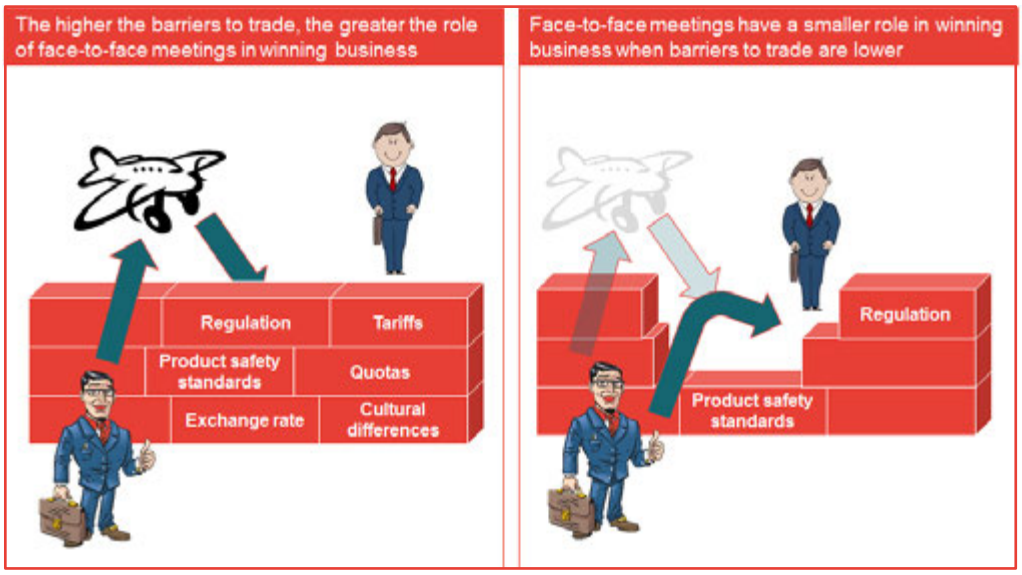
In spite of the increase in use of technologies such as videoconferencing, face-to-face meetings continue to play an important role in developing and maintaining successful business relationships. Most relationships are built on trust between business partners and face-to-face meetings are still the most effective way to build and establish trust. In addition, in-person meetings can be used to inspect production sites and meet larger teams which cannot be done through videoconferencing.

Face-to-face meetings therefore play a role in overcoming trade and FDI barriers between economies. The most common barriers include:

- **Product market regulation —** a range of different types of regulation (product standards, safety regulation, etc.) can inhibit trade and FDI across borders;
- **Tariffs and quotas, local content requirements —** formal trade barriers such as tariffs also reduce the likelihood of trade;
- **Exchange rate —** the risk of changes in the exchange rate can pose a significant barrier to trade and FDI, as exchange rate volatility can increase the spread of potential returns; and
- **Cultural differences —** language differences and different business cultures can impede business relationships across cultures as it is more difficult to build trust.

Business travel can reduce or overcome some of these barriers, as face-to-face meetings enable a better understanding of local product market regulation and formal trade barriers. Face-to-face meetings are also one of the key ways to build trust across cultures. **Figure 14** illustrates this concept.

Figure 14. Illustration of differences in trade barriers



Source: Frontier Economics

Review of evidence

There is a range of qualitative, survey-based evidence that suggests face-to-face meetings play an important role in business relationships, which we elaborate on below. The importance of in-person meetings for trade facilitation is also supported by the existence of trade missions. For example, the recently formed Department for International Trade (DIT) helps UK-based businesses in establishing links with overseas partners[99]. Among other events, they organise trade missions for different sectors/industries involving workshops, fairs, speakers, etc. which facilitate networking and business opportunities.

The World Travel and Tourism Council (2012) found that sales conversion rates with an in-person meeting are 50%, compared to conversion rates of 31% without an in-person meeting[100]. The results are based on surveys in Brazil, China, Germany, the UK and the USA and are consistent across these countries. In 2011, the WTTC conducted another survey on the importance of business travel and found that 28% of existing business could be lost without face-to-face meetings and sales conversion rates are estimated to be 20-25% higher with face-to-face meetings[101]. This is further supported by a range of qualitative studies.

- Frankel (1997)[102] illustrates the importance of face-to-face meetings as follows:

  Consider a kind of export important to the United States: high-tech capital goods. To begin sales in a foreign country may involve many trips by engineers, marketing people, higher ranking executives to clinch a deal, and technical support staff to help install the equipment or to service it when it malfunctions.

- A survey by the UK Institute of Directors (2008)[103] asked about the impact on businesses if the amount of business travel by air was significantly curtailed. 30% of respondents said that there would be significant adverse effects while 44% indicated small adverse effects.
- Poole (2010)[104] finds that business travel to the United States by non-resident, non-citizens has a positive impact on export margins. This report has also been cited by the Airports Commission.
- Aradhyula & Tronstad (2003)[105] find that their results support the hypothesis that both formal business exploration and casual exposure to cross-border business opportunities have a positive impact on trade.
- Strauss-Kahn & Vives (2005)[106] find that headquarters relocate to metropolitan areas with good airport facilities, low corporate taxes, low average wages, high levels of business services, and an

99 More information about their activities is available at: https://www.gov.uk/government/organisations/department-for-international-trade/about

100 World Travel and Tourism Council, (2012), The Comparative Economic Impact of Travel & Tourism, Available https://www.wttc.org/-/media/files/reports/benchmark%20reports/the_comparative_economic_impact_of_travel__tourism.pdf

101 World Travel and Tourism Council, (2011), Business travel: A catalyst for Economic Performance, Available http://www.wttc.org/site_media/uploads/downloads/WTTC_Business_Travel_2011.pdf

102 Frankel, (1997), Regional trading blocs in the world trading system

103 UK Institute of Directors (2008), High Fliers: Business Leaders' views on air travel, Available http://www.iod.com/intershoproot/eCS/Store/en/pdfs/policy_paper_Aviation.pdf

104 Poole (2010), "Business travel as an input to international trade", Available http://www.scu.edu/business/economics/upload/Poole.pdf

105 Aradhyula & Tronstad (2003), "Does tourism promote cross-border trade", http://www.jstor.org/discover/10.2307/1244983?uid=3738032&uid=2129&uid=2&uid=70&uid=4&sid=21102568114193

106 Strauss-Kahn and Vives (2005), "Why and where do headquarters move?", Available http://papers.ssrn.com/sol3/papers.cfm?abstract_id=776568

agglomeration of headquarters in the same sector of activity. The effects are quantitatively significant (for airport facilities in particular).

- The City of London (2008)[107] surveyed finance and insurance companies on the importance of air travel. They found that 69% of firms consider air travel to be critical for business travel by their staff, with only 2% viewing it as not important.
- Boeh & Beamish (2012)[108] demonstrate that travel time between different locations has a significant predictive power in firm governance and location decisions, as travel time could otherwise be employed for productive purposes.
- Napier University (2004)[109] finds that *"[…] air transport per se is not a necessary condition, but what is important are: the extent to which that area is plugged directly into other major international hubs - availability and efficiency of routes (direct, hubbed); costs and the level of competition in global transport market, and; perceived and actual interchange efficiencies. This is a key consideration in the level of foreign investment into an area and is most important for firms with international trading or contacts such as, high-tech firms, financial services and pharmaceutical firms".*

Survey-based evidence also suggests that the importance of face-to-face meetings depends on differences between business partners. Evidence from the World Travel and Tourism Council (WTTC) and the Harvard Business Review indicates that international business travel plays a more improtant role in generating and sustaining business than domestic travel. The WTTC (2012)[110] found that:

- One extra dollar invested in international business travel would generate on average US$17 in trade; and
- One extra dollar invested in domestic US business travel by companies results in an increase in revenue of US$9.50.

This implies that the return on investment for international travel is roughly double that for domestic travel. **Figure 15** illustrates the difference in the return on investment.

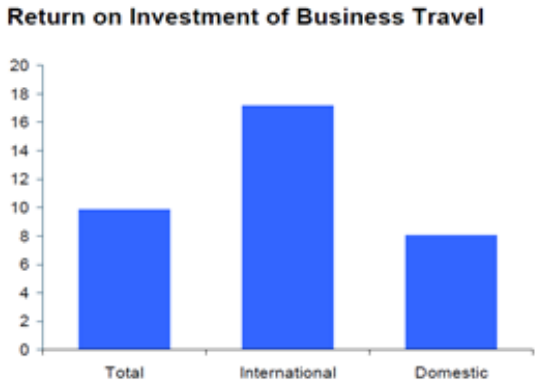
107 The City of London (2008), Aviation Services and the City, Available http://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Documents/research-2008/Aviation%20Services%20and%20the%20City_ExecutiveSummary.pdf

108 Boeh & Beamish (2012), "Travel time and the liability of distance in FDI: Location choice and entry mode", http://www.palgrave-journals.com/jibs/journal/v43/n5/abs/jibs201210a.html

109 Napier University (2004) "The Importance of Transport in Business' Location", Available http://www.stopstanstedexpansion.com/documents/SSE10_Appendix_9.pdf

110 World Travel and Tourism Council, (2012), The Comparative Economic Impact of Travel & Tourism

Figure 15. Return on investment



Source: World Travel and Tourism Council, 2011

Similarly, the Harvard Business Review (2009)[111] confirms the role of face-to-face meetings in facilitating and sustaining business deals and also provides some evidence for the specific role of business travel in overcoming barriers to trade across different cultures. For example, it found that:

- 93% of survey respondents agreed that in-person meetings are helpful in negotiating with people from different language and cultural backgrounds;
- One survey respondent said that *"Communicating with our Chinese partners is enough of a challenge without face-to-face, because it is very difficult to explain a difference in perspective without body language"*; and
- A number of respondents described the need to work with clients in their own environment to get a full picture of the challenges and opportunities they face.

There is a small amount of literature that supports this view.

- Cristea (2011)[112] found robust evidence that the demand for business-class air travel is directly related to volume and composition of exports in differentiated products. The paper finds that trade in R&D intensive manufactures and goods facing contractual frictions is most dependent on face-to-face meetings. Contractual frictions are more likely to occur with higher trade barriers, so this would support a conservative assumption of an elasticity of zero for trade between the UK and Europe compared to the rest of the world.
- Poole (2010)[113] finds that business travel for the purpose of communication acts as an input to international trade. The effect is stronger for differentiated products and for higher-skilled travellers, reflecting the information intensive nature of differentiated products. The effect is driven by travel from non-English speaking countries, for which communication with the U.S. by other means may be less effective. The findings therefore also confirm our view that business travel plays a bigger role when connecting firms from different cultural backgrounds.

111 Harvard Business Review (2009), Managing Across Distance in today's Economic Climate: The value of face-to-face communication

112 Cristea (2011), "Buyer-Seller Relationships in International Trade: Evidence from U.S. State Exports and Business-Class Travel", http://www.sciencedirect.com/science/article/pii/S0022199611000250

113 Poole (2010), "Business travel as an input to international trade", Available http://www.scu.edu/business/economics/upload/Poole.pdf

Selection of assumption values

It is difficult to statistically isolate the impact of face-to-face meetings from the other factors that influence trade and FDI. As a result, there is not a vast amount of quantitative evidence on the relationship between face-to-face meetings and trade/FDI is difficult to obtain.

The World Travel and Tourism Council (WTTC) performed an econometric analysis on the relationship between flights and trade/FDI for a range of countries as shown in **Figure 16**. The figure shows the correlation coefficient as well as the results of the Granger test for causality. The figure shows that the correlations vary between 0.17 for outbound business travel from Italy to 0.98 for outbound business travel from Brazil[114].

Figure 16. Trade and business travel by country

Trade & Business Travel by country

	Inbound business travel vs imports Causality (% confidence)			Outbound business travel vs exports Causality (% confidence)		
	Correlation	Travel causes Trade	Trade causes Travel	Correlation	Travel causes Trade	Trade causes Travel
US	0.87	95%	26%	0.65	82%	86%
Canada	0.92	100%	99%	0.85	98%	87%
UK	0.54	65%	85%	0.61	95%	80%
France	0.49	57%	85%	0.63	61%	92%
Germany	0.97	90%	81%	0.69	60%	98%
Italy	0.52	99%	100%	0.17	58%	99%
Spain	0.20	75%	99%	0.74	91%	80%
Japan	0.91	97%	53%	0.40	74%	92%
China	0.32	92%	95%	0.67	90%	99%
Russia	0.83	50%	90%	0.52	100%	95%
Brazil	0.57	100%	100%	0.98	88%	87%
India	0.72	84%	66%	0.46	99%	58%
UAE	0.42	83%	49%	0.82	95%	64%
Singapore	0.70	96%	94%	0.74	83%	53%
Hong Kong	0.67	95%	100%	0.43	86%	78%

Note: causality is shown as the probability that the identified casual relationship is true

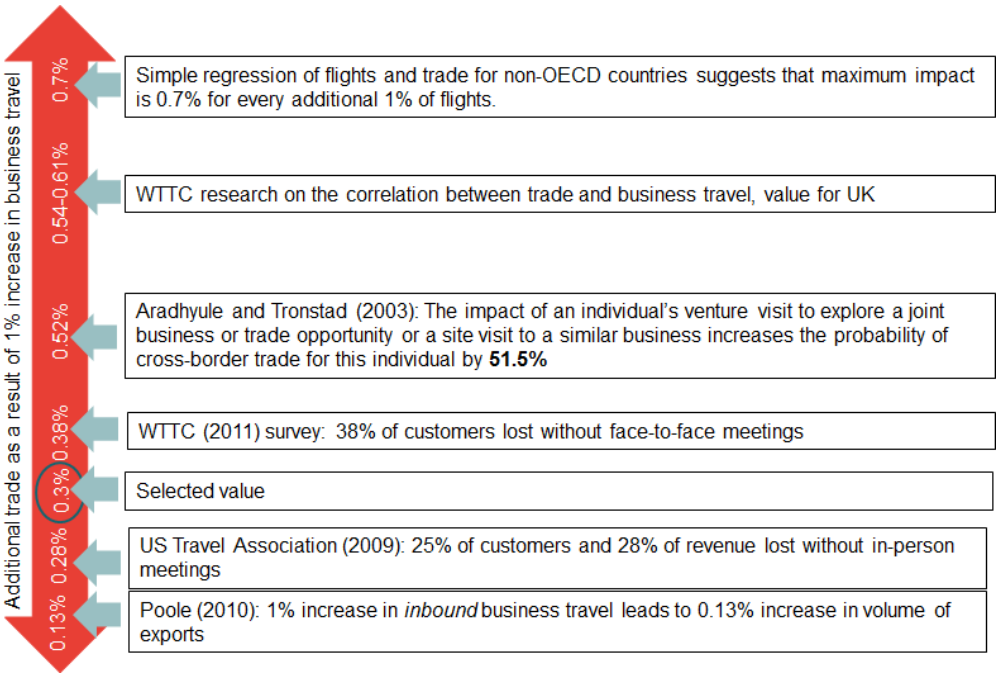
Source: WTTC, 2012

We realise that it is difficult to select an appropriate estimate for the relationship between trade and business travel. Having considered a range of evidence as illustrated in **Figure 17** we have selected 0.3% as the elasticity. Given the available evidence, this is a conservative estimate.

It is even more difficult to select an appropriate estimate for the relationship between FDI and flights as little research has been done on this topic. As shown below, there is a range of estimates. In order to select a conservative estimate, we have selected 0.3 as the elasticity of business travel to FDI.

[114] World Travel and Tourism Council, (2012), The Comparative Economic Impact of Travel & Tourism

Figure 17. Evidence on relationship between face-to-face meetings and trade



Relationship between passengers and tourism spending

A change in passenger flows between countries leads to a change in direct spending from passengers in both directions. This covers both:

- Australians spending money abroad (outbound spending)
- Foreign passengers spending money in Australia (inbound tourism)

To quantify the impact on tourism spending we have used data from Tourism Research Australia[115] on inbound tourism spending per passenger, and on inbound and outbound tourist passenger volumes[116].

We have then applied these 'per passenger' figures to the extra passengers that fly under lower airport charges scenario. As a result, this produces an estimate of increased inbound and outbound spending.

FDI, trade and productivity, GDP and employment

We break this section into separate relationships:

- Trade, productivity and GDP;
- FDI, productivity and GDP;
- GDP and employment

115 Tourism Research Australia (2018), International Visitor Survey Results, available: https://www.tra.gov.au/International/international-tourism-results

116 TRA does not collect information on outbound tourism expenditure, so we have assumed that it is identical to inbound expenditure. This is likely to be an underestimate for countries where tourists have particularly high expenditures like China.

Trade, productivity and GDP

A large body of academic research investigates the positive impact of trade on productivity at the firm level. At the economy-wide level, there are also some studies which suggest additional trade leads to higher productivity. The key mechanisms by which trade influences productivity can be characterized in three ways:

- **Innovation -** trade is one of the key "transmitters" of innovation as it exposes companies to a wider range of products and processes in other countries. This applies regardless of whether the partner country is a developed or developing economy.
- **Competition -** as trade increases the market size companies that export or import are faced with more intense competition. Competition puts pressure on companies to be more efficient. This applies to trade with any partner country.
- **Economies of scale -** larger market sizes imply that production processes can benefit from economies of scale. This also applies to trade any partner country.

For example, the OECD, (2012)[117] found that: "A main channel through which trade increases income is productivity growth. Importing creates competition that forces domestic firms to become more efficient and provides access to inputs of international calibre; exporting creates incentives for firms to invest in the most modern technologies, scales of production and worker training. The combined effect is to spawn a process of continual resource reallocation, shifting capital and labour into activities with higher productivity".

Importantly, the impact of trade on productivity holds for both exports and imports. This is because we are considering the long-term impact on trade on productivity instead of the short-term. In the short-term import substitution can lead to structural changes in the economy that require some adjustments. However, once resources are allocated to more productive uses, imports have a long-term positive impact on productivity. The study that underpins our main assumption uses a measure of "real openness" which is the sum of exports and imports over GDP.

The OECD has undertaken a study with data from 21 high-income countries over nearly 30 years controlling for other factors: every 10-percentage point increase in trade exposure (as measured by trade share of GDP) contributes a 4-percent increase in GDP per capita[118]. Similarly, in 2007 the European Commission stated that "For instance, empirical analysis indicates that, on average, a 1% increase in the openness of the economy, as measured by the ratio of imports to value added, results in an increase of 0.6% in labour productivity in the following year"[119]. To select a conservative assumption, we have used the lower figure of 0.4 as indicated by the OECD research.

FDI, productivity and GDP

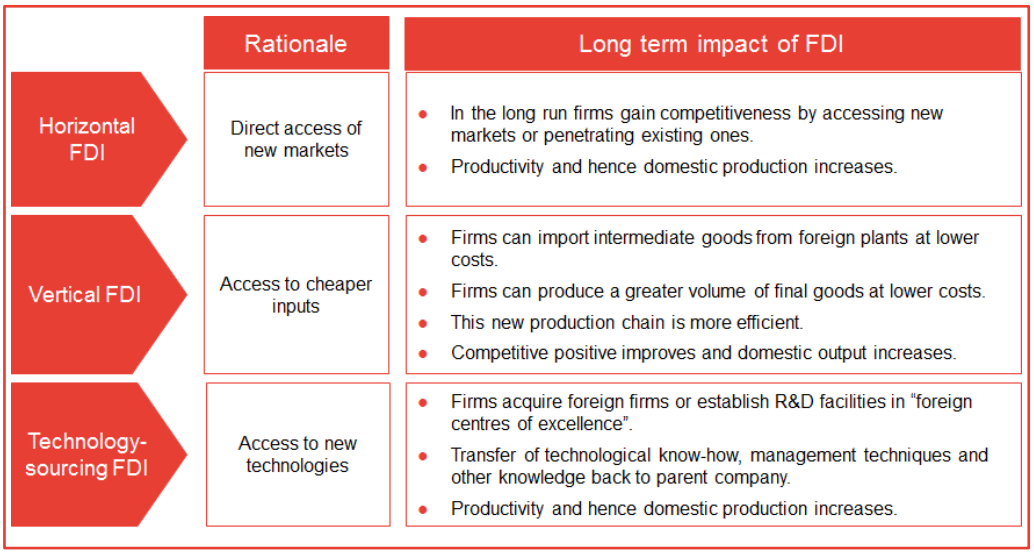
Both inward and outward FDI have a positive impact on productivity and competitiveness. Our research suggests that access to new markets, cheaper inputs and new technology or know-how boosts the scale and efficiency of domestic production. The underlying theory is similar to that applied to free trade agreements. **Figure 18** summarises how FDI can impact productivity.

117 OECD, (2012), Policy Priorities for International Trade and Jobs, Available http://www.oecd.org/site/tadicite/50286917.pdf

118 ibid

119 European Commission (2007), Moving Europe's productivity frontier, Available http://ec.europa.eu/economy_finance/publications/pages/publication10130_en.pdf

Figure 18. Impact of FDI on productivity



Source: Frontier Economics

Evidence on the specific impact of FDI on productivity is limited. We have found the following studies:

- DIW (2009)[120] studies the relationship between outward FDI and economic growth. They find that FDI enables firms to enter new markets, import intermediate goods from foreign affiliates at lower costs and access foreign technology. As a result the domestic economy benefits from outward FDI due to increased competitiveness of the investing companies and associated productivity spill-over to local firms. The analysis shows that for every 1% increase in outward FDI stock, local GDP increases by 0.19%.
- Korea Institute for International Economic Policy (2008)[121] studies the relationship of inward FDI and productivity using Ireland as a case study. They find that FDI advances new foreign technology or import of new intermediary goods and enhances growth by accumulation of human capital by means of labour training or absorption of technology and new management techniques. Their analysis shows that for a 1% increase in inward FDI stock, local GDP increases by 0.24%.

Based on the quantitative analysis we reviewed, we make the following assumptions:

- a 1% increase in inward FDI increases productivity and thus, GDP by 0.24%; and
- a 1% increase in outward FDI increases productivity and thus, GDP by 0.19%.

GDP and employment

The relationships between trade, FDI and GDP give us a percentage change in GDP resulting from the change in trade and FDI. We translate the impact on GDP into employment numbers using the national GDP/jobs ratio – i.e. actual GDP divided by the number of jobs.

120 DIW, (2009), Outward FDI and economic growth

121 Korea Institute for International Economic Policy, (2008), "The Impact of Foreign Direct Investment on Economic Growth: A Case Study of Ireland"

D OTHER WIDER ECONOMIC BENEFITS

We consider there is the potential for wider economic benefits (WEB) to result from incremental improvements in domestic air connectivity.

Wider Economic Benefits (WEBs) are welfare improvements resulting from transport improvements that are not easily captured in a traditional economic cost-benefit analysis.[122] In this annex we begin by providing an overview of WEBs, including discussing their relationship to the benefits previously estimated, before discussing those WEBs of relevance to the proposed remedies being considered.

We have not attempted to monetise the WEBs that may result from incremental improvements in domestic air connectivity as a result of the proposed reforms that better constrain airport market power.

Rather, we address these more qualitatively as additional benefits, beyond those described in section 6, that are likely to flow from the proposed reforms.

What are wider economic benefits?

WEBs arise because of market failures, or market imperfections, which can mean economic agents cannot capture the entire benefits of their actions.[123]

The concept of WEBs has gained considerable currency in the analysis and evaluation of public infrastructure projects, particularly in the area of transport. The estimation of WEBs is an accepted practice in the evaluation of transport interventions in Australia, the UK and New Zealand. Although the estimation of WEB related to transport improvements is relatively recent in Australia, it has been common practice in the UK since the early 2000s. Guidelines have been published in various jurisdictions to assist in the identification and valuation of WEBs.[124]

We consider the following WEBs to be of most relevance to the proposed reforms being considered:[125]

- **Domestic agglomeration effects:** The benefits of geographic co-location to firms, workers or consumers.
- **Output change in imperfectly competitive markets:** The welfare gain associated with the increase in production in goods and services in markets for which transport is an input.

We discuss each of these benefits in turn in the following sections.

WEBs are distinct from the benefits estimated in conventional cost benefit analysis and presented in section 6 of this paper. WEBs expand conventional cost-benefit analysis in two key ways:[126]

- Conventional benefits estimation assumes existing productive relationships, for example capital and labour stocks and productivity, are maintained. WEBs recognise a change in airport pricing may change these parameters, and therefore generate an additional benefit.

122 Australian Transport Assessment and Planning Guidelines, T3 Wider economic benefits, August 2016, p2.

123 Anthony Venables (2016), Incorporating wider economic impacts within cost-benefit appraisal, Discussion paper 2016-05, International Transport Forum, OECD, p6 The main sources of market failure include externalities, public goods, market power and incomplete information. Sources of market failure may provide a role for government intervention, including for example, more effective economic regulation of airports.

124 See, for example, Australian Transport Assessment and Planning Guidelines (2016), T3 Wider economic benefits, and United Kingdom Department for Transport (2018), TAG unit A2-1 wider economic impacts appraisal.

125 Australian Transport Assessment and Planning Guidelines (2016), T3 Wider economic benefits, August, p2.

126 United Kingdom Department for Transport (2018), TAG unit A2-1 wider economic impacts appraisal, p8.

- Conventional benefits estimation assumes markets are perfectly competitive, including those markets that rely on airports to obtain inputs and deliver outputs.[127] WEBs recognise that markets are imperfect, and therefore a change in airport pricing may have welfare implications beyond those captured by conventional cost-benefit analysis.

Figure 19 illustrates the relationship between conventional and wider economic benefits.

Figure 19: Relationship between conventional and wider economic benefits

Source: Frontier Economics, with reference to Anthony Venables (2016), Incorporating wider economic impacts within cost-benefit appraisal, Discussion paper 2016-05, International Transport Forum, OECD, p6, and Patrick Tsai (2016), Wider economic benefits: debunking the myths, p2.

The magnitude of WEBs depends on the context being considered, including the nature of the intervention and local attributes, including the skills of the workforce.[128] There is some evidence to suggest that WEBs can account for a material proportion of the economic benefit of a transport improvement. For example, in the UK WEBs were found to increase the estimate of conventional measures of benefits by 5% in the context of the South Yorkshire Bus Subsidy to 44% for London's Crossrail project.[129] In the Australian context WEBs have been estimated to account for between 9% and 28% of total benefits for major transport infrastructure projects.[130]

The measurement of WEBs is not straightforward, and there is limited data to facilitate their estimation in any specific context.[131] We acknowledge that the potential benefits associated with a change to airports regulation is likely to be smaller than these estimates, recognising the incremental nature of this intervention.

127 Dobes, L, Leung, J & Argyrous (2016), 'Appendix 3: Wider economic impacts in the transport sector' in Social cost-benefit analysis in Australia and New Zealand: the state of current practice and what needs to be done, ANU Press, Canberra, p161.

128 United Kingdom Department for Transport (2018), TAG unit A2-1 wider economic impacts appraisal, p1.

129 Duncan Kernohan and Lars Rognlien (2011), Wider economic impacts of transport investments in New Zealand, NZ Transport Agency Research Report number 448, p75.

130 Patrick Tsai (2016), Wider economic benefits: debunking the myths, p4.

131 Productivity Commission (2015), PC Productivity Update, p42; Australian Transport Assessment and Planning Guidelines (2016), T3 Wider economic benefits, and United Kingdom Department for Transport (2018), TAG unit A2-1 wider economic impacts appraisal.

Domestic agglomeration effects

What are agglomeration effects?

Agglomeration effects refer to the efficiencies that arise when businesses and people locate close to each other.[132] Locating close together enables firms and workers to increase productivity by taking advantage of location specific economies of scale.[133] Transportation cost savings (such as those that would arise from the proposed remedies) and transport interventions more broadly can lead to agglomeration effects which in turn can increase productivity in the economy.[134]

There are three broad sources of agglomeration effects that have been identified in the literature:[135,136]

- **Knowledge transfer:** Improvements in transport connections can increase interaction between firms and workers and therefore facilitates learning and knowledge transfers or spillovers.
- **Access to labour:** Better transport connections can increase the pool of labour and thus create a "thick" labour market.[137] A thick labour market is one that facilitates matching supply and demand for skills. This improves productivity by providing specialised and deep labour markets:
  - Specialised labour markets: When firms requiring similar types of skills locate together, the availability of those specialised skills increases as the cluster attracts qualified workers and encourages local institutions to respond to demand.
  - Deep labour markets: Search costs are reduced for workers and firms, because matches occur more often and tend to be higher quality.
- **Input effects:** Transportation connections can facilitate the provision of specialised inputs more efficiently, providing firms with a larger choice of suppliers and the capacity to select the input type required for each specific production process.

Agglomeration effects are, to a degree, self-reinforcing. That is, the existence of these agglomeration effects induces an increase in economic activity, which in turn reinforces the agglomeration effects.

Agglomeration economies in consumption, rather than production like those listed above, have also been identified:[138]

- **Consumption benefits:** Improved access to large cities may also result in better access to goods and services not available elsewhere (for example, opera, restaurants or specialised facilities), and social interactions.

132 Productivity Commission (2017), Realising the productive potential of land, Supporting paper no 10, p3.

133 Eddington (2006), Agglomerations in the UK and the role of transport policy, Eddington Review: Research Annex 1.3.

134 Edward L. Glaser (ed) (2010), Agglomeration Economics, The University of Chicago Press, p1.

135 See, for example, SGS Economics & Planning (2012), Productivity and Agglomeration Benefits in Australian Capital Cities, Final Report for the COAG Reform Council, pA12; and Eddington (2006), Agglomerations in the UK and the role of transport policy, Eddington Review: Research Annex 1.3.

136 The guidelines published by the UK Department of Transport suggest additional sources of benefits, including for example the induced investment associated with relieving transport capacity constraints. For the purposes of simplicity, we focus our discussion on those WEB recommended in the Australian guidelines.

137 See Paul Krugman (1998), "What's new about the new economic geography?", Oxford Review of Economic Policy, Vol. 14, No.2

138 Eddington (2006), Agglomerations in the UK and the role of transport policy, Eddington Review: Research Annex 1.3, p5.

Application to Australian airports and domestic air travel

There is a rich literature on the impact of transport on agglomeration economies. Evidence of labour market benefits is strongest, with knowledge transfer and input effects closely related to the geographic area considered.[139] In simple terms improvements in transport connections can influence agglomeration effects by:

- Supporting the development of clusters, which in turn generate agglomeration economies.
- Increasing the speed and reducing the cost of transport, in effect increasing the density of clusters, thereby generating agglomeration economies.

The second of these effects is of most relevant to improvements in the efficiency of domestic air services in Australia.

The extent to which agglomeration effects emerge following an intervention depends on area-specific factors including:[140]

- **Employment density:** Agglomeration effects are likely to be more material in large and fast-growing cities, because there are more workers and firms able to benefit from the productivity boost.
- **Industrial composition:** Services sectors are most amenable to agglomeration effects as a result of interventions which lower air travel cost. This is because in these sectors, such as finance, insurance, real estate and consulting services face-to-face contacts are important.
- **GDP:** Productivity gains associated with improved accessibility are greater for workers with high, or intermediate, skills levels; and in areas where productivity is already high.

In summary there is consensus in the literature that agglomeration economies exist and have the effect of improving productivity, but there are a wide range of estimates about the effect of interventions that lower the cost of transport.[141]

Studies undertaken in the UK show a £0.01 reduction in the cost of journeys originating or ending at existing airport infrastructure resulted in agglomeration effects accounted for between 2% and 13% of the total benefits to users, in addition to the cost savings associated with the reduction in travel times. The benefits are largest at London airports and smallest at regional airports, showing the important relationship between density and agglomeration benefits.[142] Australian rail and road projects show agglomeration benefits estimates generate an uplift of between 7% and 20% on the conventional benefits estimated.[143] Estimates in the literature cite agglomeration economies of the order of 10-20% of conventional user benefits.[144] Agglomeration elasticities are largest for the services sector, suggesting the largest benefits are likely to accrue in Australia's capital cities where these industries are largely based.[145]

139 Agglomerations in the UK and the role of transport policy, Eddington Review: Research Annex 1.3.

140 Eddington (2006), Agglomerations in the UK and the role of transport policy, Eddington Review: Research Annex 1.3. Frontier Economics, Accessing the productivity benefits of improving inter-city connectivity in Northern England: A report prepared for the National Infrastructure Commission, March 2016.

141 Daniel Graham and Stephen Gibbons (2018), Quantifying wider economic impacts of agglomeration for transport appraisal: Existing evidence and future directions, p6.

142 Eddington (2006), Agglomerations in the UK and the role of transport policy, Eddington Review: Research Annex 1.3, p12.

143 Neil Douglas and Brendan O'Keefe (2016), Wider economic benefits – When and if they should be used in evaluation of transport projects, Australasian Transport Research Forum 2016 Proceedings, p17.

144 See, for example, Graham (2008), Agglomeration economies and transport investment, p98.

145 See, for example, Graham (2008), Agglomeration economies and transport investment, p109.

However, there are issues in the estimation of agglomeration benefits. For example, it is difficult to establish a causal relationship between transport intervention and productivity increases.[146] Moreover, it may be the case that transport improvements disperse rather than concentrate firms and workers, and therefore result in disbenefits.[147]

Output change in imperfectly competitive markets

What are the benefits associated with output change in imperfectly competitive markets?

Where business users of domestic airport services have market power in their markets, a reduction in air transport costs is likely to have two effects:[148]

- First, it can lead to an increase in consumer surplus associated from additional demand (on both existing and new connections). We have captured this effect in section 6.
- Second, it can increase social welfare by lowering costs for transport-using businesses potentially enabling them to expand to new geographical markets and therefore increasing competition (in what may have been imperfectly competitive markets). It is this second effect that is not captured with in our earlier analysis and is the focus of this discussion.

Much of the literature on WEBs centres around the gains that accrue from the pro-competitive impact of transport links in the presence of imperfect competition. The argument is that interventions that lower transportation costs confer a public benefit by increasing the degree of competitive constraints on a given set of firms, by lowering barriers to entry into a market and/ or bringing new suppliers into play.

However, the possibility of producing welfare-enhancing competition impacts does not *require* imperfect competition. Benefits can also arise in a situation where firms are price takers. Transport costs act as a form of natural protection, meaning price taking firms face a market price marked up for transport costs. A reduction in these costs – for example through changes to the arrangements for airport regulation – lowers the natural rate of protection.

The benefits to society of lower priced goods and services in each region connected by air services are analogous to the benefits that would accrue through tariff liberalisation. Moreover, reducing natural forms of protection associated with transportation costs reduces anti-export biases (which arise because protection biases incentives towards the production of import-competing goods over exportables by raising the price of the former relative to the latter). Together with import liberalisation, this contributes to increased specialisation in an expanded market, and growth through the gains from trade. This is sometimes called "Smithian growth",[149] referring to Adam's Smith's observation that the extent of specialisation is limited by the size of the market. The beneficial effects of reducing natural protection effects is one reason why transport infrastructure investment is considered valuable in countries with poor external linkages and a necessary complement to trade policy reform.[150]

146 Leo Dobes and Joanne Leung (2015), Wider economic impacts in transport infrastructure cost-benefit analysis – A bridge too far?, Agenda, 22(1), p83.

147 Peter Abelson, The Wider Economic Impacts of Transport Infrastructure, p24.

148 Leo Dobes and Joanne Leung (2015), Wider economic impacts in transport infrastructure cost-benefit analysis – A bridge too far?, Agenda, 22(1), p80.

149 See for example, T. R. Lakshmanan (2007), "The wider economic benefits of transformation: An overview", *OECD/ International Transport Forum Joint Transport Research Centre Discussion Paper* No. 2007-8.

150 See for example Chris Milner (1998), "Trade regime bias and the response to trade in Sub-Saharan Africa", *Kyklos*, Vol. 51, pp 219-236

It is important to note that the effects here are independent of any consideration of agglomeration effects, discussed in the previous section.

Application to Australian airports and domestic connectivity

There are several ways these market access benefits might materialise in the context of reforms that better constrain airport market power and therefore reduce the cost of air travel at Australian airports:

- **Increased product/service market competition:** If changes to airport pricing increase mobility and therefore reduce switching costs, it allows consumers a wider degree of choice between suppliers particularly in relation to services such as finance and consulting.
- **Increased labour market competition:** If changes to airport pricing attract new workers (for example, through increased access to FIFO workers).

The extent of these benefits will depend in part on the extent to which constraints in existing air transport services restrict competition in related markets.

UK guidelines recommend an estimate of 10% of business user conventional benefits as an estimate of the welfare gain associated with the output change in imperfectly competitive markets, in addition to the estimate of conventional benefits, based on research on price-cost margins and demand elasticity.[151]

While analysis in the New Zealand context has estimated welfare improvements relating to the reduction in deadweight loss in imperfectly competitive markets can add around 10% to estimates of conventional benefits.[152]

151 United Kingdom Department for Transport (2018), TAG unit A2-1 wider economic impacts appraisal, p22.

152 Duncan Kernohan and Lars Rognlien (2011), Wider economic impacts of transport investments in New Zealand, NZ Transport Agency Research Report number 448, p47.

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APPENDIX C

Report on the policy framework for economic regulation of airport services in Australia

for

Airlines for Australia and New Zealand

(A4ANZ)

Margaret Arblaster

3 September 2018

TransAv

Transport economics consulting

Brief

I have been asked by Airlines for Australia and New Zealand (A4ANZ) to provide a report on the economic regulation of airports in Australia reflecting my experience at the Australian Competition and Consumer Commission, and previously at the Prices Surveillance Authority, and the expertise that I have developed since that time.[1] The report is to be used as input into a submission by A4ANZ to the 2018 Productivity Commission of Inquiry into the Economic Regulation of Airports.

Profile of Margaret Arblaster

Margaret has had over 19 years of experience at the Australian Competition and Consumer Commission (ACCC) and a predecessor organisation, the Prices Surveillance Authority (PSA), including 16 years in senior management up to July 2010. As General Manager of the Transport and Prices Oversight Branch, Margaret was responsible for the ACCC's regulatory work in the transport sector and in some other industries. This work involved managing the implementation of airport regulatory arrangements post privatisation of the airports, including the administration of airport price caps (1997 to 2002), monitoring price and quality of service at major Australian airports 1997 to 2008, and the assessment of access arrangements including the arbitration between Virgin Blue and Sydney Airport (2005).

Other management responsibilities related to airports included assessment of price notifications, in particular Sydney Airport's major price notification in 2001 and ACCC submissions to Productivity Commission inquiries reviewing price regulation of airport services (2002, 2007). The work on airports was undertaken under a variety of regulatory frameworks including Prices Surveillance (Part VIIA) and Access to Services (Part IIIA) provisions of the *Competition and Consumer Act 2010* (the CCA), previously the *Trade Practices Act 1974*, and the *Airports Act 1996* (the Airport Act).

Margaret has been project leader for three price inquiries under Part VIIA of the CCA including the Prices Surveillance Authority inquiry into the Federal Airports Corporation's aeronautical and non-aeronautical charges (1993), an inquiry into credit card interest rates (1992) and the ACCC inquiry into the price of unleaded petrol (2007).

Since 2011, Margaret has been a Teaching Fellow at the Institute of Transport Studies, Monash University where she is Unit Leader for the Transport Economics course in the post-graduate program in Transport and Traffic. Additionally, Margaret undertakes independent research on transport infrastructure specializing in economic regulation of aviation infrastructure. In February 2018 Margaret's book, *Air Traffic Management: economics, regulation and governance*, was published by Elsevier. Other recent publications include papers in the Journal of Air Transport Management and Transport Policy, a chapter in the book *The Economics of Airport Operations* published in the United States by Emerald Books (2017). Margaret has also provided consulting advice to the Victorian Government and the ACCC. Margaret holds a Bachelor of Economics, a Master of Economics and a Master of Business Administration from Monash University.

[1] This advice is based on my experience and professional expertise for the purpose of a submission to the Productivity Commission's 2018 Inquiry into the Economic Regulation of Airport Services. It does not constitute legal advice.

Overall conclusions on the economic regulation of airports in Australia

The current approach to economic regulation

Current airport monitoring does not meet the objectives that it was intended to achieve. The design of the framework, including its legislative base, means that it is unlikely to deter abuse of market power and therefore promote economically efficient airport performance. There have been significant compliance costs for the Australian Competition and Consumer Commission (ACCC) in administrating the framework in comparison to other areas of regulation. There are no particular features of the framework that would promote negotiated outcomes between airports and users for services associated with airport market power, other than in comparison to direct ex ante regulation.

The information revealed from monitoring is not capable of identifying abuse of market power. Monitoring is based on tracking movements in indicators of costs, profits and prices and quality of service over time. The level and structure of prices and the standard of quality of service are not assessed in the monitoring function. Further, there are limitations in the indicators used, including that they do not readily adjust to changed market circumstances.

Under airport monitoring the threat of a stronger regulatory action relies on identifying misuse of market power. Monitoring cannot do this.

Prices restrictions (previously called price surveillance) and price inquiries are the existing legislative provisions in Prices Surveillance, Part VIIA, of the *Competition and Consumer Act 2010* (the CCA) which support the ACCC's monitoring function. The legislative provisions in Part VIIA of the CCA, with the exception of the monitoring function, were developed in the early 1980s as part of the Hawke Government's Prices and Incomes Accord. They were used for a different purpose in that period than they are today. The provisions have changed very little since the 1980s and they are not 'fit for purpose' in the current regulatory framework which applies to *privatised* airports.

Price inquiries under Part VIIA of the CCA are a possible mechanism to assess the level of airport prices and to ascertain whether airports have used their market power. If the ACCC were asked to undertake price inquiries under Part VIIA of the CCA to assess whether an airport was using its monopoly power, the level of prices would need to be considered on an individual airport basis, and the task would be akin to a regulatory price determination, very resource intensive, intrusive and complex.[2]

If a price inquiry established that the level and structure of prices reflected the use of monopoly power, the applicable legislative provisions available in the CCA (Part VIIA) would be price restrictions. As price restrictions under Part VIIA are voluntary, they are not likely to be effective for *privatised* firms and they could only apply to price *increases* going forward. An example of this is a price determination by the ACCC that proposed price increases were not justified which was wilfully ignored by the harbour towage company, Adsteam Marine Ltd in 2002, with no apparent penalty.

[2] Note the PSA's Inquiry into the FAC's prices in 1993 concentrated on the structure of prices across airports and between airport services because of very obvious inefficiencies associated with the network pricing approach the FAC had adopted across its 22 airports as well as FAC methodologies for price and investment determination and also high level performance indicators. (Prices Surveillance Authority, 1993. Inquiry into the Aeronautical and non-aeronautical charges of the Federal Airports Corporation.)

There would be significant difficulties in reapplying price caps to airports under the price restriction provisions. In addition to some of the earlier difficulties experienced with price caps under the prices surveillance provisions, establishing new price caps would be likely to require a broad ranging, resource-intensive review of current and proposed future price levels. Importantly, there is no industry support from airport users for a return to airport price cap regulation.

It is difficult to envisage an appropriate and timely outcome that could arise from an ACCC price inquiry into the use of airport market power. In my view the potential for a Government to use either the price restrictions, or price inquiries provisions, as a threat of a stronger regulatory action in the event that there was concern about the abuse of market power by airport operators is not credible.

Overall, it is difficult to see what 16 years of airport monitoring, two Productivity Commission inquiries that have reviewed airport monitoring and over ten years of the ACCC raising concerns about airport performance has achieved. Given the inherent limitations of the airport price monitoring framework, there is a good case for discontinuing it in its current form.

Negotiate-arbitrate regulation as an alternative approach to economic regulation of airports

Negotiate-arbitrate regulation in Part IIIA of the CCA is the only alternative that is currently available in legislation and which is consistent with the Government policy of promoting negotiated outcomes between airports and airport users. However, the experience to-date of negotiate-arbitrate regulation of airport services, and in some other transport related industries, has shown that there can be long time frames and associated high costs in using the declaration framework under Part IIIA.

Concern expressed in previous inquiry reports that negotiate-arbitrate regulation could be viewed as the default option and so discourage negotiated solutions and lead to the return of direct regulation have not been borne out in practice for airport services, nor in other transport related industries. There has only been one completed arbitration under Part IIIA since the legislation was passed in 1995. Further, where airport users have sought to have negotiate-arbitrate regulation apply, it has been related to a variety of issues related to potential misuse of airport market power, including access to airport facilities by an off-airport car rental and parking firm, and access to terminal space by a low cost airline, not just price determination.

Looking forward

Increased availability of negotiate-arbitrate regulation to airport services, such as through adoption of a streamlined declaration provision similar to the previous s.192 in the Airports Act, can be related to the Government objectives identified for airport regulation in the PC's Terms of Reference.

A well-designed declaration process for negotiate-arbitrate regulation of airport services is more likely to promote economic efficiency because it would involve an effective deterrent for the use of market power. An inbuilt, credible threat of stronger regulation, an arbitration, can be triggered as a last resort by parties unable to negotiate balanced terms and conditions. This can be contrasted with measures based on Part VIIA, the prices surveillance part of the CCA, or the introduction of new legislation, which would involve recourse to a Government decision, associated delays and potential lobbying. In the event that an arbitration is conducted by the ACCC under Part IIIA, it is required to be consistent with Pricing Principles and Objects and Criteria which relate directly to economic efficiency.

A streamlined approach to declaration for negotiate-arbitrate regulation could be expected to reduce industry compliance costs in comparison to the current national process under Part IIIA. As well it would save Government resources involved in appeal processes and the ACCC resources associated with producing airport monitoring reports.

General information about airport financial performance and list charges currently incorporated in ACCC airport monitoring reports, including airport financial reporting requirements under Part 7 of the Airports Act, could be put on airport websites.[3] This would save costs and avoid any false expectations in the community about the ACCC's role. Detailed passenger numbers at airports are already published by the Bureau of Infrastructure, Transport and Regional Economics (BITRE).[4]

Negotiate-arbitrate regulation under Part IIIA of the CCA is designed to promote negotiated outcomes. If the declaration process implies that Part IIIA of the CCA has limited applicability to airport services, or if it is very costly to use in terms of time, resources and uncertainty, then negotiated outcomes are not promoted. Adoption of a streamlined approach to declaration, similar to the previous s.192 process available in the *Airports Act 1996*, would be an effective regulatory measure to promote negotiation. In contrast, the current airport monitoring framework does little, if anything, to promote negotiation.

In summary, airport monitoring is an ineffective approach to regulation and a well-designed s.192 style of negotiate-arbitrate regulation is likely to be a more effective and light-handed approach to economic regulation of airports.

[3] A similar requirement is associated with the Information Disclosure regulation of New Zealand's major airports.
[4] See BITRE website: https://bitre.gov.au/publications/ongoing/airport_traffic_data.aspx

CONTENTS

1. The current approach to economic regulation of airports

1.1 Background on the introduction of monitoring of airport services

The current economic regulation of airports is based on Part VIIA of the *Competition and Consumer Act 2010 (*CCA) (known as the Prices Surveillance part) and Parts 7 and 8 of the *Airports Act 1996* ("Accounts and Reports of airport-operator companies" and "Quality of service monitoring and reporting" respectively).

The prices surveillance provisions of the CCA were developed in a different era to current economic policy and relate to different objectives than the ones that they are used for today. The *Prices Surveillance Act 1983* (the PS Act) was part of the Hawke Government's policy approach to controlling inflation, known as the *Prices and Incomes Accord*, and was administered by the Prices Surveillance Authority (PSA). The prices surveillance and price inquiry functions of the PSA were aimed at providing restraint in pricing as a balance to wage restraint exercised under the Accord between the Government and the Australian Council of Trade Unions.

Prices surveillance was applied in sectors of the economy where effective competitive disciplines were thought not to be present and where prices were of strategic importance to the general price level.[5] The PSA's role was essentially to ensure that large firms which were in "a position to substantially influence a market for goods or services" [6] did not take advantage of that power in setting prices. The role of prices surveillance was to support a new, centralised wage fixing system by discouraging "cost increases arising from increases in wages and changes in conditions of employment inconsistent with principles established by relevant industrial tribunals."[7]

The legislative criteria guiding the operation of Part VIIA are now contained in s. 95G (7) of the CCA:

> (7) In exercising its powers and performing its functions under this Part, the Commission must, subject to any directions given under section 95ZH, have particular regard to the following:
>
> (a) the need to maintain investment and employment, including the influence of profitability on investment and employment;
>
> (b) the need to discourage a person who is in a position to substantially influence a market for goods or services from taking advantage of that power in setting prices;
>
> (c) the need to discourage cost increases arising from increases in wages and changes in conditions of employment inconsistent with principles established by relevant industrial tribunals.

These provisions have not changed since the 1980s, although Australia's industrial relations framework and its relevance to pricing have changed. The criteria differ from those related to modern

[5] PSA 1991, A Review of the Prices Surveillance Authority's role.

[6] Wording used in section 17(3) (b) relating to factors that the PSA should have regard to in exercising its powers and performing its functions under the PS Act.

[7] Wording used in section 17(3) (c) relating to factors that the PSA should have regard to in exercising its powers and performing its functions under the PS Act.

economic regulation in general, including regulation under other parts of the CCA, for example those in the national access regime in Part IIIA and in telecommunications access regulation in Part XIC.

Except for the introduction of the object clause[8] and the monitoring provisions, the Prices Surveillance provisions in Part VIIA of the CCA are essentially the same as the original 1983 PS Act.[9] Similarly, there have not been any changes to the legislative provisions that govern the assessment processes and their time frames, although procedural adaptions have had to be made. The language used is not user-friendly nor easy to interpret in today's environment. The accountability under the prices surveillance part of the CCA is limited because there are limited possibilities for formal review processes. Appeal or review is limited to appeals under the *Administrative Decisions (Judicial Review) Act 1977*.

There are three main mechanisms available to the Australian Government under Part VIIA of the CCA: price monitoring, price surveillance and price inquiries. Price monitoring under Part VIIA of the CCA was applied to aeronautical services provided by the four largest airports in 2002, following removal of the price caps on aeronautical services. Price monitoring of aeronautically-related services[10] was also removed in 2002. Additionally, the Government introduced price monitoring of car parking prices at major airports on 7 April 2008.

Price monitoring of airports was set up against a backdrop of the Government's response to the Productivity Commission (PC) review of the *Prices Surveillance Act 1983*. In relation to monitoring, the Government agreed with the PC:

> that the ACCC's authority should not allow it to impose overly onerous reporting requirements and therefore it should be prevented from requesting information beyond that specified in the Minister's declaration, or other relevant instruments. The Government also agrees that the ACCC should be required to publish and report (in an appropriate form, given consideration of commercial confidentiality) on the information it has collected under price monitoring.[11]

The Government has identified objectives associated with price monitoring of airport services in the Terms of Reference given to PC inquiries on the economic regulation of airport services which commenced in 2006 and 2010. The objectives have included the promotion of "economically efficient and timely operation, use of and investment in airports and related industries", "minimizing unnecessary compliance costs on airport operators and the Government"; and "facilitating commercially negotiated outcomes in airport operations" (Productivity Commission, 2006, p. iv and 2011, p. v). The Terms of Reference for the current inquiry asks the PC to:

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[8] The object of Part VIIA of the CCA "is to have prices surveillance applied only in those markets where, in the view of the Minister, competitive pressures are not sufficient to achieve efficient prices and protect consumers." (s. 95E of CCA)

[9] See in particular the notification provisions in s.95Z, 95ZA and s.95ZB of the CCA.

[10] Monitoring of aeronautical-related services covered charges for aircraft refuelling, aircraft maintenance sites and buildings, freight storage facilities, ground support equipment sites, check-in counters and car parks.

[11] Government response to 2001 PC Inquiry into the Prices Surveillance Act 1983
Peter Costello, The Treasurer,
http://webarchive.nla.gov.au/gov/20080720063505/http://www.treasurer.gov.au/DisplayDocs.aspx?pageID=010&doc=publications/20020820.htm&min=phc Accessed 25 July 2018

"report on the appropriate economic regulation of airport services, including the effectiveness of the price and quality of service monitoring, in achieving these same objectives:

- promoting the economically efficient operation of, and timely investment in, airports and related industries;
- minimizing unnecessary compliance costs; and
- facilitating commercially negotiated outcomes in airport operations."[12]

1.2 The legislative base for price monitoring

A legislative provision for price monitoring was introduced as part of the Competition Policy Reforms implemented in 1995 through the insertion of a price monitoring function into the *Prices Surveillance Act 1983*. There are few requirements specific to price monitoring in the legislative provisions of the CCA.[13] Under the CCA provisions (now s.95ZA to s.95ZG of the CCA), the Minister can direct the ACCC "to monitor prices, costs and profits relating to the supply of goods or services" and the ACCC is required to make copies of a report on its monitoring publicly available as soon as practical after the report has been completed. Under Part VIIA of the CCA (s. 95ZH), the relevant Minister can give special directions to the ACCC for its administration of the monitoring function, as well as for prices restriction and price inquiry functions.

In addition to airport services, container stevedoring charges at major Australian ports and unleaded petrol prices are examples of goods and services in other industries which have been monitored under the s.95ZG provisions.

The ACCC also undertakes price monitoring under the ACCC's general powers in the CCA following a Ministerial direction from the Government. The monitoring of professional indemnity and public liability insurance premiums and medical indemnity premiums following tort law reforms are two examples where this has occurred. A distinctive feature of this type of monitoring is that the release of reports on monitoring is at the discretion the government.

Monitoring has most commonly been used to provide information on the general effect of microeconomic reforms and the effect of changes in Government taxes and subsidies on prices in an industry. The monitoring of movements in domestic airfares which commenced in the early 1990s following abandonment of the Two Airline Policy, is one of the earliest examples of price monitoring being used to monitor a microeconomic reform. Another example is the Government direction given to the ACCC to monitor the price of drinking milk prices following deregulation of milk prices on 1 July 2000.[14] Wide scale monitoring across a range of industries was undertaken when the GST was introduced in 2000. To my knowledge, the application to airport services was the first time price monitoring under Part VIIA of the CCA had been applied to a monopoly industry.

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[12] The Government's Terms of Reference as published in Productivity Commission (2018).Issues Paper, p. iv

[13] Under the legislative provisions in the CCA for price monitoring, the Minister can give the ACCC a direction to monitor a specified industry or a specified firm or firms (s. 95zE and s.95ZF). Legislative requirements common to monitoring an industry and specified firm/s are:

- The ACCC monitors "prices, costs and profits relating to the supply of goods or services"
- The Minister's direction to the ACCC involves giving "the Minister a report on the monitoring at a specified time or at specified intervals within a specified period"
- The ACCC "must, in preparing such a report, have regard to the need for commercial confidentiality"
- The ACCC "must make copies of the report available for public inspection"

[14] See ACCC Media Release 8 January 2001, No. 079/01.

1.3 The methodology used for price monitoring

Price monitoring has been regarded as a less restrictive form of regulation than prices surveillance. The ACCC does not have to consider proposed price increases under monitoring.

Price monitoring has normally involved developing a set of indicators at the beginning of a period and tracking these over time. The price monitoring indicators have primarily relied on historical financial information. There are general features of price monitoring which are common. For example, monitoring relies on historical financial accounting information, and the general format that information should be provided in is specified. The methodologies that should be used in preparing information, such as specific directions on cost allocations between monitored and non-monitored services, are not specified except in very general terms. The specific approaches adopted to monitoring, including the data requirements, have varied for different industries, reflecting the written directions to the ACCC from the relevant Minister and the reasons for adopting price monitoring.

In my experience, price monitoring has never been designed to assess the level of prices, but rather to track movements in indicators of costs, profits and prices over time. Assessment of the *level* of prices has been considered a function that could be undertaken through stronger regulatory measures, such as through administering price restrictions under Part VIIA of the CCA.

1.4 Information for prices monitoring of airport services

In addition to the supply of information directly through the ACCC's price monitoring function under Part VIIA of the CCA, the ACCC also receives financial information on airport operations under Part 7 of the *Airports Act 1986*. The Airports Act has required airport operator companies to develop separate accounts for airport companies (which exclude the complications of unrelated activities such as hotels) and which separate their accounts into aeronautical and non-aeronautical parts of the airport business. Other aspects relating to preparation of the accounts, such as auditing, and provision of the accounts to the ACCC, are provided for in the Airports Act. The ACCC has not had information-gathering powers in relation to its monitoring of financial information associated with airport services under Part 7 of the Airports Act.

Under the prices surveillance provisions, the ACCC has general powers to require organisations and individuals to provide relevant information or documents relevant to monitoring and other functions under Part VIIA of the CCA. There is no specific power for the ACCC to prescribe how airports are to prepare and provide information on costs, profits and prices. In contrast, the Information Disclosure regulation in the amended *New Zealand Commerce Act 1985*, provides a legislative basis for the Commerce Commission to develop 'input methodologies'. The ACCC has provided airport operators with a "guideline" for information requirements for price monitoring and financial reporting which is quite detailed. [15] However, checking whether information provided to the ACCC is in accordance with the Guideline would be a very resource-intensive exercise. Further, it is not clear that there could be a penalty associated with any non-compliance with the Guideline.

1.5 Limitations of price monitoring indicators

[15] The latest version of the Australian Competition and Consumer Commission, Airports prices monitoring and financial reporting guideline was published on 30 June 2009 and is at: https://www.accc.gov.au/publications/airport-prices-monitoring-financial-reporting-guideline
Accessed 31 July 2018.

As monitoring relies on tracking changes in indicators of a firm or an industry's performance over time, for the indicators of performance to be meaningful, there needs to be relative stability in the circumstances to which they are relevant. However, over time, changes in market circumstances occur. A difficulty for analysis undertaken by the price monitoring function is that, as time passes, a set of indicators developed at the beginning of a monitoring period can become less relevant as they are tracked over time. For example, in the case of monitoring container stevedore charges, the greater use of 40 foot containers instead of 20 foot containers in the early 2000s led to changes required in the indicators. Some ACCC monitoring functions have been short term; partly because of the difficulty of identifying reasons for changes in prices as time passes. Monitoring the effect of the introduction of the GST covered a two year period (i.e. one year before and one year after the introduction of the GST).

The limitations associated with the airport monitoring indicators are illustrated by the changes that occurred in the definition of aeronautical services, the basis on which asset values were initially made and the change in accounting standards that occurred in 2005-06 from Australian Generally Accepted Accounting Principles to Australian equivalents to International Financial Reporting Standards (AIFRS).

Definition of aeronautical services

The changing definition of "aeronautical services" is one area which led to difficulties in interpretation of the monitoring data. Until the change in the definition occurred in 2007-08, there was some inconsistency in the services covered by the price monitoring (and previously price caps) and services covered by the financial reporting provisions (Part 7) of the Airports Act.

The initial definition in the directions to the ACCC's prices surveillance and monitoring functions were based on a definition of aeronautical charges in s.56(1) of the *Federal Airports Act 1986* which used as a final demarcation of whether a particular charge for a service was an aeronautical or a non-aeronautical charge depended on whether the provision of the service, on the date the airport lease was granted, was "the subject of a contract, lease, licence, or authority given under the common seal of the Federal Airports Corporation". A clearer and more robust definition of aeronautical services and facilities was established in July 2007. The changing of the definition would have had different effects between airports.

Airport asset values

Difficulties associated airport asset values have been another limitation of the monitoring indicators. The treatment of aeronautical asset values was a significant issue for the early airport price monitoring regime. At the time of privatisation, explicit values were not established for airport assets for regulatory purposes, with the exception of Sydney Airport where the value of aeronautical assets was determined through a regulatory price determination process. Airport profitability measures became distorted and some airports sought to justify higher airport charges on the basis of revalued assets.

Asset values used in the ACCC monitoring report until 2006-07 reflected significant revaluations that occurred at most of the airports after privatisation. This created industry tensions and undermined the value of reported information. Following a recommendation of the 2006 PC Inquiry, a "line in the sand" approach to asset valuation was adopted, whereby asset values for monitoring purposes were set to reflect the value of assets at 30 June 2005 plus adjustments going forward for new investment and depreciation of assets.

Change in accounting standards

In 2005-06 airports implemented the change in accounting standards that had occurred in Australia, which involved a change from Australian Generally Accepted Accounting Principles to Australian equivalents to AIFRS. The change in accounting standards affected some of the information used to calculate cost indicators.

Other

A detailed analysis of these and other limitations of the price monitoring indicators is contained in Appendix A4. Methodology to the ACCC Airport Monitoring Report 2016-17.

1.6 Quality of airport services

Quality of service is an important dimension of airport performance. Prices for airport services need to be seen in context of the quality of the services provided, as is the case with most goods and services, especially where quality is not tightly controlled by regulated standards.[16]

At the time of privatisation of the airports, it was recognised that in the case of monopoly services which are associated with price restraints, such as a price cap, there is an incentive to reduce quality as a means of reducing costs and staying under the price cap. As there was no power to assess quality of service in the context of economic regulation under the pricing provisions of the CCA (i.e. Part VIIA), the ACCC was given responsibility for monitoring the quality of certain key airport services and facilities under the Airports Act (Part 8).

Quality of service indicators were developed jointly by the ACCC and the Department of Transport and Regional Services in 1996. It was recognised that not all factors contributing to service quality are under the airport operators' direct control, but the adequacy of facilities they provide is a major determinant of quality of service. The key performance indicators were concerned to identify congestion of facilities as well as the standard of facilities. For example, they included indicators of efficiency in aircraft movement areas, terminal crowding and waiting times in passenger processing and baggage handling areas.

From the outset, data relevant to quality of service was collected from a variety of sources. Annual reports on airport infrastructure, such as parking bays, aerobridges, check-in desks, security clearance, gate lounges and car parks were obtained from airport operators. Other information was sourced from Airservices Australia and Australian Customs Service. The ACCC conducted annual surveys of airline companies' views on the standard of airport facilities and services, including runways and taxiways, gates, aerobridges, equipment storage, check-in and baggage processing facilities as well as airport operator responsiveness to airline concerns. Information was obtained from passenger surveys conducted for, and funded by, the airport operators to assess specified services, such as airport access, information display, check-in facilities and seating in gate lounge areas.

The complementarity between price and quality of service in airport performance, and the need to identify trends in quality of service performance as a complement to airport price monitoring, has been recognised in the continuation of quality of service monitoring by the ACCC under Part 8 of the Airports Act.

[16] In this respect I am referring to non-safety standards.

1.7 Limitations of quality of service monitoring indicators

Airports are complex businesses providing a wide variety of services to a wide variety of users. Monitoring the quality of airport services over time has some of the same limitations associated with price monitoring as well as additional limitations. Multiple indicators of quality of service were developed for particular services to reflect the differing responsibilities for service provision in the case of some services, such as check-in counters. For example, in addition to waiting times for facilities, measures of the utilisation of facilities, such as custom desks and check-in counters, were developed to give an indication of the relationship between congestion of facilities and staffing of the facilities provided by other parties, such as Australian Customs and airlines.

Technological change, change in airport user preferences and the provision of new services could be expected to have a dramatic effect on the relevance of quality of service indicators over time. For example, in modern airports, check-in is typically available off-airport and at automated booths within an airport. Security screening has become more involved, reflecting an increased assessment of terrorism risks. Increased use of digitised data services by airlines and airport users increases the importance of the reliability of airport IT systems. Given all the changes that occur, and the complexity of airport services, it is difficult to see how a system based on tracking indicators for particular services can give a reliable and up-to-date indication of airport service quality over time.

The extent to which airports willingly participate and collaborate with other parties in the supply chain is an important dimension of service quality that does not appear to be captured by current monitoring. Increasing attention is being paid to interconnectedness between services through information-sharing systems and collaborative decision making. Air traffic flow management (ATFM) and airport collaborative decision making (A-CDM) are processes that result in fuel- and time-savings for airlines, and improve the efficiency of existing airport facilities. They involve harmonising operations between air navigation service providers (ANSPs), airlines and airports, both within an airport and across major airports. These processes are increasingly being used by ANSPs internationally, especially at major airports which are becoming increasingly congested.[17]

The indicators and information collected for quality of service monitoring is essentially the same for the four monitored airports when in fact there are significant differences between airports. This can lead to discrepancies in the importance of various aspects of quality. For example, in the case of Sydney Airport, the issue of transferring between the domestic terminal and international terminal is important because of the separation of the terminals. In Melbourne, the configuration of the terminal roadways and pedestrian crossings suggests that the issue of landside access to the terminal is likely to be particularly important. The ease of passenger wayfinding through Duty Free shopping areas, for example, varies considerably between airports.

Under airport quality of service monitoring a wide variety of results for a selection of airport services are combined to give an aggregate quality of service score. This permits only a "broad brush" interpretation of airport quality of service. ACCC monitoring reports form conclusions on the movement of overall airport quality of service as reflected in an aggregate indicator. This and other limitations associated with the ACCC's quality of service indicators are identified in Appendix A4. Methodology to the ACCC Airport Monitoring Report 2016-17.

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[17] See Airservices Australia Media release: New data sharing system to save aviation industry millions, 29 May 2018, http://newsroom.airservicesaustralia.com/releases/new-data-sharing-system-to-save-aviation-industry-millions Accessed 1 August 2018.

2. Effectiveness of the current price and quality of service monitoring of airport services in meeting its objectives

The Government has asked the PC to assess the current economic regulation of airport services, including the effectiveness of price and quality of service monitoring, in achieving the objectives of:

i. promoting the economically efficient operation of, and timely investment in, airports and related industries;

ii. minimising unnecessary compliance costs; and

iii. facilitating commercially negotiated outcomes in airport operations.[18]

The objectives for airport monitoring have remained essentially constant since the introduction of price and quality of service monitoring in 2002 (see discussion in section 1.1). This section discusses the design and operation of airport monitoring from the point of view of the extent to which the monitoring framework can meet the Government's objectives.

2.1 Promoting the economically efficient operation of, and timely investment in, airports and related industries

The exercise of monopoly power by an airport is not consistent with promoting economically efficient operations, including airport investments. This in turn adversely effects the performance of current and potential airport users. From a policy framework point of view, a key question in relation to this objective is the question in the PC's issues paper:

> … whether the existing regime is effective in appropriately deterring potential abuses of market power by airport operators?

Three main dimensions relating to whether airport monitoring by the ACCC can effectively deter potential abuses of market power are discussed in this section, as follows.

The degree of transparency provided by monitoring airport performance

The ability of current airport monitoring to provide transparency on airport performance, and therefore identify adverse performance, such as excessive prices, poor quality or denied access to services, contributes to whether or not monitoring is effective. The extent to which monitoring provides transparency of airport performance affects the probability of a stronger regulatory action or regulatory intervention.

Some of the limitations associated with the airport monitoring data were identified in s. 1.5 and s. 1.7 above. The airport monitoring reports contain historical data based on trends of broad financial indicators, not governed by prescribed methodologies and not designed to provide consistent information on *economic*[19] costs and revenues. As a result, it has not been possible for the

[18] Productivity Commission (2018), op. cite.
[19] As opposed to accounting concepts.

ACCC to make conclusive assessments of whether airports are economically efficient from their own monitoring reports.

Further, analysis by the PC in the 2006 and 2011 inquiries on economic regulation of airports, suggests that the PC has not relied on information from ACCC monitoring reports to assess whether airports have abused their market power. The 2006 PC report sought to provide "an indicative picture" of experience under light handed regulation.[20] The PC's views about the performance of monitored airports in the 2011 Inquiry seem to be largely based on existing international benchmarking studies including studies undertaken by the Air Transport Research Society (ATRS) and submissions from participants to the inquiry.

It is not surprising that to-date, neither the ACCC nor the PC have made positive, *definitive* conclusions on whether airport performance could be considered economically efficient under airport monitoring, in particular in relation to the use of airport market power. Monitoring data is not designed to assess the level of prices and the adequacy of service quality. An assessment of the use of market power would require substantial additional information and analysis.

The credibility of a threat of stronger regulation under the current airport monitoring framework

In privatising Australia's airports, the Government was keen to see airports operate in an efficient and commercially-driven manner, but at the same time was aware that the major airports in Australia had market power stemming from their natural monopoly characteristics. The price oversight arrangements were intended to protect airport users from any potential abuse of market power by airport operators. For a variety of reasons, the initial pricing arrangements proved to be more interventionist than was anticipated and in particular were considered as not promoting negotiated outcomes between airports airport users.

Under light handed regulation, the threat of stronger regulation is expected to influence the performance of airports. In introducing price monitoring in 2002, the Government considered that:

> A lighter-handed approach provides greater scope for airports to price, invest and operate efficiently. Price monitoring enhances market transparency by allowing the community to scrutinise prices and market outcomes, and can also assist the competitive process, without resort to heavy-handed price controls.[21]

The Government identified that a review would be conducted towards the end of a five year period "to determine whether there have been unjustifiable price increases that warrant reimposition of price controls" but reserved "the right to bring forward a review if there is a strong indication that an airport has unjustifiably increased its prices".[22] Further, the "Government would only consider re-introducing price controls on an airport if it formed the view that the airport had operated in a manner

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[20] Productivity Commission, Review of Price Regulation of Airport Services, Inquiry Report, 2006, p.12

[21] Minister for Transport & Regional Services, Treasurer, Joint Press Release, Productivity Commission Report on Airport Price Regulation, Media Release No.24, 13 May 2002 http://webarchive.nla.gov.au/gov/20110602103648/http://www.treasurer.gov.au/DisplayDocs.aspx?pageID=&doc=pressreleases/2002/024.htm&min=phc, Accessed 30 July 2018

[22] Minister for Transport & Regional Services, Treasurer, Joint Press Release, Productivity Commission Report on Airport Price Regulation, Media Release No.24, 13 May 2002 http://webarchive.nla.gov.au/gov/20110602103648/http://www.treasurer.gov.au/DisplayDocs.aspx?pageID=&doc=pressreleases/2002/024.htm&min=phc, Accessed 30 July 2018

inconsistent with the following principles: …"[23] (Here the government referred to the 'Review Principles' which are discussed later in s. 3.1.) The credibility of the threat of stronger regulation has been a key issue in the last two reviews of economic regulation of airports by the PC. For example, in 2011, the PC considered that:

> Fundamental to the effectiveness of the light handed approach is the credible threat of sanction for airports that abuse their market power.[24]

ACCC monitoring reports over the last decade have pointed to the possibility that some airports might have earned monopoly rents and undertaken insufficient investment. The ACCC's 2016-17 Airport Monitoring Report concludes "Brisbane, Melbourne, Perth and Sydney airports all significantly increased their profits from aeronautical activities in 2016-17".[25] In a media release, the Chairman of the ACCC, Rod Sims, identifies:

> We remain concerned that the current regulatory regime which is limited to monitoring the covered airports, doesn't constrain the market power of four of Australia's major airports. Unconstrained monopolies often have an incentive and ability to charge excessive prices while lacking strong incentives to improve services.[26]

Although the threat of a stronger regulatory action has been seen as "fundamental", a stronger regulatory measure hasn't been invoked to-date.

A key characteristic of a credible threat of stronger regulation, or a penalty, is the availability of suitable alternative regulation or a penalty. In my view there currently isn't a suitable regulatory action available in Part VIIA of the CCA which could be invoked.

The current sanctions of price restrictions and price inquiries under Part VIIA of the CCA

In addition to price monitoring, Part VIIA of the CCA gives the ACCC roles of price restrictions and price inquiries. The suitability of potential application of price restrictions and/or price inquiries under the CCA to airports that are suspected of abusing their market power, are discussed in this section.

Prices restrictions (previously 'prices surveillance')

Companies declared for prices restrictions are required to notify the ACCC (and previously the PSA) of proposed price increases for declared goods and services. The number of companies declared for prices surveillance has decreased progressively over time. The greatest reduction occurred between 1984 and 1991 when beer, biscuits, premixed-concrete, instant coffee, petroleum products, tea and toothpaste were among the industries removed from price restrictions (prices surveillance). Since 2003, the services supplied by three firms have remained covered by price restrictions; aviation services supplied by Airservices Australia, standard letter services supplied by Australia Post and aeronautical services supplied to regional airlines by Sydney Airport. This position remains today.

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[23] Ibid
[24] PC, 2011, p. XXXV
[25] ACCC, 2018. Media Release, Airport profits continue to grow, 26 April 2018. https://www.accc.gov.au/media-release/airport-profits-continue-to-grow Accessed 2 August 2018.
[26] Ibid

Under price restrictions there is a penalty for failing to notify proposed price increases before implementing them but no penalty for not complying with an ACCC determination on prices. Under the legislative provisions, the ACCC has 21 days to decide whether it has no objection to the proposed prices, or that it considers that there should be a lower price increases or no price increases, following notification of proposed price increases. The ACCC cannot determine that current prices should fall. At the completion of the price assessment process, the prices for the declared goods and services are placed on a public register. There have not been any changes to the legislative provisions that govern the assessment processes and time frames associated with proposed prices under the price restriction provisions since they were introduced in 1983.

Over the last two decades, pricing issues in the industries where price restrictions have been applied (aviation infrastructure, harbour towage services and postal services) have warranted more complex assessment processes than envisaged in the original legislation. This has meant that administrative processes were developed in the 1990s to increase the time available to undertake an assessment of price notifications, enabling more rigorous assessments than undertaken in the 1980s and early 1990s. The adoption of additional administrative processes is voluntary and relies on the cooperation of the firm involved.

The current version of assessment procedures for proposed price increases are contained in the Statement of Regulatory Approach to Assessing Price Notifications, 2009.[27] An illustration of the use of the-assessment process is the Sydney Airport Company Limited (SACL) pricing proposal; which was first provided to the ACCC in Draft form in December 1999, with an ACCC final determination in May 2001. [28]

To-date one company, Adsteam Marine Limited in 2002, has acted against an ACCC (or PSA) pricing determination.[29] It is to be expected that, where companies are wholly owned by the Commonwealth Government, such as Airservices Australia and Australia Post, Ministerial roles in relation to their pricing arrangements would be a factor which effectively reduces their discretion to not comply with a pricing decision made by the ACCC under the prices restriction provisions.

The application of price caps to airport services

There were considerable difficulties in applying CPI-X price caps under the price restriction provisions to newly privatised airports in 1997 and 1998. Ministerial Directions under s.95ZH of the CCA were used in the implementation of price caps on aeronautical charges at major airports to specify the details of the price caps. Under s.95ZH of the prices surveillance part (Part VIIA) of the CCA, Ministerial Directions can be given to the ACCC "to give special consideration to a specified matter or matters in exercising its powers and performing its functions under this part". A difficulty in application

[27] ACCC 2009, Statement of Regulatory Approach to Assessing Price Notifications, June at http://www.accc.gov.au/publications/regulatory-approach-to-price-notifications

[28] See ACCC, 2001. Sydney Airport Corporation Ltd. Aeronautical Pricing Proposal Decision May, P.26. http://registers.accc.gov.au/content/item.phtml?itemId=978120&nodeId=47121da3c023548ab0d05d3f8830b925&fn=ACCC%27s%20Decision.pdf Accessed 10 August 2018.

[29] See ACCC Media release, ACCC publishes reasons for habour towage decision, 28 February 2002, https://www.accc.gov.au/media-release/accc-publishes-reasons-for-harbour-towage-decision
And Annual Report 2001-02, pp. 128-129. http://www.accc.gov.au/system/files/ACCC%20Annual%20report%202001-02.pdf
Accessed 10 August 2018.

of price caps under Part VIIA is the inconsistency between the language in the provisions for Ministerial Directions (s.95ZH) and the provisions relating to price restrictions (s. 95N). The Ministerial instruments under Part VIIA were reissued a number of times.

Would price restraint on airport services be implemented under the prices surveillance provisions today?

I do not think it is likely that price caps established through the prices restriction provisions in the CCA would now be generally regarded as an acceptable and effective alternative regulatory measures that could be invoked in the event that privatised airports were identified as using their market power. Since the removal of price caps on airports in 2002, airlines have not favoured a return to price regulation in submissions to the PC inquiries into airport services.[30] The reintroduction of price regulation would discourage negotiation between airports and airport users.

An additional reason why it is unlikely new price caps would be established for aeronautical services going forward, is that establishing robust price caps would require a broad assessment of current aeronautical prices. This would be a resource-intensive exercise for the airports, airport users and the ACCC, and be seen as a heavy regulatory burden for all parties involved.

In summary, the threat of introducing price control under the PS provisions in the CCA does not appear to be a credible threat.

Price inquiries

Price inquiries under Part VIIA have been identified as an instrument of direct action that potentially could be taken to explore the level of airport prices. It was noted in the 2011 PC airport regulation inquiry that the ACCC has not recommended a Part VIIA inquiry and that the relevant Minister has not instructed the ACCC, nor any other body, to undertake one.[31]

Price inquiries under Part VIIA have not been undertaken on a regular basis. Over the period 1983-84 to 1990-91 there were 33 price inquiries undertaken related to pricing in particular industries.[32] During this time, price inquiries were largely seen as a measure to encourage a company declared for prices surveillance to comply with a PSA pricing decision and also to increase the amount of time required to assess a company's proposed prices. Under the price inquiry provisions there is the possibility of a freeze on prices for the period of the inquiry (s.95N).

In the early to mid-1990s, price inquiries assessed whether a particular firm had market power and made recommendations on appropriate regulation or deregulation. In the timeframe between the formation of the ACCC in 1995 and 2010, there were only three price inquiries under the prices surveillance provisions, two related to petrol pricing (1996 and 2008) and one into grocery prices (2009). [33] In 2017 and 2018, the ACCC has been directed to hold a number of inquiries under s.95H including into prices charged by Authorised Deposit-taking Institutions affected by the Major Bank

[30] See Productivity Commission inquiry reports, 2006 and 2011.
[31] PC Report, 2012, pp.XXXIV – XXXV
[32] PSA 1991, op.cite
[33] The three Inquiries under the prices surveillance provisions in Part VIIA of the *Competition and Consumer Act 2010* that have occurred since the ACCC was formed are:
Inquiry into Petroleum Products Declaration, 1996
Inquiry into the price of unleaded petrol, 2007
Inquiry into the competitiveness of retail prices for standard groceries, 2008

Levy, supply chain for dairy products, home insurance industry in the Northern Territory, the retail electricity industry and the gas supply industry.

What would a Part VIIA price inquiry into airport services involve?

All inquiries are public, although the ACCC may accept some submissions on a confidential basis. In addition to the provision allowing the ACCC to require organisations and individuals to provide relevant information or documents relevant to monitoring and other functions, Part VIIA of the CCA gives additional information powers for public inquiries. For example, the ACCC can summons people to appear as witnesses under oath at inquiries.

Conducting a price inquiry to determine whether airports have used their market power and warrant a stronger form of regulation than a light handed monitoring environment, is likely to be complex and resource intensive. The Airport Pricing Inquiry undertaken by the Commerce Commission in New Zealand which was commenced in 1998 provides an illustration:

The Airfields Pricing Inquiry required the Commerce Commission to report on whether a recommendation should be made to impose price controls over airfield activities at any of the three major airports in New Zealand. This assessment involved examining airport performance from the point of view of economic efficiency as specified in the Commerce Act.[34] At the time, the airports in New Zealand had been subject to limited information disclosure under the *Airports Authorities Act 1966* so the Commerce Commission had a limited information base at the start of the Inquiry. A large amount of additional data and substantial analysis of the performance of the three major airports took place over a four year timeframe. [35]

From the detailed analysis performed in the Airfields Pricing Inquiry, the Commerce Commission concluded that Auckland Airport and Wellington Airport had earned excess returns historically. Further, that there had been a trend of increasing returns in the case of Auckland Airport and, to a lesser extent, Wellington Airport. They considered that there was room for improvement in productive efficiency at all three airports. There was evidence of dynamic inefficiency at Auckland airport and insufficient constraint on the airport's market power. The majority of commissioners considered that there would be a net benefit from the application of price controls on Auckland Airport. A minority of commissioners disagreed with the finding because of a different view on the methodology used to assess the value of specialised airport assets.

While the scope of a price inquiry would depend on the Terms of Reference determined by the relevant Minister, it seems likely that relevant Terms of Reference for a price inquiry following an ACCC airport monitoring report would cover the *level* of prices of aeronautical services and car parking at one or more of the monitored airports. An inquiry involving such an assessment would involve complex analysis and substantial resources for the ACCC, airports and airport users.

What would be the likely outcome of a price inquiry following an airport monitoring report?

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[34] New Zealand Commerce Commission 2002. Part IV Inquiry into Airfield Activities at Auckland, Wellington, and Christchurch International Airports, Final Report, 1 August. Also see the New Zealand Commerce Commission website at: https://comcom.govt.nz/regulated-industries/airports/commissions-role-in-airports/history-of-airport-regulation Accessed 9 August 2018.

[35] The Inquiry was initially required to report by 14 December 1999 but was later extended to 27 August 2002.

The outcome of price inquiries are findings and recommendations. *If,* as a result of a price inquiry, the ACCC concluded that an airport prices reflected the use of monopoly power, what then? The main possibilities are that the ACCC would recommend to the Government that stronger regulation be applied to the airports going forward.[36] This is the issue currently being considered by this PC inquiry into economic regulation of airport services.

It is unlikely, however, that prevailing airport prices would be affected by a price inquiry finding involving evaluation of the level of prices. For a start, it is not clear what powers the Government would have in this circumstance to affect prices going forward.

A proposal put to the 2006 PC Inquiry was that a dispute resolution mechanism could trigger a Part VIIA inquiry, and that where a Part VIIA inquiry found an airport had breached overarching (pricing) principles, the airport could ultimately be subject to declaration under Part IIIA.[37] This process would be extraordinarily long and convoluted, with the processes under Part VIIA and Part IIIA involving substantial assessments against different criteria.[38]

It seems to me that the main achievement of a Part VIIA price inquiry would be to increase evidence for policy determination going forward. As a measure to support regulatory policy determination, and as a potential form of deterrence to monopoly pricing, price inquiries are a blunt and resource-intensive instrument, both for the industry and the ACCC. Additionally, unnecessary uncertainty for the industry would be created because of the potential wide-ranging[39] and discretionary nature of a price inquiry.

Conclusion on effectiveness of measures under Part VIIA of the CCA in deterring abuse of market power

Airport monitoring provides very limited transparency of airport performance in terms of identifying potential misuse of market power. Prices restrictions and price inquiries are not suitable alternative regulatory measures that can be invoked if poor performance is identified and could not be considered credible threats of sanction for use of market power. Without a credible threat of stronger regulatory action, the current airport monitoring regime is ineffective and cannot promote the efficient operation of the airports.

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[36] Note that the initial price oversight arrangements applying to airports issued to airport lessees specified that the ACCC would review the prices oversight arrangements for airports towards the end of the first five years. In the early 2000s this was changed to a Productivity Commission review consistent with best practice regulation whereby a review of regulation is not generally undertaken by the regulator who has been administering the regulation. Similarly, the Productivity Commission undertook a review of the whether prices surveillance should continue to be applied to harbour towage services in major ports.

[37] PC 2006 Inquiry Report, p.90

[38] My understanding is that this mechanism would involve the following steps. In the event of a dispute, the Minister would issue a terms of reference to the ACCC to conduct an inquiry taking into account the Aeronautical Pricing Principles. If the outcome of the Part VIIA inquiry found that the airport had breached the principles, the ACCC inquiry report would contain a recommendation to the Minister to submit a declaration application under Part IIIA as the Minister must be satisfied that all the declaration criteria in s. 44H.4 are satisfied. If the NCC then recommended declaration to the Minister, then the Minister *could* declare the airport services. The Minister's decision to declare the services (or not) could then be appealed to the Australian Competition Tribunal or to the Federal Court. The airport services would be declared if there were no appeals or the appeal processes had been finalised. In getting to this point it would still be possible for the dispute not to be resolved without the commencement of an arbitration process (See discussion in s.4.2).

[39] The Prices Surveillance Authority Inquiry into the Federal Airports Corporation (FAC) in 1993 covered aeronautical and non-aeronautical services at FAC airport and involved a price freeze on all these services for the period of the inquiry. (See Prices Surveillance Authority, 1993. Inquiry into the Aeronautical and Non-aeronautical charges of the Federal Airports Corporation, matter no. PI/92/7, Report no. 48.)

The Australian Competition Tribunal decision in the appeal on the Virgin Blue declaration decision in 2005 reflects the current situation. The Tribunal concluded that "we are satisfied that any threat of re-regulation is, in reality, quite limited."[40] Factors that contributed to the Tribunal conclusion were that no conduct on the part of Sydney Airport had to-date "stimulated any further Government action or interest" and that there was:

> no firm basis upon which there can be any conclusion as to what the Commonwealth Government's policy would be at any particular time in the future, that there would be a delay of at least several years before stronger regulation came into operation, if stronger regulation came into operation it would not operate retrospectively and so airlines would not be able to redress the consequences of Sydney Airport's market power. (pp.129-130)

2.2 Minimising unnecessary compliance costs

This section focuses on ACCC staff resources associated with monitoring airports.

Under price monitoring in Part VIIA of the CCA, the ACCC is required to release public reports. The ACCC's annual airport monitoring reports have been in the range of 200 to 300 pages and contain a large amount of data and other information which has to be carefully checked for accuracy. The work involved has a large repetitive component.

From a management point of view, I found that the preparation of airport monitoring reports involved a significant ongoing resource commitment for the ACCC. The work is intensive for at *least* six months of *every* year (the time when requests for information are responded to by the airports and other parties and reports are published). In addition, occasional reviews of information formats, methodologies and specialist economic and accounting advice was required. Apart from the required data from industry, there was a need to undertake research on industry trends and obtain additional information on industry developments to give context to the calculated indicators. In addition to the work undertaken by several analysts/researchers, draft reports and methodological issues associated with the reports were reviewed by middle and senior managers, the Transport and Prices Oversight Committee (a specialist committee of two to three ACCC Commissioners) and the full Commission, before being publically released.

It has often seemed an anomaly to me that work associated with airport monitoring (and other monitoring functions) have typically been far more resource-intensive than other regulatory functions which are considered more interventionist than monitoring. For example, during my period as General Manager of the Transport and Prices Oversight Branch, prices surveillance functions were undertaken infrequently and were less resource-intensive than monitoring. Similarly, prices surveillance associated with standard letter (reserved services) prices involved comparatively fewer resources than airport monitoring. The assessment of rail access undertakings for interstate rail services was again less resource intensive because the major review occurred only periodically, with comparatively minor annual compliance checks, and occasional reviews of variations to undertakings. Access undertakings covering ARTC's interstate track were put forward to be assessed in 2002, 2008 and 2018.[41]

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[40] Australian Competition Tribunal (ACT), 2005. Virgin Blue Airlines Pty Limited, (including summary and determination) ACompT 5 (12 December 2005), http://www.austlii.edu.au/au/cases/cth/ACompT/2005/5.html Accessed 4 August 2018

[41] See ACCC website: https://www.accc.gov.au/regulated-infrastructure/rail/artc-interstate-rail-access-undertaking Accessed 4 August 2018.

From an airport point of view, although there would be on-going compliance costs, I would expect that the main compliance costs would have been the setting up of the information systems to generate the required data at the outset.

2.3 Facilitating commercially negotiated outcomes in airport operations

Price and quality of service monitoring provides reports on historical information about airport services that are published approximately nine months after the period to which the information applies. As commercial negotiations relate to prices and quality of services going forward, the information in airport monitoring reports is likely to be of limited value in facilitating negotiations with airport operators.

Further, as the information in monitoring reports is highly aggregated, the current price and quality of service monitoring framework is likely to have little, if any, effect on commercially negotiated outcomes for specific airport services. However, in comparison with ex ante direct regulation of airport prices and quality of service, airport monitoring allows greater scope for negotiation.

3. Enhancing airport monitoring

This section discusses three possible avenues to enhance the airport monitoring framework which have either been considered in the past or are related to the PC's Terms of Reference and Issues Paper:

i. Use of the Aeronautical Pricing Guidelines (formerly Review Principles) and the adoption of a "show cause" or similar mechanism
ii. "Enhancing monitoring", such as through requiring additional information to be provided to the ACCC and/or specification of methodologies
iii. Use of airport benchmarking

3.1 Aeronautical Pricing Principles and proposed 'show cause' mechanisms

Aeronautical Pricing Principles

Following the 2006 PC Inquiry, it was proposed that Aeronautical Pricing Principles developed by the Government could be used as a guide, or standard, for airport behaviour. The Aeronautical Pricing Principles were based on Review Principles used for previous inquiries and principles recommended in the 2006 PC Inquiry report. The principles build on the Pricing Principles in Part IIIA of the CCA. In the introduction to the Principles, it states that they represent "the Government's expectations on the pricing behaviour and outcomes that should apply to aeronautical services and facilities that are subject to significant market power."[42] The principles include the three Pricing Principles in Part IIIA of the CCA for access disputes and access undertakings or codes (s. 44ZZCA) and four additional principles (see Attachment A for the full Aeronautical Pricing Principles).

In addition to the efficient pricing principles contained within Part IIIA, the Government's Aeronautical Pricing Principles emphasise that prices should reflect commercial negotiation and include a reasonable sharing of risks between airports and their users, and that quality of service should be consistent with users' reasonable expectations.

While the principles make economic sense, the key issues are how they would work, and how effective they would be, in the current regulatory framework for airports. The principles are very high level and open to interpretation. For instance, price discrimination under monopoly conditions can promote efficiency in situations of declining long run costs or it can be used for monopoly pricing and anticompetitive practices. Further, "reasonable" would be interpreted differently by different interest groups and also by an independent regulator.

Making an adequate assessment against the Aeronautical Pricing Principles is likely to require a comprehensive review of airport performance involving access to a lot of detailed information. Such a review would have similar issues to those discussed in relation to Price Inquiries in s.2.1. Given the difficulties associated with interpretation of the Aeronautical Pricing Principles, it is not likely that they

[42] Government response to Productivity Commission Report - Review of Price Regulation of Airport Services, Media Release No. 032, 30 April 2007.
http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2007/032.htm&pageID=003&min=phc&Year=&DocType=0 Accessed 27 July 2018.

could influence airport performance in the context of a monitoring framework, nor outside the airport monitoring context.

'Show cause' mechanisms

The PC Inquiry of 2006 recommended a "show cause" mechanism to be used to provide clarity on when the Government considers further scrutiny of an airport's conduct is necessary, and in doing so, "ensures that the threat of re-regulation is both measured and credible".[43] Under the proposed "show cause" notice, price-monitored airports may be required to demonstrate to the Government why their conduct should not be subject to more detailed scrutiny such as a formal price inquiry under the CCA. Further:

> The Government will give regard to these Pricing Principles when assessing the behaviour of the monitored airports. A persistent failure to produce results consistent with these Principles could lead to more detailed scrutiny of an airport(s) under the 'show cause' mechanism (see the response to Recommendation 4.1 (relating to Pricing Principles)) and potentially the imposition of more heavy-handed regulation.
>
> The Government also considers that these Pricing Principles should act as a guide for the conduct of all airports, whether price monitored or not.[44]

The 2011 PC Inquiry recommended a variation of the "show cause" mechanism proposed in 2007. This mechanism involved the ACCC publishing a draft airport monitoring report and having the option to nominate an airport to 'show cause' why its conduct should not be subject to a price inquiry. If the ACCC was not satisfied with an airport's response, the ACCC "should make a recommendation to the relevant Minister that a price inquiry be held under Part VIIA of the Competition and Consumer Act 2010."[45] The Government did not implement the recommendation to introduce a 'show cause' mechanism, noting the independence of the ACCC as a regulatory agency.[46]

The proposed 'show cause' mechanisms involve the initiation of further inquiries. The 2007 mechanism would have brought the Government back into the price determination process as was the case prior to privatisation and contrary to one of the objectives associated with airport privatisation. Both processes would result in delays and uncertainty for all parties.

3.2 'Enhanced' monitoring

Proposals to enhance monitoring suggest that additional information should be collected and reported on. In order for 'enhanced' monitoring to be effective in making an assessment of airport pricing, it would need to enable an improved assessment or identification of the use of market power by the airports. A difficulty of expanding the information requirements for monitoring is that it would be difficult to know when to stop. As weaknesses or gaps in information are identified, there is likely

[43] Ibid
[44] Government response to Productivity Commission Report, 2007, op.cite.
[45] Australian Government response to the Productivity Commission Inquiry into the Economic Regulation of Airport Services Announced 30 March 2012 by the Minister for Infrastructure and Transport, the Hon Anthony Albanese MP, and the Assistant Treasurer and Minister Assisting for Deregulation, the Hon David Bradbury MP. https://static.treasury.gov.au/uploads/sites/1/2017/06/Economic_Regulation_of_Ai.pdf Accessed 27 July 2018
[46] Ibid

to be a desire for more information to establish a more robust picture. (For example, a comparison of the earliest monitoring reports with more recent ones shows an increase in the information obtained.)

The New Zealand Information Disclosure regulation that has applied to the three largest airports, Auckland, Wellington and Christchurch commencing in 2010 under the amended *Commerce Act 1986*, involves significantly enhanced information in comparison to the Australian airport monitoring framework. Under the New Zealand framework:

> The Commission does not regulate the prices Auckland, Wellington, and Christchurch International Airports charge. The airports may set prices as they see fit, but must consult with substantial customers, like airlines, on charges and any major capital expenditure plans.[47]

The new Information disclosure regulation framework contains information requirements which are comprehensive, rigorous and incorporate forecast information.[48] The information requirements require:

> the three airports to publish information each year detailing their performance including profitability, expenditure and quality performance measures, and forward-looking information such as price-setting information and demand forecasts.[49]

The Information Disclosure framework recognises that a multidimensional approach to assessing the efficiency of airport performance is required, including assessing whether service quality is what consumers expect, airports undertake appropriate innovation and whether airports are likely to have extracted excessive profits.[50] The greater information requirements permit the Commerce Commission to undertake assessments of whether airports performance is efficient and consistent with a workably competitive outcome. For instance, the Commerce Commission has made quantitative assessments of the level of airport prices relative to estimated efficient levels.[51]

There are some significant distinguishing characteristics of the current information disclosure regime in New Zealand in comparison to airport monitoring in Australia. Airports are required to provide forward looking information related to price determination. The regime requires more information to be supplied in information categories and there is more prescription in the way the information is provided. Input Methodologies based in legislation are prescribed for key economic variables to facilitate the Commerce Commission's analysis of airport profitability.

The development of the information disclosure framework in New Zealand, including the input methodologies, was resource intensive and took over two year period to establish. Taking into account the relatively small size of New Zealand's major airports, especially Wellington and

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[47] New Zealand Commerce Commission website: https://comcom.govt.nz/regulated-industries/airports/commissions-role-in-airports Accessed 9 August 2018

[48] See documents on New Zealand Commerce Commission Airport Information Disclosure website http://www.comcom.govt.nz/regulated-industries/airports/airports-information-disclosure/ Accessed 2 August 2018 and https://comcom.govt.nz/__data/assets/pdf_file/0031/78772/Airport-services-information-disclosure-determination-2010-consolidated-3-April-2018.pdf Accessed 9 August 2018,.

[49] See New Zealand Commerce Commission website: https://comcom.govt.nz/regulated-industries/airports/disclosure-requirements-for-airports Accessed 9 August 2018

[50] See for example the Commerce Commission's report to the Minister on Auckland Airport in 2014 at: https://comcom.govt.nz/__data/assets/pdf_file/0029/63947/Auckland-International-Airport-Limited-Draft-s56G-Report-30-April-2.pdf Accessed 10 August 2018.

[51] See documents on New Zealand Commerce Commission Airport Reports to Ministers http://www.comcom.govt.nz/regulated-industries/airports/section-56g-reports/ Accessed 2 August 2018.

Christchurch airports, the compliance and administrative costs of the new information disclosure framework are likely to be relatively high compared to airport monitoring in Australia.

The requirements of Information Disclosure regulation of airports in New Zealand illustrates the point that in order for airport monitoring to identify whether airports are efficient and have abused their market power; rigorous, extensive and comprehensive information is required. Australia has a comparatively simple approach to light handed regulation which is not likely to be strengthened through analysis of just a few extra pieces of information.

3.3 Benchmarking

International benchmarking studies provide some useful information on comparative airport performance. My understanding is that these studies are generally orientated to operational (technical) efficiency and not designed for the purpose of identifying the use of market power.

The Air Transport Research Society (ATRS) Benchmarking Study[52] is a well-known, highly regarded international airport benchmarking study. The ATRS note that due to data limitations that their methodology for airport productivity relies on variable factor productivity indicators (not total factor productivity) and that their results do *not* take into quality of service.[53] The results of this study are normally reported by region, with Australian and New Zealand Airports incorporated into the Asia Pacific or an Oceanic group.

Conclusion

In my assessment, the most likely measures that could be adopted to enhance the current airport monitoring framework are unlikely to lead to any substantive improvements in its effectiveness. Rather than considering improvements to the current airport monitoring framework it would be more productive to introduce an alternative, more effective regulatory framework.

I have not come across another nation that has adopted a similar framework of economic regulation for major privatised airports. [54] The closest economic framework that I am aware of is New Zealand's Information Disclosure regulation. In comparison to airport monitoring in Australia, this framework has a stronger legislative base, involves the collection of data which is rigorously specified through Input Methodologies, and involves the collection of extensive current and forward looking information. As a result of these features the New Zealand framework is likely to have significantly greater compliance costs and be relatively interventionist for industry in comparison to the Australian framework. There is a good case for discontinuing Australia's 16 year 'experiment' of a regulator monitoring a limited number of performance indicators over time, in the absence of a credible threat of stronger regulation .

[52]See ATRS website: http://www.atrsworld.org/docs/2014_%20Info_Package.pdf and http://www.atrsworld.org/airportawards.html Accessed 2 August 2018

[53] See presentation by Chunyan Yu http://www.atrsworld.org/docs/Key%20Findings%20of%20%202017%20ATRS%20Benchmarking.pdf Accessed 2 August 2018

[54]Based on my research and from regularly attending international aviation conferences.

4. Negotiate-arbitrate regulation as an alternative form of airport regulation

In reviewing alternative forms of regulation, the Australian Government's expressed preference for light-handed regulation should be kept in mind. This raises the issue of what are the attributes light handed regulation. In my view a useful definition is:

> Light-handed regulation is a form of ex post regulation where the regulated firm determines its prices and service quality based on negotiation without regulatory intervention unless specific circumstances arise, such as the outcome of a regulatory review that has assessed market performance or due to the introduction of a dispute resolution process, such an arbitration.

Under light-handed regulation, the prospect of possible intervention by a regulator, or the introduction of stronger regulation from a regulatory review, provide incentives for 'good performance' by a firm. An important aspect of light-handed regulation is that it is expected to be less interventionist or intrusive into the affairs of regulated entities, and involve relatively low costs of compliance and greater flexibility for the regulated firm than conventional ex ante approaches to regulation. A further factor in considering alternative forms of regulation is the Australian Government's expressed preference from the outset of privatisation that negotiation between airports and airport users should be promoted.

Greater scope for negotiation of airport charges has benefits in its own right. Negotiation of prices allows for the development of arrangements that are better tailored to the needs of airlines and their passengers. The use of bilateral contracts can provide a framework for the provision of greater diversity in the services offered to airlines and other airport users, facilitating innovation in marketing strategies and promoting competition. Also, reduced regulatory intervention through greater scope for negotiation has advantages in terms of the cost of regulation. The challenges for regulators in dealing with issues of information asymmetry and regulatory gaming and the scope for regulatory error are reduced when there is less regulation.

4.1 Negotiate-arbitrate regulation in the context of light-handed regulation

Negotiate-arbitrate regulation can be viewed as a form of light-handed regulation. Regulatory intervention is not determined on an *ex ante* basis but *ex post*. Under negotiate-arbitrate regulation, a regulatory action (an arbitration) can only be invoked if negotiation of terms and conditions for access to services do not result in an agreed outcome. Further, the scope of regulation relates to the matters in dispute, which could be price or other terms and conditions associated with the provision of services.

Negotiate-arbitrate regulation contrasts with direct regulation which is ex ante regulation, such as would occur through application of a price cap through the prices surveillance provisions of the CCA or through the introduction of industry specific legislation. In contrast to direct ex ante regulation, negotiate-arbitrate regulation could be expected to be narrower, based on the issues in disagreement on price and terms and conditions.

Negotiate-arbitrate regulation can constrain market power through the potential influence of the regulation on the countervailing power of users. In such a framework, imbalances in market power are reduced through both parties being put on a more even footing. The possibility of an independent party determining the outcome of a dispute deters a firm with market power from misusing market power. Market behaviour, as a result, can be conditioned ex ante.

Key factors that have been identified as affecting airport market power include the degree of substitutability in the demand for, and supply of, core airport services, potential competition from other airports or service providers and whether airport users possess a degree of countervailing buyer power. It is generally considered that countervailing buyer power arises in an otherwise uncompetitive market when buyers have a credible option to cease buying or have other 'outside alternatives'. In an airport context, the degree of countervailing power of an airport user will be affected by the ability of the user to switch to another airport, on the business model of the user and the costs of switching to another airport (if possible).Further, in markets where there is the potential for other airlines willing to take the place of the incumbent airline, airline countervailing power will be reduced.

As the previous PC inquiries into the economic regulation of airport services have observed, fundamental to the effectiveness of light-handed regulation is a credible threat of a sanction, such as a stronger regulatory action, if abuse of market power is identified. Once a service is covered by negotiate-arbitrate regulation, there is effectively an 'inbuilt' threat of a stronger regulatory measure through the possibility of an arbitration. As there is no further need for intervention by a government, or a regulatory process required to invoke an arbitration, a stronger regulatory measure has increased credibility.

If negotiate-arbitrate regulation is applied to circumstances where an airport has market power, and there is effective competition in the downstream (airport user) market, it could be expected to promote efficient use and investment in airports as intended under the Access to services provisions in Part IIIA of the CCA.

4.2 Alternative routes to negotiate-arbitrate regulation

Two alternative routes to negotiate-arbitrate regulation are explored here; the current Part IIIA declaration process and the previous deemed declaration process available through s.192 of the Airports Act.

Part IIIA declaration

The national access regime can be applied to infrastructure services assessed as having met five declaration criteria, specified in sections 44CA(1) of Part IIIA of the CCA. Declaration of a service is the first stage in the process and allows the negotiation of the terms and conditions of a service with provision for arbitration in the event of unsuccessful negotiation. The assessment of whether services meet the declaration criteria and therefore whether the services could be 'declared' under the access provisions is made by the National Competition Council (NCC) on a case-by-case basis and depends on the specific market circumstances. The decision on declaration is made by a government Minister

following a recommendation from the NCC. In making a decision, the Minister must be satisfied that all the criteria for declaration are met.

Once a service is declared for access, it is declared in respect of the service provider and any access seekers, not merely the parties to the application for declaration. Declaration is time-limited to allow for changing industry circumstances. Declaration gives access seekers the right to seek binding arbitration by the ACCC under the arbitration provisions in part IIIA of the CCA.

Declaration under Section 192 of the Airports Act 1996

In addition to the general national framework for access to infrastructure industries under the national access framework, industry-specific access regulations have been developed and applied to specific industries, including airport services, telecommunications services, grain handling terminals and natural gas pipelines. The airport-specific framework (s.192 of the Airports Act) applied to newly privatised airports as a transitional measure in the privatisation process and was repealed in 2003. The airport-specific access provisions streamlined the application of the national access provisions. Under this access framework, airport services which met airport specific declaration criteria were automatically declared by the Minister for access under the national framework. This meant particular users could apply to the ACCC to invoke the arbitration provisions of Part IIIA if negotiations with airports had broken down.

Under the previous s.192, the criteria for an airport service to be a 'declared service' were based on whether the service was necessary for civil aviation and whether it was provided by significant facilities that could not be economically duplicated[55]. The ACCC had the power to interpret the application of the criteria in cases where interpretation of the criteria in relation to specific services was not clear cut, and therefore whether specific services were covered by the Minister's declaration.

The ACCC's approach to interpreting the Minister's declaration under s. 192 of the Airports Act when the provisions operated is outlined in Attachment B

A simplified comparison of the declaration process under Part IIIA and s.192 of the Airports Act is contained in Table 1 below.

[55] Criteria s.192(5) of the *Airports Act 1996* – now repealed.

Table 1: Application of negotiate-arbitrate regulation to airport services under the generic provisions in the national access regime and under airport specific access arrangements[56]

National access regulation (Part IIIA) of *Competition and Consumer Act 2010 (Cth)*	**Airport access provisions in *Airports Act 1996* (*Cth*) (s. 192) – repealed 6 September 2003**
Application to National Competition Council (NCC) for declaration assessment against criteria	Government declares airport services at specified airports that meet aviation specific criteria
NCC makes a recommendation to the Minister on declaration of services and Minister makes a decision based on NCC's recommendation.	Airport users could apply to the ACCC to assess whether a particular service met the criteria and therefore whether the service is declared.
Possible appeals of the decision to the Australian Competition Tribunal and Federal Court	No appeal provision
Negotiate-arbitrate regulation applies to a declared service	Negotiate-arbitrate regulation applies to a declared service
If negotiation fails, arbitration by the ACCC can occur under Part IIIA of the CCA	If negotiation fails, arbitration by the ACCC can occur under Part IIIA of the CCA
Possible appeal of an arbitration decision on the merits of the decision and/or legal issues	Possible appeal of an arbitration decision on the merits of the decision and/or legal issues

4.3 Experience with negotiate-arbitrate regulation of airport services

This section provides a brief description of six cases relating to airport services which have involved the use of negotiate arbitrate provisions.[57] The first four cases have involved declaration processes under Part IIIA of the CCA and the following two cases have involved the use of the previous s. 192 declaration process. Table 2 at the end of this section summarises time frames and processes involved in the six case. Insights from the experience of the alternative routes to negotiate arbitrate regulation follow.

Under Part IIIA of the CCA

There have been at least four applications for declaration of airport services under the national provisions in Part IIIA, two of which were successful and one which was withdrawn.

Freight handling at Sydney and Melbourne[58] airports

Australian Cargo Terminal Operators (ACTO) was one of the first companies to apply for declaration under Part IIIA. In 1996 ACTO applied for declaration of a range of freight handling and related services at Sydney and Melbourne international airports. The services included freight aprons and stands needed to load and unload freight from international aircraft, areas for moving and handling freight, equipment storage areas and land to construct terminals. The facilities were variously owned by the former Federal Airports Corporation (FAC), Qantas and Ansett.

[56] Arblaster, M. 2016.Negotiate-arbitrate regulation of airport services: Twenty years of experience in Australia, *Journal of Air Transport Management,* Volume 51, July, pp. 27-38, Table 1.
[57] Based on Arblaster, M. (2016), op. cite.
[58] In 1997 services at Melbourne Airport were declared for a period of one year only to take into account the prospective overlap of the access arrangements under the Airports Act 1996. At the time the airport specific arrangements under the Airport Act did not apply to Sydney Airport as it was not privatised.

ACTO, a small, independent firm providing international cargo terminal services to airlines, proposed to provide ramp handling[59] services and required access to the freight and passenger apron of Sydney and Melbourne airports.[60] New contractual arrangements for cargo terminal operations and ramp handling services were established immediately prior to privatisation. At the time, two major airlines, Ansett Airlines and Qantas, were major providers of ground handling services, and had a conflict of interest arising from serving their own and their competitors' aircrafts. The services were regarded as poor, high-priced, and of insufficient capacity. [61] The FAC ran a tender process for selection of cargo operators and ramp handlers which incorporated a number of restrictions, including the requirement for full service operators to provide the services. The tender process resulted in two large international companies, Jardines and Ogden, being selected to provide services in addition to Ansett and Qantas. The two small independent service providers, including ACTO, were removed from providing services.

The Minister's decision declared the ground handling services, allowing application of negotiate-arbitrate regulation on the basis it would promote competition in ground handling services the freight forwarding market, and the airlines market, particularly for freight airlines which were dependent on these services.[62] Some services related to the use of areas to construct cargo terminals at Sydney and Melbourne airports were not declared because an area to construct a cargo terminal could be provided off-airport.

The decision was appealed to the Australian Competition Tribunal by Sydney Airport. In the appeal decision, the Tribunal considered the tender process was deficient and identified that the tender criteria should be objective, relevant, non-discriminatory, and transparent, and that any party should have the right to appeal to an independent public authority other than the managing body of the airport.[63] The Tribunal observed that:

> … from an economic perspective new entrants can be a source of innovation and therefore competitive pressure. This is not a matter of the number of entrants but the variety of the competitive behaviour that wider entry would generate.[64]

ACTO went out of business before the completion of the declaration process, however a negotiated arrangement between Sydney Airport and South Pacific Airmotive Pty Ltd (SPAM), a small independent firm, occurred without an arbitration.

Airside services for domestic passenger services at Sydney airport

In the early 2000s Virgin Blue was a new entrant airline operating on a low cost business model including configuring their aircraft to maximize the number of seats. Following a significant increase

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[59] Ramp handling services involve the loading and unloading of freight and passenger baggage at the aircraft on the apron.
[60] Australian Competition Tribunal (2000). Decision: Re Sydney International Airport [2000] ACompT (1 March 2000) http://www.austlii.edu.au/au/cases/cth/ACompT/2000/1.html Accessed 4 August 2018
[61] National Competition Council, (NCC) (1997). Application for declaration of Certain Airport Services at Sydney and Melbourne international Airports, Reasons for Decision. Application for Declaration under Section 44F of the Trade Practices Act 1994, 8 May, p. 22. (The NCC referred to the Vaille Report) Accessed 4 August 2018 http://www.ncc.gov.au/images/uploads/DEAiAtRe-001.pdf
[62] National Competition Council, (NCC) (1997). Application for declaration of Certain Airport Services at Sydney and Melbourne international Airports, Reasons for Decision. Application for Declaration under Section 44F of the Trade Practices Act 1994, 8 May. http://www.ncc.gov.au/images/uploads/DEAiAtRe-001.pdf
[63] Australian Competition Tribunal (2000). Decision: Re Sydney International Airport [2000] ACompT (1 March 2000) Accessed 4 August 2018 http://www.austlii.edu.au/au/cases/cth/ACompT/2000/1.html
[64] Ibid

in aeronautical charges at Sydney Airport in 2001, Qantas and some other airlines, negotiated the replacement of separate landing charges with a single passenger service charge. Sydney Airport introduced the change to the charging structure on 1 July 2003 despite Virgin Blue's objections.[65]

A declaration application by Virgin Blue relating to runway and landing facilities for domestic airlines resulted in a Ministerial decision not to declare the services. Virgin Blue successfully appealed the Minister's decision; with the Tribunal finding that Sydney Airport had used its monopoly power in a way that increased its revenue by favouring Qantas.[66] The change in tariff structure had put low cost carriers, such as Virgin Blue (a low cost carrier at the time), at a competitive disadvantage to full service airlines, such as Qantas.[67]

In 2007, Virgin Blue initiated an arbitration on the charges made by Sydney Airport for domestic landings and take-offs, following unsuccessful negotiations with Sydney Airport. The arbitration was withdrawn by Virgin Blue around four months after its commencement, when agreement between the parties was reached. The ACCC heralded the outcome in a media release on 24 May, with the Chairman of the ACCC, Graeme Samuel stating:

> The outcome of this arbitration illustrates that Part IIIA is working as intended, and that the regulatory framework provides a useful backdrop that supports effective commercial negotiations.[68]

Jet fuel facilities at Sydney Airport

In 2011, the Board of Airlines Representatives of Australia (BARA), representing international airlines operating in Australia, applied for declaration of jet fuel facilities owned and operated by the fuel companies and Qantas at Sydney Airport. The application resulted from concerns that the lack of effective competition between jet fuel suppliers had caused high prices of aviation fuel and insecurity in the fuel supply. While the NCC found that the market for the supply of jet fuel was not characterised by effective competition, they concluded that application of negotiate-arbitrate regulation was unlikely to promote additional competition due to capacity constraints.[69] Further, they considered opportunities for greater competition should emerge in the future.[70]

Tiger Airways application for declaration of domestic terminal services provided by Sydney Airport

Tiger Airways, a new entrant low cost airline, applied to the NCC to have domestic terminal facilities declared for negotiate arbitrate regulation in 2014. The airline had had difficulty negotiating

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[65] Australian Competition Tribunal (ACT) (2005). Virgin Blue Airlines Pty Limited, op. cite.
[66] Ibid
[67] Ibid, paras. 524,525.
[68] Australian Competition and Consumer Commission (ACCC) (2007a). ACCC media release: ACCC welcomes commercial resolution of access dispute between Virgin Blue and Sydney Airport, 24 May. https://www.accc.gov.au/media-release/accc-welcomes-commercial-resolution-of-access-dispute-between-virgin-blue-and-sydney Accessed 10 August 2018.
[69] National Competition Council (NCC), (2012a). Jet Fuel Supply infrastructure at Sydney Airport, Application under s. 44F of the Competition and consumer Act 201o for declaration of services provided by the Caltex Pipeline and the joint user hydrant installation at Sydney Airport, Final Recommendations, 13 March. http://www.ncc.gov.au/images/uploads/DEJFBAFR-001.pdf
[70] International airlines continue to be concerned about competitive conditions and the price of jet fuel at Sydney Airport. The current inquiry covers this issue.

increased access to terminal facilities to accommodate its planned growth.[71] One month after the application was submitted, an agreement with Sydney Airport was reached and the application for declaration of the services under negotiate-arbitrate regulation was withdrawn.[72] Tiger Airways CEO described the outcome:

> Following productive, in-depth, commercial discussions at the negotiating table, we have achieved a successful resolution that offers good outcomes for all the parties involved, delivering infrastructure access for Tigerair.[73]

The previous s.192 declaration process in the Airports Act[74]

Two cases for access have been considered under the previous s.192 (now removed) of the Airports Act 1996

Landside access to roads and facilities for dropping off and picking up passengers Melbourne Airport

In October 1998, Delta Car Rentals, a company operating an off-airport car rental and car parking service close to Melbourne Airport, sought a determination from the ACCC under the Airports Act on whether landside roads and associated vehicle facilities for dropping off and picking up passengers adjacent to the airport terminal were subject to negotiate arbitrate regulation. Following the privatisation of the airport and expiration of contracts, Melbourne Airport proposed that all off-airport car rental operators use a designated meeting point located in a multilevel car park for dropping off and picking up passengers, instead of the landside drive area adjacent to passenger terminals. Delta sought access to drop off and pick up points on landside roads closer to the passenger terminals.[75]

The ACCC determined that "the provision of landside roads and associated vehicle facilities for dropping off and picking up passengers at Melbourne Airport" to be services covered by the former declaration provisions in s.192 of the *Airports Act 1996.* Melbourne Airport and Delta Car Rentals negotiated an outcome.

Passenger terminal services at Melbourne Airport

In 2001 Virgin Blue requested a determination on whether a new Multi-User Domestic Terminal (MUDT) at Melbourne airport was covered by the airport specific access provisions, and therefore whether these services were covered by negotiate-arbitrate regulation.[76] At the time,

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[71] Tiger Airways Holdings Limited, (2014a). Application under Part IIIA of the Competition and Consumer Act 2010 (Cth) requesting a recommendation that the Domestic Terminal Service provided by Sydney Airport Corporation Limited be declared, Non-confidential version. 3 July. Accessed 23 March 2015. http://ncc.gov.au/images/uploads/DEAiTAAp-001.pdf

[72] Tiger Airways Holdings Limited, (2014b). Media Release. Tigerair confirms infrastructure access agreement with Sydney Airport: withdraws NCC application, 11 August. Accessed 23 March 2015. https://www.tigerair.com/news/TT_20140916_20140811.pdf

[73] Ibid

[74] S.192 of the Airports Act was removed in 2003 and no longer appears in the current version of the Airports Act.

[75] Australian Competition and Consumer Commission (1999). Determination Pursuant to section 192 of the Airports Act 1996 - Delta Car Rentals, Statement of Reasons.

[76] Australian Competition and Consumer Commission Media Releases, Virgin Blue Access Request at Melbourne Airport, 15 March, https://www.accc.gov.au/media-release/virgin-blue-access-request-at-melbourne-airport and ACCC draft decision on domestic terminal access at Melbourne Airport, 21 October 2001. https://www.accc.gov.au/media-release/accc-draft-decision-on-domestic-terminal-access-at-melbourne-airport Accessed 10 August, 2018.

another airline had already negotiated access to the MUDT but at a higher price than Virgin considered reasonable.

The ACCC determined that it was not desirable to regulate access to the MUDT through applying the s.192 provision because it would result in overlapping regulatory arrangements given that the MUDT was already covered by a price cap, and it was not declared for access regulation.[77] References have been made by Melbourne Airport and in a previous PC inquiry report that the ACCC determination led to a negotiated agreement being overturned. However, in this case, the regulatory determination associated with the necessary new investment decisions under the price that applied at the time was for a lower price than that agreed to by the airline.[78]

Summary of experience with negotiate arbitrate regulation of airport service

In over twenty-two years of access regulation in Australia, there have been at least six cases where airport users have made an application to the NCC, or the ACCC, to have services provided on airports covered by negotiate arbitrate regulation. Arbitration was commenced, but not completed, following declaration in one case. The six cases and their processes are summarised in Table 2.

Table 2 – Summary of applications for negotiate-arbitrate regulation of airport services in Australia[79]

Applicant	Legislative base for application	Final Decision	Review of decision (appeal process)	Date of Application for negotiate arbitrate regulate	Date of decision on declaration	Time from application for declaration to completion of the process
Australian Cargo Terminal Operators Pty Ltd (ACTO)	National access (Part IIIA of CCA)	Declaration	Australian Competition Tribunal	6 Nov. 1996	1 Mar. 2000	3 years 4 months
Delta Car Rentals	Airports Act 1996 (s.192)	Declaration	Not possible	21 Oct. 1998	17 May 1999	7 months
Virgin Blue (1)	Airports Act 1996 (s.192)	Not to declare	Not possible	2 March 2001	19 Oct. 2001 (Draft decision)	7 and half months
Virgin Blue (2)	National access (Part IIIA of CCA)	Declaration	Australian Competition Tribunal and the Federal Court	1 Oct. 2002	2 Mar. 2007[80]	4 and a half years
Board of Airline Representatives of Australia (BARA)	National access (Part IIIA of CCA)	Not to declare	No reviews sought	27 Sept. 2011	10 May 2012	8 months
Tiger Airways Australia	National access (Part IIIA of CCA)	Application for declaration withdrawn	Not applicable	3 July 2014	Not applicable	Not applicable

Source: Derived from various NCC, ACCC and ACT publications.

[77] Under the provisions of the *Airports Act 1996* (s.192 (4B)) the ACCC had the discretion to determine that a service is not an Airport Service, even if it otherwise meets the criteria.

[78] This airline went out of business shortly after the ACCC decision.

[79] Derived from Table 2 in Arblaster (2016).

[80] On 9 Dec. 2005 the Australian Competition Tribunal (ACT) issued a decision to declare the services for a period of 5 years. This decision was appealed to the Federal Court on 6 Jan 2006 Sydney and dismissed in 2 March 2007. Arbitration was commenced by Virgin Blue in February 2007.

The airport-specific access provision were more streamlined and less time consuming than the declaration process under the national access arrangements, involving seven to eight months in duration. The ACTO[81] and Virgin Blue[82] declaration processes under the general Part IIIA provisions took over three years in each case and were costly for the parties involved. Since these declaration processes were undertaken, amendments to the CCA have introduced time limits in Part IIIA processes. The BARA application for declaration of jet fuel facilities in 2012, which occurred after the time limits were introduced and involved no appeal processes, was a comparatively expeditious process, taking around eight months.

An important observation on the case history with negotiate-arbitrate regulation of airport services in Australia is that where airport services were declared, a negotiated outcome occurred and an arbitration either did not occur, or in the case where an arbitration was commenced, it was not completed. Additionally, negotiate-arbitrate regulation has been sought by a range of airport users, not just airlines, and for a range of issues, not just the level of prices.

Recent changes to the declaration criteria in Part IIIA

Since 2010, there have been several amendments to the declaration criteria under Part IIIA of the CCA as well as court interpretations of the declaration criteria, which potentially reduce the applicability of the national access regime to airport services. Amendments to the declaration criteria (a) of ss. 44CA (1) in 2011 required that declaration of services in a particular market should lead to a *material* increase in competition in at least one dependent market.[83] In addition, there have been further amendments to Part IIIA through the Competition and Consumer Amendment (Competition Policy Review) Act 2017 and judicial decisions.[84]

4.4 **Experience with access arrangements for other transport related the services**

Declaration processes for port and rail services under Part IIIA – Access to services

There have been some lengthy declaration processes under the Part IIIA declaration process in transport related industries, most notably for channel services in the Port of Newcastle and for rail services in the Pilbara.

Glencore Coal Assets Australia Pty Ltd (Glencore) has had a dispute on the level of charges and access terms set by the Port of Newcastle Operations Pty Ltd (PNO) in relation to the use of the shipping channel service provided at the port. Glencore sought to have the shipping channel service at the port declared through in an application to the National Competition Council (NCC) on 13 May 2015. A long, convoluted process has evolved since that time involving the following steps which took

[81] Australian Competition Tribunal (2000). Decision: Re Sydney International Airport [2000] ACompT (1 March 2000).
[82] Australian Competition Tribunal (ACT) (2005). Virgin Blue Airlines Pty Limited, (including summary and determination) ACompT 5 (12 December 2005).
[83] CCA 2010, s.44G(2) "(a) that access (or increased access) to the service would promote a material increase in competition in at least one market (whether or not in Australia), other than the market for the service;"
[84] The High Court of the decision of the Full Federal Court in the case of Port of Newcastle Operations Pty Ltd v Australian Competition Tribunal [2017] FCAFC 124 (Port of Newcastle FCAFC) is an example.

place over a three year period and are still not complete because PNO has initiated another process through the NCC to have the declaration revoked.[85] A summary timeline for the steps involved follows:

- 13 May 2015 – Glencore applies to the NCC to have the shipping channel service declared
- 8 January 2016 – the Minister decided not to declare the service under Part IIIA
- 16 June 2016 – the Australian Competition Tribunal declared the shipping channel service
- 14 July 2016 - PNO applied to the Full Federal Court for a review of the Tribunal decision
- 16 August 2017- Full Federal Court dismisses PNO's application for review of the Tribunal's decision
- 12 September 2017 – PNO appeals the Full Federal Court decision to the High Court
- 23 March 2018 – the High Court denies PNO's request to appeal the 2016 Tribunal decision
- 2 July 2018 – PNO applies to the NCC to revoke the declaration following the Amendments to the CCA

Four railway services in the Pilbara were the subject of declaration applications under Part IIIA initiated in 2007-08. A long process resulted involving recommendations by the NCC, decisions by the Treasurer, several rounds of appeal hearings by the Australian Competition Tribunal and appeals to the Full Federal Court and the High Court. [86] These processes took place over a five year period ending in 2013 and have been very resource intensive for the parties involved including the Government. The end result of the declarations for rail services in the Pilbara has been that one railway line, the Goldsworthy line, has been declared for access under Part IIIA.

The experience outlined above illustrates that declaration processes can be long, costly and uncertain under the national Part IIIA declaration process, even with the introduction of time limits for stages in the processes. Expansion in the availability of negotiate-arbitrate regulation for airport services could occur through a streamlined declaration process, similar to the one previously available under s.192 of the Airports Act.

Arbitrations under Part IIIA

The Services Sydney Part IIIA arbitration 2007

The one completed arbitration undertaken under national access provisions (Part IIIA of the CCA) related to the access pricing methodology for sewerage transportation services provided by Sydney Water and was initiated by a small independent firm, Services Sydney Pty Ltd[87]

In the Services Sydney case, the ACCC narrowed the scope of the arbitration to the access pricing methodology to be used to determine the price at which Sydney Water was to provide declared services to Services Sydney. The arbitration determined that the "retail-minus" methodology was the

[85] This follows the 2017 Amendments to the CCA which may have possible implications for interpretation of the declaration criteria in their case.
[86] A summary of the steps in the process can be found on the NCC website at: http://ncc.gov.au/application/third_party_access_to_various_pilbara_railways Accessed 9 August 2018
[87] ACCC, 2007. Access dispute between Services Sydney Pty Ltd and Sydney Water Corporation Arbitration report, 19 July 2007 https://www.accc.gov.au/public-registers/access-to-services-registers/s-44zzl-determinations-determination-of-the-access-dispute-between-services-sydney-and-sydney-water

appropriate methodology for determining the per customer access charge to Sydney Water's retail sewerage/wastewater services, minus the avoidable costs for Sydney Water as a result of supplying the declared sewage transportation services to Services Sydney. The price of Sydney Water's retail sewerage/wastewater services would continue to be determined (from time to time) by the Independent Pricing and Regulatory Tribunal of New South Wales.

The arbitration could be considered cost-effective in that it took only seven months to complete and involved limited legal representation and use of economic consultants by the applicant. The Services Sydney arbitration demonstrates that arbitration under the national access regime is not necessarily a costly process only available to large infrastructure users.

4.5 Factors to consider in applying negotiate arbitrate-regulation to airports

This section considers a number of factors relevant to adoption of negotiate-arbitrate regulation for airport services.

Concern that parties will not negotiate, and arbitration will become the default option

A concern that has been frequently expressed, and which was a concern expressed in previous PC inquiries, is that the incentive to negotiate in good faith will be reduced and that arbitration will become the default option. The experience of negotiate-arbitrate regulation in airport services over a 22 year period, and in other transport related industries, has shown that the arbitration option is rarely used.

It has also been argued that an ACCC arbitration would in effect lead to broad ranging, generic price determinations and so a return to direct regulatory intervention similar to the previous price cap approach. The one completed arbitration undertaken by the ACCC determined a pricing methodology suitable for the specific circumstances, which was not the general Building Block model. Further, the experience has shown that there are a range of access issues, other than issues relating to the general level of aeronautical charges, which have been a concern to airport users.

Examples of transport-related industries, where negotiate-arbitrate regulation applied (or services were covered by independent dispute resolution) and the incidence of arbitration follow.

Rail

ARTC Interstate Access Undertakings under part IIIA have had dispute resolution provisions associated with negotiation of terms and conditions by rail users since 2002, which include the possibility of an arbitration by the ACCC based on the Part IIIA process. To date the arbitration provisions have not been used.[88] ARTC's proposed 2018 Undertaking additionally has an ACCC arbitration process in the dispute resolution process associated with negotiation of access (s.3.12.4, p.18).[89]

[88] Based on my experience at the ACCC and from a review of the ACCC website

[89] Australian Rail Track Corporation Limited (ARTC), Interstate Access Undertaking 2018. https://www.accc.gov.au/system/files/ARTC%20Interstate%20Network%20-%202018%20Access%20Undertaking%20-%20clean_0.pdf
Accessed 4 August 2018.

Although the Goldsworthy line has been declared it has not led to an arbitration by the ACCC. The Tasmanian rail network was declared for access from 2007 to 2017 without any recorded applications for arbitration by the ACCC.[90]

ACCC role in bulk mail postal disputes

In 2003, amendments to the *Australian Postal Corporation Act 1989* (s.32B) allowed the ACCC to inquire into disputes about the terms and conditions, including price of access to Australia Post's bulk mail services. The purpose was "to provide safeguards against Australia Post using its market power to impose unreasonable terms and conditions of access to its network."[91] The ACCC has released a guide on how the ACCC would inquire into potential disputes between Australia Post and users of its bulk mail services.[92] I understand that to-date the ACCC has not had to exercise this role.[93]

Arbitration processes under Part IIIA of the CCA

The interest of parties in establishing and maintaining a commercial relationship generally provides an incentive for parties not to have a dispute resolved by arbitration. In the event that parties cannot agree on a reasonable price or other aspects of a service, an arbitration by the ACCC or some other form of dispute resolution may be invoked. Arbitrations under Part IIIA are not conducted by the full commission but by a separate commissioner or group of commissioners established within the ACCC for the purpose of the arbitration of the particular dispute. They are supported by ACCC staff.

The ACCC has issued guidelines to resolution of access disputes under Part IIIA.[94] Important features of an ACCC arbitration include:[95]

- negotiation can continue while the ACCC arbitrates a dispute
- parties can withdraw from an arbitration of a dispute at any time before the ACCC makes its final determination
- the ACCC satisfies itself that there is genuine disagreement between the parties at the outset of an arbitration
- arbitration hearings are conducted in private[96]
- the structure and processes for conducting an arbitration can vary to suit the parties to the dispute and matters in dispute
- the ACCC aims to conduct an arbitration with as little formality as possible
- the ACCC gives directions in relation to confidentiality for the arbitration process

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[90] See the public registered of services declared for access on the ACCC website: https://www.accc.gov.au/system/files/public-registers/other/910173-1-Declaration.pdf Accessed 4 August 2018.
[91] Postal Services Legislation Amendment Bill 2003, Explanatory Memorandum, Part 2, https://www.legislation.gov.au/Details/C2004B01442/Explanatory%20Memorandum/Text Accessed 3 September 2018.
[92] See ACCC website: https://www.accc.gov.au/regulated-infrastructure/postal-services/inquiries-into-disputes-about-bulk-mail-services
[93] Based on my experience at the ACCC, a review of the ACCC website and confirmation from ACCC staff.
[94] See ACCC website: https://www.accc.gov.au/regulated-infrastructure/about-regulated-infrastructure/acccs-role-in-regulated-infrastructure/national-access-regime-under-part-iiia#access-disputes Accessed 8 August 2018.
[95] Based on ACCC (2006). Arbitrations A guide to resolution of access disputes under Part IIIA of the Trade Practices Act 1974 A summary guide April 2006, https://www.accc.gov.au/system/files/Arbitrations%20-%20a%20summary%20guide%20to%20resolution%20of%20access%20disputes%20under%20Part%20IIIA%20of%20the%20TPA.pdf Accessed 8 August 2018. The ACCC identifies that is updating the Guide.
[96] Except where otherwise agreed by the parties to a dispute.

- The ACCC must make a final determination within 180 days from the day a dispute notification is received

Access undertakings as an alternative to declaration

Access undertakings are an alternative approach to access for services under Part IIIA. Providers of infrastructure services can voluntarily submit access undertakings to the ACCC which cover services which would otherwise be declared for negotiate-arbitrate regulation under Part IIIA. Access undertakings can relate to existing or proposed infrastructure and sets out the terms and conditions on which access to relevant services will be provided. Where an access undertaking is accepted by the ACCC, the service will not be declared under Part IIIA of the CCA.

The ACCC has not accepted any access undertakings for airport services to-date. Two privatised airports, Perth and Melbourne airports, developed access undertakings accepted by the ACCC within the first twelve months of privatisation. The undertakings did not proceed. [97] Amongst the considerations in the ACCC's assessment were that access seekers required adequate information as part of the negotiation process, effective dispute resolution processes associated with negotiation processes should be in place and that access undertakings need to be sufficiently detailed so that they are legally enforceable documents which would satisfy interpretation by a court *if necessary*.

The wide variety and complexity of airport services is likely to make the development of a comprehensive airport undertaking which suits the stringent requirements associated with Part IIIA undertakings challenging. Further, changing market circumstances and the multidimensional nature of airport services could lead to many variations to undertakings over time. Access undertakings covering a *broad* range of airport services are unlikely to be a suitable approach to the regulation of airport services.

Competition in the downstream market

There is a need for effective competition between users to pass on the benefits of improved terms and conditions. Negotiate-arbitrate regulation is not likely to be a suitable approach to economic regulation in all circumstances, such as in a situation where there is bilateral market power between an airport and airport user.

In some situations, the transaction costs of negotiation may be high, such as when there are a very large number of parties/users for an airport to negotiate with. In these situations, there may be the possibility of using an industry association to negotiate for the airport. For example, BARA negotiates on behalf of international airlines under an arrangement which has been authorised under Part VII of the CCA by the ACCC.[98]

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[97] See ACCC Media Releases, 13 May 1998, no. MR086/98 and 29 May 1998, no. MR095/98 and Australian Competition and Consumer Commission (1998), Draft Determination – Melbourne Airport Access Undertaking, https://www.accc.gov.au/media-release/melbourne-airport-access-undertaking-draft-determination
and Australian Competition and Consumer Commission 1998, Draft Determination – Perth Airport Access Undertaking, https://www.accc.gov.au/media-release/perth-airport-access-undertaking-draft-determination
Accessed 10 August 2018.

[98] See ACCC (2015). Determination Application for revocation of A91200 and substitution authorisation A91466 lodged by the Board of Airline Representatives of Australia Inc to collectively bargain on behalf of its members with providers of Essential Aviation Services Date: 25 March 2015 Authorisation number: A91466.
https://www.accc.gov.au/system/files/public-registers/documents/D15%2B37881.pdf Accessed 13 August 2018.

Situations of uneven bargaining power, where smaller users are not able to access negotiate-arbitrate regulation (e.g. due to costly processes or high threshold declaration criteria) could be harmful to competition. If the declaration process is costly and/or has a high threshold criteria for application, smaller market participants may be forced to exit, or not enter, the market.

Information requirements under negotiate-arbitrate regulation

In situations where the costs (availability) of information to users relevant to negotiations are high, measures to support negotiations may be helpful. For example, negotiation between firms and industry could be facilitated by requiring specified, relevant information necessary for commercial negotiations to be disclosed by firms to airport users under confidentiality arrangements.

It seems likely that the availability of an arbitration process would provide an incentive for airport operators to provide sufficient information to resolve an issue in dispute in a negotiation process, because otherwise information provision could be compelled in an arbitration.

4.6 Final Offer Arbitration as an alternative approach to arbitration

The ACCC guidelines on arbitrations referred to in Section 4.5 identify that the ACCC has some flexibility in the approach to procedures in the way an arbitration is conducted under Part IIIA of the CCA. In some circumstances, the resolution of a dispute through the use of Final Offer Arbitration may be appropriate.

Final-offer arbitration (FOA) (sometimes called 'Last Offer' or 'Baseball' arbitration) refers to arbitration in which both parties are required to submit their final offer to the arbitrator, and the arbitrator chooses one of the unalterable offers put forward by each party. Final offers are based on the elements of either party's final proposals made during the negotiating process. Under FOA the arbitrator must select the position of one of the parties and cannot select a compromise position. This procedure gives each party an incentive to make a reasonable offer in the offers put before the arbitrator. The arbitration process is considered to encourage parties to reach commercial settlement of their disagreement by its all-or-nothing approach.

FOA has been used to resolve certain types of disputes. Relevantly, it has been used in Canada under the *Canadian Transportation Act 1996* for resolution of disputes between shippers and carriers in certain circumstances and has also been applied to rail and marine services.[99] FOA is also used by Canadian Radio-television and Telecommunications Commission, to resolve issues in dispute related to the distribution of media.[100] In the United States, FOA has been used in relation to wage rate determinations, primarily in disputes involving public employees, such as police and firefighters, where strikes would result in significant economic loss or danger to public health and safety, and also disputes involving professional sports players.[101] There have also been proposals to use FOA to settle tort cases in order to relieve court congestion.[102]

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[99] Canadian Transportation Act 1996, Part IV, ss. 159 – 169.3

[100] See Broadcasting Decision CRTC 2016-262 PDF version Ottawa, 12 July 2016 Application 2016-0241-7 Final offer arbitration request by Videotron G.P. regarding the distribution of Bell Media Inc.'s RDS services, https://crtc.gc.ca/eng/archive/2016/2016-262.pdf

[101] Where a player is contractually tied to an organisation and cannot be voluntarily employed elsewhere until his or her contract is completed.

[102] Lok, A. (2008). Final offer arbitration, ADR Bulletin, Volume 10, No. 4, Article 1. *https://epublications.bond.edu.au/cgi/viewcontent.cgi?article=1431&context=adr* Accessed 2 August 2018

Use of Final Offer Arbitration in Canada

Final Offer Arbitration under the Canadian Transportation Act

FOA provisions were introduced into legislation in Canada[103] as a dispute resolution mechanism in 1987. FOA is one of three types of arbitration made available by the Canadian Transportation Agency for shippers dissatisfied with a rate or condition of service associated with the movement of goods. The provision of FOA is primarily used for issues relating to the prices that are intended to be charged for freight service by railways and by maritime services. The other types of arbitration are specific to rail arbitrations and relate to level of service contracts and specific rail issues, including the application of any rate or charge for the movement of goods and charges for incidental services. There are separate arbitration procedures to settle disputes between a shipper and a railway company regarding the establishment of service agreements.[104] Additionally, under the arbitration provisions, the parties can undertake mediation.

Final offer arbitration can be used for disputes between shippers and railway companies or air and marine carriers; or Governments and railway companies. A less expensive summary FOA process is available to allow all rail shippers and those with non-complex cases to have access to the mechanism. The timeframes are 60 days or 30 days for disputes involving freight charges of less than $2,000,000, unless an extension is requested. The dispute is arbitrated by an external arbitrator or panel of three arbitrators. The Canadian Transportation Agency has established a list of arbitrators with criteria for inclusion on the Agency's list and has rules of ethics for prospective arbitrators. The parties (or the Agency if the parties agree) choose the arbitrators. The shipper and the carrier share the cost equally.

Under the Canadian Transportation Act, FOA applies only to the carriage of goods but does not apply to their carriage internationally. The Act identifies basic requirements that the final offer must contain. The Canadian Transportation Agency may supply administrative, technical and legal assistance to the arbitrator. The Agency provides a Final Offer Arbitration: A Resource Tool on its website: https://otc-cta.gc.ca/eng/publication/final-offer-arbitration-a-resource-tool (Dated 10 January 2012).

FOA has been retained with strengthened procedures following a major review of the Canadian transportation system and the legal and regulatory frameworks which govern it, including a review of the Canada Transportation Act released in 2016.[105]

The Canadian Radio-television and Telecommunications Commission[106]

The Canadian Radio-television and Telecommunications Commission has used FOA to resolve disputes in the context of rights of the distribution of media rights. When resolving disputes by way of final offer arbitration, the Commission assesses the proposed rates based on the fair market value

[103] The relevant legislative provision covering final offer arbitration is section 161 of the *Canada Transportation Act 1996*.
[104] *Canadian Transportation Act 1996,* Part IV, ss. 169.31 to 169.43
[105] The *Canada Transportation Act* (CTA) Review Report (2015). Pathways: Connecting Canada's Transportation System to the World http://www.tc.gc.ca/eng/ctareview2014/canada-transportation-act-review.html Accessed 9 August 2018.
[106] Canada, Broadcasting Decision CRTC 2016-262, op. cite

of the service, taking into account a *Wholesale Code* (*Broadcasting Regulatory Policy 2015*), and a number of listed factors, where applicable; including historical rates, rates paid for programming services of similar value to consumers, taking into consideration viewership and other factors.

Under the dispute resolution process used by the Commission, parties have the opportunity to make submissions regarding which fair market value factors should apply, how different factors should be interpreted and how much weight should be given to a specific factor. Parties can also make submissions on which public policy objectives are relevant to a given case. The Commission can apply a public interest test to assess whether the proposed wholesale rates are consistent with the relevant public policy objectives.

The Commission has stressed to the parties involved in an FOA, that they are responsible for including concise supporting arguments stating all the facts when they file their final offers. Since the purpose of the comments is to allow each party to comment on the other party's final offer, procedural fairness requires that the parties' entire positions be put forward at the beginning of the process, namely as part of the final offer. Under FOA, it is not appropriate to file new evidence and formulate new arguments as part of the comments or any reply, if that evidence or the arguments could have been filed or formulated when filing the final offers.

Strengths and limitations of Final offer Arbitration

Strengths of Final Offer Arbitration

One of the main strengths identified with final-offer arbitration is that it is more likely to result in compromise and settlement of disputes because parties will not expect an extreme offer will be chosen by the arbitrator. Both sides are likely to take a position which is more in line with the other party's position. This is because the party which loses has the prospect that the settlement will be further away from its desired position.

A further advantage attributed to FOA is that it is said to not impose the 'chilling effect' upon the incentive to bargain, a defect of the conventional arbitration process.[107] The chilling effect arises when either party believes that it will gain a better outcome from the arbitrator than it will through negotiating so it does not negotiate with skill, disclosure or creativity and leaves the decision up to the arbitrator. This effect leaves the parties with little incentive to bargain with some degree of honesty, disclosure and skill.

A reduced burden on the arbitrator is another advantage that is attributed to FOA. Under FOA, the arbitrator would *not* have to delve into all the particulars of the industry before it comes to a decision. In a Part IIIA setting, an arbitration process would only have to understand each final offer and determine which is more reasonable given the Part IIIA pricing principles and the statutory requirements to promote community welfare, efficiency and an adequate return on investments.

A submission to the Canada Transport Act Review Panel by the Commissioner of Competition[108] identifies that:

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[107] Lok, A., op.cite

[108] Commissioner of Competition submission to Canada Transport Act Review Panel, February 27 2015. http://www.competitionbureau.gc.ca/eic/site/cb-bc.nsf/eng/04040.html#section2_c_5 Accessed 4 August 2016

FOA was reported by some stakeholders as the only effective limit to excessive rates charged by railways to captive shippers, effectively serving as a "last resort" in the event that a shipper cannot obtain satisfactory terms through commercial negotiation. Even where a shipper does not ultimately resort to FOA, the threat of initiating the process serves as an important bargaining tool for shippers in their negotiations and serves to limit the rates proposed by the railways.

Limitations of Final Offer Arbitration

FOA is considered less suitable when the dispute involves a 'package selection'.[109] It can be challenging to collapse a set of diverse aspects, such as quality of services, enforceability of terms and conditions and pricing over a period of time, into a single point of comparison where the arbitrator has to choose one of two disparate packages. Where the offer contains not only a price, but also terms and conditions which are nuanced and possibly tailored to the unique needs of one party they are not easily standardised nor summarised in a single number.

A further potential defect of FOA in the context of 'package selection' is there is the potential for either or both sides to mistakenly or deliberately make offers which include terms that are inequitable to the other side. [110] In this case, the arbitrator may be left with no choice but to choose the best of the inequitable options. It has been argued that parties may deliberately include such terms into an otherwise equitable offer in order to gain ground with respect to an issue to which the other side would normally never agree. If both parties participate in such behaviour, then one party will 'be rewarded for its misjudgement or deviousness while the other suffers a severe penalty'.

Conclusions on Final Offer Arbitration

The appropriate approach to an arbitration under Part IIIA is likely to vary depending the nature of the dispute and the parties involved. To date there has only been one completed arbitration in the 22 year history of Part IIIA legislation. The ACCC's arbitration guidelines and the limited experience of one arbitration suggest that the ACCC has some flexibility in the approach it adopts to arbitrations. Final offer arbitration is one approach to arbitration that the ACCC could consider using if it considers the circumstances are appropriate. Experience with the use of final offer arbitration in Canada over the last forty years suggests that FOA can be an effective dispute resolution mechanism for price disputes and disputes which are not complex, such as disputes involving multidimensional factors including quality of service aspects.

[109] Ibid
[110] Lok, A. (2008), op.cite.

Attachment A - Aeronautical Pricing Principles[111]

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

a) that prices should:

(i) be set so as to generate expected revenue for a service or services that is at least sufficient to meet the efficient costs[112] of providing the service or services; and

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

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

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

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

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

d) that price structures should:

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

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

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

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

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

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[111] Australian Government Department of Infrastructure, Transport, Regional Development and Local Government, Aeronautical Show Cause Guideline, January 2009, Attachment A

[112] For the purpose of determining aeronautical prices through commercial negotiations, these should be long-run costs unless another basis is acceptable to the airports and their customers.

ATTACHMENT B - How did the previous s.192 access provision operate?

The s.192 legislative provision

The specific access rules under s.192 the Airports Act applied to core regulated airports until they were repealed in 2003. Following privatisation airport operators were allowed one year (with a possible one year extension) from when their leases began to have an access undertaking accepted by the ACCC. An access undertaking is a legally binding document with terms and conditions under which businesses can access the services provided by essential airport facilities. If the ACCC did not accept the access undertaking, services at the airport were automatically "declared" by the Minister through the s.192 provision which applied negotiate-arbitrate provisions in Part IIIA of the CCA (then called the *Trade Practices Act 1974*).

The Minister determined that airport services were declared under s. 192(2) at Phase 1 airports (Melbourne, Brisbane and Perth) in July 1998; and Phase II airports[113] in 1999. Declaration of services provided the right to have an access dispute between airport operators and access seekers arbitrated by the ACCC if negotiations prove unsuccessful. The Airports Act did not list declared services, but instead declaration was by reference to services provided at core regulated airports that meet criteria specified in s.192(5) of the Airports Act. Under s.192(5) "airport services" were defined:

Airport service means a service provided at a core regulated airport, where the service:

(a) Is necessary for the purpose of operating and/or maintaining civil aviation services at the airport; and
(b) Is provided by means of significant facilities at the airport, being facilities that cannot be economically duplicated;

And includes the use of those facilities for those purposes.

This meant that services covered by negotiate-arbitrate regulation were not the same as aeronautical services, defined in the Airports Regulations 1997 Part 7, they were a broader set of services. Amendments to the Airports Act gave the ACCC the power to interpret whether a particular service met the declaration criteria in the Airports Act and therefore whether the service was, or was not, an 'airport service' and therefore subject to negotiate-arbitrate regulation.. Prior to the Amendment, the general definition of 'airport services' in s.192 had meant that in the case of some services it was not clear whether particular services met the criteria in s.192(5).

The ACCC's decisions on whether a specific service was an 'airport service' under the amended Airports Act were disallowable instruments which meant they were not reviewable by the Australian Competition Tribunal, but they were subject to review by Parliament.

The ACCC's approach and process for interpreting which services were 'airport services' under s.192

The Commission developed and sought comments from interested parties on a discussion paper which outlined its views on interpretation of 'airport services' under s.192 (5). This was released in December 1997. A "Draft guide' to 'Section 192 of the Airports Act – Declaration of airport services" was released in October 1998. The ACCC undertook to make a determination on whether or not a service is declared in the event that a party approached it seeking a declaration following a written request to do so and before undertaking an arbitration.

[113] Phase II airports included Adelaide, Alice Springs, Canberra, Coolangatta, Darwin, Hobart, Launceston and Townsville,

Based on the interpretation of the s.192 declaration criteria the ACCC's Draft guide[114] set out an assessment of services against s.192 criteria. The assessment enabled whether particular services, such as "Airside facilities (runways, taxiways, aprons, etc.)" and "landside vehicle facilities" were "likely to be within the definition in s.192(5)" in the affirmative; or the service *not* likely to meet the s.192(5) test, such as "Administrative office space" and "Commercial and retail facilities"; or would need to be assessed on a "case by case basis", such as "domestic passenger processing areas" and "ground service and freight handling equipment storage facilities".

ACCC processes used to determine whether a specific service was covered by the Minister's declaration under s.192

The Commission's processes for determining whether a specific service was an "airport service" covered by the Minister's declaration under s.192 are illustrated by Delta Car Rentals (Delta) request for an ACCC determination in October 1998.

Delta Car Rentals operated an off-airport car rental service and short and long-term car parks close to the airport. It provided a shuttle bus service to transport passengers to and from the terminal. Delta did not agree with the terms of access being offered by Melbourne Airport and asked the ACCC to determine whether the service was covered by the Minister's declaration.

Summary of steps in the Delta process:[115]

21 October 1998 – Delta requests that the ACCC make a determination under s.192 in relation to its request for "access to the landside drive area of Melbourne Airport to pick up and drop off our clients"

1 December 1998 – ACCC released a discussion paper inviting submissions on the issues. 13 submissions received.

25 January 1999 – ACCC holds a public hearing to better understand the issues raised in the submissions and to give interested parties the opportunity to present new material for consideration.

09 March 1999 - Draft Determination to section 192 of the Airports Act 1996 and Statement of Reasons released with request for submissions

April 1999 – Final Determination under s.192 The ACCC decided that service roads needed for picking up and dropping off passengers are essential to the operation of civil aviation at Melbourne airport, and had natural monopoly characteristics.

Melbourne Airport was required to negotiate with Delta and any other company, such as a bus, taxi or hire car company, which seeks access to roads and associated facilities for dropping off and picking up passengers. Although an ACCC arbitration was available following the s.192 declaration, the ACCC was not called on to arbitrate.

[114] See ACCC (1998). Draft guide: Section 192 of the Airports Act – Declaration of airport services, October. https://www.accc.gov.au/system/files/Section%20192%20of%20the%20Airports%20Act%20-%20declaration%20of%20airport%20services.pdf Accessed 25 July 2018.

[115] See ACCC (1999). Draft Determination Pursuant to section 192 of the Airports Act 1996, Statement of Reasons and Utility Regulators Forum (1999). Network, Issue 1, pp. 11-13. https://www.accc.gov.au/publications/network/network-issue-1 Accessed 25 July 2018.

APPENDIX D

JOHNSON WINTER & SLATTERY
LAWYERS

Memorandum

Date:	5 September 2018
To:	Airlines for Australia & New Zealand
From:	Aldo Nicotra and Michele Laidlaw
Subject:	Economic Regulation of Airports – Productivity Commission Issues Paper
Our Ref:	C1073
Doc ID:	74189995.1

1 EXECUTIVE SUMMARY

1.1 As the Harper Review Final Report (2015) identified, airports tend to have strong natural monopoly characteristics.[1] In relation to Australian airports specifically, we refer to the report of Frontier Economics, prepared for Airports for Australia and New Zealand (**A4ANZ**), which found there were very few circumstances where these airports might face any material competitive constraints.[2]

1.2 Against this background, we have been asked to prepare a memorandum of advice for A4ANZ that addresses the following:

(a) the remedies that are available under the current framework for the economic regulation of airports, in particular the implications of recent changes to Part IIIA of the *Competition & Consumer Act 2010* (Cth) (**CCA**) – see section 2; and

(b) certain modifications to the regulatory regime that A4ANZ is proposing the Productivity Commission consider – see section 3.

1.3 Michael O'Bryan QC, who has practised extensively in the area of competition law and was a member of the Competition Policy Review Panel (the Harper Panel) in 2014 – 2015, has conducted a high level 'peer review' of this memo. See **Appendix A** for confirmation.

1.4 Airports are currently subject to 'light handed' regulation. It is not controversial that for such a regulatory regime to appropriately deter abuses of market power there must be a credible threat of effective remedies, which can be deployed when abuses occur. One of the lynchpins of the current regime is the threat that airport users can seek to have airport services 'declared'

[1] Competition Policy Review, Final Report, March 2015, p.205
[2] Frontier Economics 2018, "The market power of Australian airports", prepared for A4ANZ

in accordance with the National Access Regime in Part IIIA of CCA and thereafter be subject to ACCC arbitration if the parties are not able to reach a commercial agreement.

1.5 While currently untested judicially, in our view recent changes to the 'declaration' criteria under Part IIIA of the CCA have increased the legal threshold that must be met, particularly in relation to non-vertically integrated infrastructure such as airports. The effect of these amendments, together with the existing significant cost, time and uncertainty associated with the 'declaration' process, is that the credible threat of declaration is likely to have deteriorated as a constraint on airports' market power when they are negotiating the terms and conditions of access with airline customers.

1.6 Recognising the ineffectiveness of current regulatory threats to curb the use of monopoly power by airport operators, A4ANZ is proposing certain modifications to the regulatory regime.[3]

1.7 One of these is that aeronautical services and facilities be subject to a 'light regulation' regime similar to the one that applies to certain 'covered' gas pipelines. Under that regime (contained in the National Gas Law), the pipeline owner determines its own tariffs, with arbitration by the Australian Energy Regulator available (and only available) if a party seeking access to a pipeline is unable to agree the terms and conditions of supply.[4]

1.8 There are a number of means by which such a regime could be implemented in relation to airports. The simplest means is to use the existing arbitration framework within Division 3 of Part IIIA of the CCA.

1.9 To bring aeronautical services and facilities within the scope of Division 3 of Part IIIA of the CCA, A4ANZ proposes that a new section 192 be added to the *Airports Act 1996* (Cth) (**Airports Act**), which would cause aeronautical services and facilities supplied by airports to be declared services for the purposes of Division 3 of Part IIIA.

1.10 There are a number of legal mechanisms by which that goal could be achieved. The following is a non-exhaustive list of such declaration mechanisms, all of which favour simplicity over complexity and seek to avoid the potential for legal disputation and delay:

(a) The first option is the simplest. The new section 192 would deem aeronautical services, as defined in regulation 7.02A of the *Airports Regulations 1997* (Cth) (**Airports Regulations**), to be declared services for the purposes of Division 3 of Part IIIA. Regulation 7.02A (see **Appendix B**) contains a clear and comprehensible

[3] For further details of the key modifications proposed by A4ANZ, we refer to A4ANZ 2018, "Submission to the Productivity Commission Inquiry into Economic Regulation of Airports" Sept 2018

[4] https://www.aer.gov.au/networks-pipelines/our-role-in-networks

definition of airport services that would be subject to light regulation under the proposed regime.

This option is akin to the "deemed declaration" advocated by the ACCC in 2011 and, while simple, represents a significant regulatory change by employing a statutory provision as the appropriate mechanism, rather than a decision by the executive or an appropriate administrative body.

(b) The second option is to limit the deemed declaration to those aeronautical services (as defined in regulation 7.02A), or airport services more broadly, in respect of which an airport operator has substantial market power. The concept of "substantial market power" is already a well understood legal standard in Australian competition law. It is commonly thought of as the ability to profitably maintain prices above the competitive level or reduce the quality of services for a period of time without rivals taking customers away.

This option targets the credible threat of regulatory intervention to the relevant conduct, namely where airport operators misuse their market power in the context of supplying goods or services. However, it also invites the prospect of disputes regarding which airport services satisfy the definition, arguments that would need to be resolved by court determination. The need for parties to address this type of jurisdictional issue, potentially multiple times across a wide variety of airport services, could give rise to significant delays and cost. This would offset its value as a potential declaration mechanism.

(c) The third option is to empower a relevant Federal Minister to determine, by statutory instrument, that one or more aeronautical services (as defined in regulation 7.02A of the Airports Regulations), or airport services more broadly, are declared services for the purposes of Division 3 of Part IIIA. The Federal Minister may be empowered to do so if the Minister is satisfied that the determination would promote the efficient supply of the services or the long term interests of users of air services.

The decision would be subject to judicial review (i.e. whether the decision has been lawfully made)[5] but the scope of such a review would be limited, given the broad discretion granted to the Federal Minister. The declaration mechanism would not

[5] The principles governing judicial review have been developed at common law (see also *Administrative Decisions (Judicial Review) Act 1977* (Cth)) and incorporate a number of grounds that include (but are not limited to) denial of procedural fairness, jurisdictional errors and outcomes that are patently unreasonable or illogical, i.e. so unreasonable that no reasonable decision-maker could have reached them (an aspect of what is commonly referred to as "*Wednesbury unreasonableness*")

involve a 'merits review' of the Federal Minister's decision.[6] In these circumstances, careful consideration would need to be given to ensuring independent and unbiased decision-making and minimising the risk of political influence.

(d) The fourth option is to empower a suitable administrative body, such as the ACCC, to determine that one or more aeronautical services (as defined in regulation 7.02A of the Airports Regulations), or airport services more broadly, are declared services for the purposes of Division 3 of Part IIIA. The ACCC has a similar power under Part XIC of the CCA which concerns telecommunications services. As for the Federal Minister, the ACCC may be empowered make such a determination if it were satisfied that the determination would promote the efficient supply of the services or the long term interests of users of air services.

As for the Federal Minister, the ACCC's declaration decision would be subject to judicial review, but no merits review would be available.[7] Again, the scope for judicial review would be limited, given the broad discretion granted to the ACCC.

[6] In broad terms a 'merits review' refers to a review of all aspects of a decision, including findings of fact. Such a review is typically undertaken by a Commonwealth merits review tribunal, such as the Australian Competition Tribunal

[7] This is akin to the situation in the telecommunications regime, where the ACCC's declaration of relevant services is not subject to merits review

2 MONITORING AERONAUTICAL SERVICES

Airports tend to have strong natural monopoly characteristics. Consequently, the effectiveness of the regulatory framework applying post-privatisation is important to ensure appropriate prices and quality of service.

Competition Policy Review, Final Report, March 2015, p.205

Three elements of light-handed regulation that affect its effectiveness as an approach, in circumstances where an airport has significant market power, are whether there is a credible threat of a stronger regulatory measure if poor performance is identified, the degree of transparency under the regulatory approach and the regulatory compliance and administrative costs involved in the approach used.

Margaret Arblaster, "Light-Handed Regulation of Airport Services: An Alternative Approach to Direct Regulation?" in The Economics of Airport Operations (2017), pp.41 – 42

The current regulatory framework

2.1 As part of the government privatisation of airports, a suite of airport-specific economic regulation was introduced in 1997 and 1998, including price cap regulation at 11 airports. Price caps were replaced with price monitoring in 2002, following a Productivity Commission recommendation in favour of "light handed regulation" as "a probationary regulatory package, designed to facilitate a transition to a more commercial environment, while providing credible constraints on the use of market power."[8]

2.2 At present, "light handed regulation" of Australian aeronautical services involves the following:

(a) the four largest leased federal airports – Brisbane, Melbourne, Perth and Sydney (collectively, the **Tier 1 Airports**) – are the subject of price and quality of service monitoring under Part VIIA of the CCA;

(b) regional air services at Sydney Airport are also subject to a price notification regime under Part VIIA of the CCA; and

(c) any (or all) airport services can potentially be covered by negotiate-arbitrate regulation, if the appropriate criteria for "declaration" are met under the general access regime set out in Part IIIA of the CCA.

[8] Productivity Commission 2002, Price Regulation of Airport Services, Report No. 19, p.XLV

2.3 Part VIIA of the CCA also allows the ACCC to recommend to the relevant Minister that there be a price inquiry regarding an airport (or airports) and the Minister can direct the ACCC to conduct a price inquiry without such a recommendation.[9]

2.4 For the reasons explored below, under this regulatory structure there no longer appears to be a "credible threat" of sanction for airports that abuse their market power. The Productivity Commission itself has previously acknowledged that such a threat is "fundamental to the effectiveness of the light-handed approach".[10]

ACCC price and service monitoring alone cannot constrain airport market power

> *Provisions in Part VIIA of the CCA and the Airports Act provide for the ACCC to monitor the prices, costs and financial returns relating to the supply of aeronautical and related services at designated airports. Relevant services include: aircraft movements; passenger processing, including security; landside vehicle access and car parking. Retail, rental and business park activities are not monitored under the 'dual till' approach. The ACCC also reports on service quality, drawing on information from airports, airlines, passengers and border agencies.*
>
> Productivity Commission 2011, Economic Regulation of Airport Services, Inquiry Report No. 57 p.XXII

2.5 It is not contentious that the ACCC's price and quality of service monitoring regime does not provide effective regulation on a stand-alone basis. While monitoring provides some insight regarding airport performance, it has a limited ability to directly address detrimental behaviour arising from the exercise of market power. It cannot prevent airports from increasing prices and allowing service quality to decline.

2.6 Instead, in theory, the information obtained from price and quality of service monitoring enables the ACCC to ascertain whether any Tier 1 Airport may have misused its market power. If this is the case, the Government can direct the ACCC (or another body) to conduct a price inquiry under Part VIIA of the CCA, which could result in the reintroduction of explicit price regulation. It has been argued these arrangements are sufficient to implicitly constrain the market power of Tier 1 Airports and presumably airports generally.

2.7 This theory does not appear to have been borne out in practice over the past 12 – 16 years:

(a) Firstly, the ACCC has identified on several occasions that the monitoring regime is limited in scope and does not enable the ACCC to assess in detail whether any Tier 1 Airport has exercised market power to earn monopoly profits.[11] For further

[9] Section 95H, CCA
[10] Productivity Commission 2011, Economic Regulation of Airport Services, Inquiry Report No. 57, p.XXXV
[11] See Appendix A4.3, ACCC Airport Monitoring Report 2016 – 2017 at pp. 189 – 190

exploration of the information revealed from monitoring and why it is not capable of identifying abuses of market power, we refer to the submission of Margaret Arblaster.[12]

(b) Within the existing parameters, for many years the ACCC monitoring report has noted and expressed concerns regarding significant increases in aeronautical revenue per passenger (a proxy for airport charges) across the monitored Tier 1 Airports. For example:

"…*average revenues per passenger have increased by 25.9 per cent in real terms across the four airports over the last decade*"[13]

"*Price increases by the airports over the decade have resulted in sizeable additional payments by the airlines. By the ACCC's estimate, the airports have collected $1.57 billion (in 2015-16 prices) more from airlines over this time than if they had instead held average prices constant in real terms (for the same passenger volumes).*"[14]

(c) However, there has been a distinct lack of government-initiated action to use this information as the basis for further inquiries regarding potential misuse of Tier 1 Airport market power. In both 2006 and 2011 the Productivity Commission itself expressed concern regarding exactly the same "passive inaction" – "… *the current situation of 'passive' inaction after the ACCC raises concerns in its monitoring reports is unsatisfactory. There is a need to make the system more 'active'*."[15]

Part VIIA price inquiries – a "credible threat" of regulatory intervention?

A public inquiry provides a systematic process for gathering, assessing and disseminating information about particular pricing issues or problems. A public inquiry process can help to minimise the risk of over-regulation and encourage the use of price control only where it is best instrumented by:

- *Informing the community and policy makers, and facilitating public debate, about the factors influencing prices in the market concerned and the significance of the pricing issue; and*
- *Providing a transparent process for evaluating policy alternatives – including alternatives to prices oversight such as pro-competitive reforms – and identifying the most appropriate way to encourage competition in a given market.*

Productivity Commission 2001, Review of the Prices Surveillance Act 1983
Inquiry Report No. 14, p. 47

[12] Margaret Arblaster 2018, Report on the policy framework for economic regulation of airport services in Australia (A4ANZ), August 2018
[13] ACCC Airport Monitoring Report 2016-2017, p.26
[14] ACCC Airport Monitoring Report 2015-2016, p.xii
[15] Op.cit (10)

2.8 Part VIIA was inserted in the CCA (then the TPA) by the *Trade Practices Legislation Amendment Act 2003* (Cth). Price inquiries are one of three regulatory measures addressed by Part VIIA, the others being "price notifications" and "price monitoring".

2.9 Price inquiries are undertaken by the ACCC, or potentially another body, and can occur at the direction of the Minister or the ACCC can, with the Minister's approval, "hold such other inquiries as it thinks fit".[16] The procedure to be followed when conducting a price inquiry is set out in Division 3 of Part VIIA and is addressed in further detail in the submission of Margaret Arblaster.[17] The ACCC describes price inquiries as involving "…*extensive investigation and analysis, including public consultation. We publish findings in a formal report to help inform consumers, encourage public debate and inform policy consideration*."[18]

2.10 Since 2015 six notices have been issued by the Government requiring the ACCC to hold price inquiries. These are summarised in **Appendix C** to this submission. None of these inquiries involve "supply by any particular person or persons". Such targeted price inquiries can potentially involve a "price freeze" for the duration of the inquiry. There have been no price inquiries involving a freeze on prices since the ACCC was created in 1995.

2.11 Even if a public price inquiry into airport services were to occur (either at government behest or upon ACCC recommendation), in our view an argument that such an inquiry would – of itself – constrain airport conduct is weak for reasons that include:

(a) The benefits of a public inquiry process, as outlined above, appear to have been replaced by Productivity Commission reviews of airport regulatory arrangements. These have taken place in 2002, 2006 and 2011, as well as the current process. The Productivity Commission has now reviewed the outcomes of ACCC price and quality of service monitoring on multiple occasions and made a range of recommendations. In these circumstances, it is difficult to see what additional, meaningful constraint could arise from the possibility of a public price inquiry.

(b) Price inquiries are often resource intensive and time-consuming, meaning that there is likely to be a significant delay between the identification of any inappropriate conduct and recommendations (let alone implementation) of stronger regulatory measures or other forms of penalty.

(c) While the ACCC must give the Minister a report on the results of each public price inquiry, it has no independent authority to implement any recommendations it might make. In this context, the sector is already well-aware that historically there has been a lack of government engagement.

[16] Sections 95G and 95H, CCA
[17] Op.cit (12)
[18] https://www.accc.gov.au/focus-areas/inquiries

For example, in both 2006 and 2011 the Productivity Commission recommended an enhanced "credible threat" in the form of a "show cause" mechanism.[19] In the first instance the proposal was abandoned and in the second case, the Australian 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*".[20]

Part IIIA declaration – a "credible threat" of regulatory intervention?

> *The regulatory issue that arises in respect of airports is generally one of monopoly pricing rather than access. Although airports are bottleneck facilities, their operators are not vertically integrated into upstream and downstream markets. Hence, they have limited incentive to reduce competition in dependent markets but they have the power to impose monopoly charges on users of their facilities.*
>
> *To some extent, Part IIIA can be used as a means of addressing monopoly pricing at airports. However, that was not its original objective and its processes are cumbersome and not well-suited to that function…*
>
> Competition Policy Review, Final Report, March 2015, pp. 427 – 428

2.12 Part IIIA of the CCA establishes a general national access regime under which access seekers may gain a legal right to use the services of national monopoly infrastructure. Under this regime, "declaration" is the first stage in a two part process where parties can seek the right to negotiate access to an infrastructure service.

2.13 Recent amendments to the relevant criteria were designed to ensure an appropriately high regulatory hurdle must be cleared before "declaration" of any infrastructure services can be achieved. Both the Productivity Commission in 2013 and the Harper Review in 2015 concluded that the declaration criteria should be targeted to ensure third-party access is only mandated where it is in the public interest.

2.14 In particular, the amended criterion (a) now reads:

"*that access (or increased access) to the service on reasonable terms and conditions, as a result of declaration of the service would promote a material increase in competition in at least one market (whether or not in Australia), other than the market for the service*."

2.15 The recent amendments mean the current criterion (a) has not yet been considered by the National Competition Council (**NCC**), Australian Competition Tribunal (**Tribunal**) or the

[19] Op.cit (10) at pp. 188 – 189
[20] Australian Government response to the Productivity Commission Inquiry into the Economic Regulation of Airport Services, p.1

Federal Court and higher courts. This makes it difficult to predict the ultimate prospect of airlines successfully obtaining "declaration" of particular airport services. However, it seems clear, indeed it was the intention of legislators[21], that the changes to criterion (a) in particular have increased the overall threshold for declaration relative to the previous interpretation of the criteria.

2.16 This conclusion is particularly important for non-vertically integrated infrastructure, such as airports, for the following reasons:

(a) in applying criterion (a), with its focus on the effect of declaration itself, there is a high likelihood an assessment will involve directly comparing the terms and conditions of access an airport operator currently provides, or will provide, to airlines (the status quo) with the *reasonable* terms and conditions of access (or increased access) that could be achieved under a declaration (a "with or without declaration" test);

(b) criterion (a) requires that access (or increased access) as a result of declaration promote "a *material* increase in competition" in another market; and

(c) regulatory and judicial authorities are highly likely to adopt the approach endorsed by the Productivity Commission when considering whether declaration will "promote a material increase in competition" in another market, namely:[22]

"*the test should not be satisfied where there is already effective competition in dependent markets because declaration would be unlikely to promote a material increase in competition*".

In this context, adopting the NCC description, 'workable or effective competition' refers to the degree of competition required for prices to be driven towards economic costs and for resources to be allocated efficiently at least in the long term.[23]

2.17 In order for an airline applicant to meet criterion (a) evidence of airport operators exercising market power (e.g. monopoly pricing), even where this is generating some economic inefficiencies, will not be sufficient if that conduct is not producing a **material** effect on competition in dependent markets. Instead, a detailed factual and economic analysis will be necessary to demonstrate that though Australian airline passenger and freight markets may appear to be "workably competitive", the existing terms and conditions of access to airport

[21] Explanatory Memorandum to Competition and Consumer Amendment (Competition Policy Review) Bill 2017 at [12.12] and [12.19] – "*That is, the amendments focus the test on the effect of declaration, rather than merely assessing whether access (or increased access) would promote competition*."
[22] Productivity Commission 2013, National Access Regime, Inquiry Report No.66, pp. 17 – 18 and 172 – 173; see also the NCC Declaration of Services Guide (April 2018) at 3.25
[23] NCC Declaration of Services Guide (April 2018) at 3.24

services are "so poor", due to the exercise of market power by the airports, that the reasonable terms and conditions associated with declaration will promote a "material increase in competition". Some situations in which this might occur are identified in Annexure A to the Frontier Economics report.[24]

2.18 However, while it is possible that airlines will be able to substantiate a case to the satisfaction of the relevant decision makers, in many situations the evidentiary threshold is likely to be high and the analysis complex, particularly in regards to demonstrating that airport market power is having (and will have) the necessary material competitive effect. As Frontier Economics concludes:[25]

"… *without detailed regulatory accounting and guidance on key pricing parameters, the burden of showing that prices are not reasonable – and so should engage a comparison with lower reasonable prices – is likely to prove an overwhelming burden for applicants and decision makers*."

2.19 Our view that the threshold for criterion (a) has risen finds some support in current NCC activity. In July 2018 the operator of the Port of Newcastle, another non-vertically integrated piece of infrastructure, submitted the NCC should recommend that the designated minister **revoke** a recent declaration[26] of its 'shipping channel services' under section 44J of the CCA. A key argument from the operator was that criterion (a), as amended, is not satisfied in relation to the shipping channel services in question.

2.20 In particular, the submission notes:[27]

"*PNO submits that criterion (a) is not satisfied because there is no basis to conclude that the terms and conditions will vary materially as between the future with declaration and the future without declaration.*

… However, even if declaration was to result in more favourable terms and conditions (including by creating a pricing constraint or promoting greater pricing certainty), criterion (a) would still not be satisfied for the following reasons (discussed in further detail below):

1. the relevant dependent markets are already workably or effectively competitive without declaration;

[24] Frontier Economics 2018, "Economic evaluation of an alternative approach to airport regulation", prepared for A4ANZ, see Annexure A; one of these examples is also identified by the NCC as a type of conduct that may adversely affect competition in a dependent market: NCC Declaration of Services Guide (April 2018) at 3.30
[25] Ibid.
[26] The declaration occurred on 16 June 2016, by orders of the ACT, with further appeal processes only being finally resolved in March 2018
[27] http://ncc.gov.au/images/uploads/Letter_to_NCC_2-7-18.pdf

2. Port charges are a minor cost element and are not material to competition in the dependent markets;

3. market participants face much greater uncertainty from other sources than they do from any uncertainty about future Port prices;

4. without declaration, the Port has the incentive to maintain volumes, protect competition and not price coal producers out of the market; further, its ability and incentive to price in a way that may impact on competition in the relevant dependent markets is constrained by the threat of regulation;

5. PNO does not have the ability or incentive to adversely affect competition by discriminating between shipping lines or coal producers when setting Port charges; and

6. even if future Port prices were set in a manner that may affect the volume of coal exported through the Port, this alone is not sufficient to satisfy criterion (a).

Criterion (a) requires that access or increased access to the service, on reasonable terms and conditions, as a result of declaration, would promote ***a material increase in competition*** *in at least one dependent market."*

2.21 Whether these arguments are ultimately endorsed by the NCC and / or other decision makers remains to be determined. However, they do highlight the fact that there are different possible approaches to the interpretation of the new criterion (a) and when declaration will materially promote competition.[28] At least some of these approaches could practically remove the prospect of declaration ever acting as a 'credible threat' with respect to airport services.

2.22 In addition to the uncertainties of the legal test, the process of seeking declaration and utilising the Part IIIA regime can be lengthy and costly. This remains the case, despite legislative amendments to introduce deadlines for various stages in the process.[29] By way of illustration, the timeline for the recent declaration application involving the Port of Newcastle is set out below.

Date	Event	Comments
13.05.15	Application for declaration received by the National Competition Council (NCC)	Applicant was Glencore
18.06.15	Deadline for submissions on the application	14 submissions received
30.07.15	NCC draft recommendation released	

[28] For further commentary on different possible approaches, we refer to the ACCC submission, "Possible NCC recommendation to revoke declaration at the Port of Newcastle", 8 August 2018: http://ncc.gov.au/images/uploads/Australian_Competition_and_Consumer_Commission_8_August_2018.pdf

[29] For example section 44GA of the CCA provides a 180 day deadline for an NCC recommendation on a declaration application – the NCC is allowed to use "clock stoppers" up to a maximum of 60 extra days, and can also obtain an extension of time from the Minister with notice in writing

Date	Event	Comments
31.08.15	Deadline for submissions on draft recommendation	9 submissions received
10.11.15	NCC sent final recommendation to the Minister	
11.01.16	Minister decision not to declare the service is published	
29.01.16	Glencore applied to the Australian Competition Tribunal (ACT) for a review of the decision	
31.05.16	ACT determined the service should be declared	Reversal of NCC original decision
16.06.16	ACT made orders that the service should be declared	
14.07.16	Port of Newcastle applied to the Federal Court of Australia (FFC) for judicial review of the ACT decision	
28.11.16	Port of Newcastle application heard before the FFC	Two day hearing
16.08.17	FFC handed down its decision dismissing the application for judicial review	Upheld the ACT decision
12.09.17	Port of Newcastle applied for special leave to appeal the FFC decision to the High Court of Australia	
23.03.18	The application was dismissed by the High Court	

2.23 From the date of application to the date of resolution the declaration process took **almost three years**. Moreover, this timeline does not include the time associated with the applicant producing its initial submission and supporting materials in the first place, nor does it include the fact the operator of the Port of Newcastle re-opened regulatory scrutiny in July 2018, with a submission that the NCC recommend revoking the declaration (see 2.19 – 2.20 above). According to the NCC, submissions from interested parties were solicited by 8 August 2018 and the NCC intends to release a statement of its preliminary views and invite further submissions, before making a decision whether to make a revocation recommendation to the Minister.

2.24 In conclusion, the corollary of an increased legal threshold for declaration under Part IIIA, together with the existing significant cost, time and uncertainty associated with the process, is that the threat of declaration is now less effective (and in some circumstances may be ineffective for all practical purposes) as a constraint on airports' market power when negotiating the terms and conditions of access with airline customers.

3 ALTERNATIVE REGULATORY OPTIONS

What are the regulatory alternatives?

3.1 By way of background, in 2011 the Productivity Commission identified a range of regulatory options for reform. These are summarised below:[30]

No.	Option	Comments
1.	Terminate the price and quality monitoring regime	Commercial negotiations only – no role for regulation
2.	Replace monitoring with self-reporting by airports – the tier 2 monitoring model	
3.	The status quo	Productivity Commission found this required strengthening in 2006 and 2011 – see Option (5) comments
4.	The status quo, underpinned by a voluntary code of conduct	
5.	The status quo, with a more credible threat of sanction for abuses of market power	Broadly reflects the Productivity Commission recommendation in 2006 and 2011 – via the introduction of a "show cause" process. This was not implemented
6.	Legislative requirement that commercial negotiations during the 'contract formation' stage provide for a dispute resolution mechanism where the parties agree to either: (a) private commercial arbitration; or (b) ACCC arbitration	
7.	Commercial negotiation conducted according to a mandatory code of conduct	A stronger, more prescriptive version of Option (4)
8.	Deem airports covered under Part IIIA (deemed declaration), making ACCC arbitration available at contract formation stage	The ACCC's proposal in 2011
9.	Regulatory specification of modelling processes; revenue capping by setting the WACC, asset betas, market risk premiums; re-specification of aeronautical services	
10.	Price regulation such as: (a) price caps; or (b) price notification	
11.	Part VIIA price inquiry into an airport or airports	

3.2 The Productivity Commission closely examined the concept of "deemed declaration" of airport services, which was advocated by the ACCC (Option 8). In its 2011 submission to the

[30] Op.cit (10) at p.207

Productivity Commission, the ACCC argued that with deemed declaration of "aeronautical services"[31]:[32]

"*Airports and airlines would be free to reach commercial agreements. However, airlines could credibly threaten to raise a dispute if an airport attempted to set prices substantially above those likely to be determined by the ACCC*."

3.3 The position of the ACCC as arbitrator was argued to have the benefit of commercial certainty for both airports and airlines. Both parties would presumably understand the likely approach of the ACCC (as the arbitrator) to assessing price based on well-established regulatory precedents.

3.4 The Productivity Commission ultimately reached the view that a "deemed declaration" was not a "subtle change" consistent with light handed regulation and did not recommend its introduction for reasons that included:[33]

(a) the ACCC could not rely on precedent, with commercial agreements primarily about price paths from new investment – the ACCC would again need to form a view about increases in prices arising from new investment;

(b) the ACCC's commentary about airport behaviour provided one party – the airlines – with an incentive to expeditiously seek arbitration; and

(c) under a different access regime (telecommunications), the ACCC had conducted nearly 100 arbitrations in the five years to 2009 – 2010, presumably demonstrating that where regulatory intervention is available to commercial parties there are likely to be incentives for one or both parties to utilise it.

Section 192, Airports Act

3.5 A4ANZ does not advocate a return to price regulation (Options 9 or 10) and the issues associated with relying on a Part VIIA price inquiry (Option 11) have been outlined in section 2 above. Instead, A4ANZ believes the most effective regulatory solution, consistent with a "light handed" approach, remains a negotiate-arbitrate model.[34] A4ANZ has indicated such an approach should be as simple and as cost effective as possible, and at the same time it is

[31] Services provided by an airport that are being used for the operation and maintenance of civil aviation services. This includes all aircraft-related and passenger-related services and facilities within the boundary of the airport (as described in tables 1 and 2 of reg. 7.02A of the Airports Regulations 1997)
[32] ACCC 2011, Submission to the Productivity Commission inquiry into the economic regulation of airport services, pp. 20 – 24
[33] Op.cit (10) at p.XL
[34] For further analysis of negotiate-arbitrate in the context of light-handed regulation, we refer to the submission of Margaret Arblaster – op.cit (12)

important there are incentives for parties to settle disputes commercially, rather than appeal to regulatory intervention.

3.6 Recognising the monopoly power held by most capital and regional airports in the supply of aeronautical services and facilities (as defined in regulation 7.02A of the Airports Regulations – see **Appendix B**), and the ineffectiveness of the price monitoring regime to curb the use of that power in the prices charged for those services, A4ANZ proposes that aeronautical services and facilities be subject to a similar "light regulation" regime as applies to certain 'covered' gas pipelines. Under that regime (contained in the National Gas Law), the pipeline owner determines its own tariffs, with arbitration by the Australian Energy Regulator available (and only available) if a party seeking access to a pipeline is unable to agree the terms and conditions of supply.

3.7 There are a number of means by which such a regime could be implemented. The simplest means is to use the existing arbitration framework within the National Access Regime in Division 3 of Part IIIA of the CCA. Under that regime, the ACCC is empowered to arbitrate disputes if the parties cannot agree terms and conditions of supply. However, consistent with a "light regulation" model, the ACCC is also empowered to terminate an arbitration if the party who notified the dispute has not engaged in negotiations in good faith or if the ACCC considers that access to the service should continue to be governed by an existing contract between the supplier and the acquirer.[35]

3.8 To bring aeronautical services and facilities within the scope of Division 3 of Part IIIA, A4ANZ proposes that a new section 192 be added to the Airports Act which would cause those services to be declared services for the purposes of Division 3 of Part IIIA. There are a number of legal mechanisms by which that goal could be achieved. The following is a non-exhaustive list of such 'declaration' mechanisms, all of which favour simplicity over complexity and seek to avoid the potential for legal disputation and delay:

(a) The first option is the simplest. The new section 192 would deem airport services, as defined in regulation 7.02A of the Airports Regulations, to be declared services for the purposes of Division 3 of Part IIIA. Regulation 7.02A contains a clear and comprehensible definition of airport services that would be subject to light regulation under the proposed regime.

This option is akin to the "deemed declaration" advocated by the ACCC in 2011 and represents a significant regulatory change by employing a statutory provision as the appropriate mechanism, rather than a decision of the executive or an appropriate administrative body.

[35] Section 44Y, CCA

(b) The second option is to limit the deemed declaration to those aeronautical services (as defined in regulation 7.02A of the Airports Regulations), or airport services more broadly, in respect of which an airport operator has **substantial market power**. The concept of "substantial market power" is already a well understood legal standard in Australian competition law. It is commonly thought of as the ability to profitably maintain prices above the competitive level or reduce the quality of services for a period of time without rivals taking customers away.

This option targets the credible threat of regulatory intervention to the relevant conduct, namely the potential for airport operators to abuse their market power in the context of supplying goods or services. However, the imposition of this threshold also invites the prospect of disputes regarding which airport services satisfy the definition, arguments that would need to be resolved by court determination. The need for parties to address this type of jurisdictional issue, potentially multiple times across a wide variety of airport services, could give rise to significant delays and cost. This would offset its value as a potential declaration mechanism.

(c) The third option is to empower a relevant Federal Minister to determine, by statutory instrument, that one or more aeronautical services (as defined in regulation 7.02A of the Airports Regulations), or airport services more broadly, are declared services for the purposes of Division 3 of Part IIIA. The Federal Minister may be empowered to do so if the Minister were satisfied that the determination would promote the efficient supply of the services or the long term interests of users of air services.

The Federal Minister's decision would be subject to judicial review (i.e. whether the decision has been lawfully made).[36] The scope of such a review would be limited, given the broad discretion granted to the Federal Minister. The declaration mechanism would not involve a 'merits review' of the Federal Minister's decision i.e. a review of all aspects of the decision, including findings of fact. In these circumstances, careful consideration would need to be given to ensuring independent and unbiased decision-making and minimising the risk of political influence.

(d) The fourth option is to empower a suitable administrative body, such as the ACCC, to determine that one or more aeronautical services (as defined in regulation 7.02A of the Airports Regulations), or airport services more broadly, are declared services for the purposes of Division 3 of Part IIIA. The ACCC has a similar power under Part XIC of the CCA which concerns telecommunications services. As for the Federal Minister, the ACCC may be empowered make such a determination if it were

[36] Op.cit. (5)

satisfied that the determination would promote the efficient supply of the services or the long term interests of users of air services.

As for the Federal Minister, the ACCC's declaration decision would be subject to judicial review but not merits review by the Tribunal (or any other Commonwealth merits review tribunal).[37] Again, the scope of judicial review in this context would be limited, given the broad discretion granted to the ACCC.

Bypassing the Part IIIA declaration criteria

3.9 The options outlined above all involve granting those seeking access to airport services recourse to ACCC arbitration under Division 3 of Part IIIA of the CCA but each employs a different 'declaration mechanism'. It has been argued previously that similar approaches circumvent the declaration criteria provided in Part IIIA of the CCA without appropriate justification.

3.10 A survey of various industry-specific access regimes in fact demonstrates that such regimes often have bespoke declaration mechanisms that have been tailored to the characteristics and requirements of the relevant infrastructure and industry. For example:

(a) *Rail* – Part 2A of the *Rail Management Act 1996* (Vic) sets out the processes by which transport infrastructure is 'declared' or covered by the Victorian Rail Access Regime. The Governor in Council, on the recommendation of the Minister, can declare a rail transport service for the purposes of access.[38] On this basis of existing Declaration Orders[39], the Essential Services Commission acts as the independent economic regulatory of the Victorian rail sector.

(b) *Gas* – access regulation only applies to gas transmission or distribution pipelines that are 'covered' and any person can apply for a pipeline to be covered under section 92 of the National Gas Law.[40] The application will, at first instance, be considered by the NCC, who is required to make a **recommendation** to the relevant Minister having regarding to the 'coverage criteria'[41] and the 'national gas

[37] Op.cit. (7)
[38] Section 38I of the Rail Management Act 1996 (Vic)
[39] On 16 December 2005 three Declaration Orders were published in the Victoria Government Gazette (No. S259 of 2005)
[40] Other ways a pipeline can be 'covered' include deemed coverage for pipelines covered under the Gas Code at the time the National Gas Law was introduced, where a service provider voluntarily submits a full access arrangement (section 127) and as a result of a tender approval process approved under the National Gas Rules (section 126)
[41] Section 15 of the National Gas Law sets out the pipeline coverage criteria. These criteria are similar, but not identical, to those for declaration under Part IIIA of the CCA

objective'[42]. The relevant Minister is responsible for making a determination as to whether or not the pipeline will be 'covered'.[43]

A Minister's coverage decision is a 'reviewable regulatory decision' under the National Gas Law and may be the subject of review by the Tribunal on certain specific grounds.[44]

(c) *Telecommunications* – an administrative body, the ACCC, can determine whether eligible services are 'declared services' for the purposes of Part XIC of the CCA.[45] A declaration can be made where the ACCC is satisfied such a decision will promote the long-term interests of end-users[46] and the ACCC must conduct a public inquiry about the proposal[47]. The Tribunal cannot conduct a merits review of a decision of the ACCC under section 152AL of the CCA.

3.11 It is clear a bespoke declaration mechanism for airport services would not be unique or surprising, if the characteristics of the aviation sector warranted such an approach.

3.12 In this context we note again that airport assets represent an example of non-vertically integrated infrastructure, where the primary concern relating to misuse of market power is generally one of monopoly pricing. The complexities associated with applying the current declaration criteria for Part IIIA of the CCA, particularly criterion (a), to monopoly pricing have been outlined in section 2 above and in Annexure A to the Frontier Economics report.

3.13 However, these complexities do not discount a conclusion that monopoly pricing, even on a uniform basis, can damage efficient market outcomes. Indeed, on one view monopoly pricing of bottleneck infrastructure is most unlikely to only produce a pure transfer of economic rents between the relevant parties. Other consequences could include placing a limit on future

[42] Section 23 of the National Gas Law provides: "*The objective of the law is to promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, safety, reliability and security of supply of natural gas*."
[43] Following a positive coverage determination, two forms of access regulation are available for the pipeline – full regulation and light regulation – with the NCC being responsible for making the decision. The former requires the service provider to have an access arrangement approved by the regulator, while the latter utilises a negotiate-arbitrate model for third party access, with arbitration by the regulator in the event of an access dispute
[44] Section 246 of the National Gas Law sets out the grounds for review: (a) the original decision maker made an **error of fact** in the decision maker's findings of facts, and that error of fact was material to the making of the decision; (b) the original decision maker made **more than 1 error of fact** in the decision maker's findings of facts, and those errors of fact, in combination, were material to the making of the decision; (c) the **exercise of the original decision maker's discretion was incorrect**, having regard to all the circumstances; and (d) the original decision maker's **decision was unreasonable**, having regard to all the circumstances.
[45] Section 152AL, CCA
[46] Section 152AL(3)(d), CCA
[47] Section 152AL(3), CCA – a public inquiry under Part 25 of the *Telecommunications Act 1997* (Cth)

investment and innovation (i.e. creating "hold ups") at both the upstream and downstream level.[48]

3.14 Given the possible interpretations of criterion (a) that may be adopted, there is a reasonable prospect that the declaration mechanism provided in Part IIIA of the CCA will not adequately encompass all relevant market failures with respect to airport assets. Consequently, regulatory alternatives should be considered. This approach is not at all unusual when one considers the bespoke regulatory regimes, and declaration mechanisms, that have already been developed in Australia to address the particular economic characteristics of different industries.

[48] This analysis was explored further by the ACCC in the context of another class of non-vertically integrated infrastructure, gas pipelines, in the ACCC Inquiry into the east coast gas market (2016): https://www.accc.gov.au/system/files/1074_Gas%20enquiry%20report_FA_21April.pdf

APPENDIX A – MICHAEL O'BRYAN MEMORANDUM

APPENDIX B – REGULATION 7.02A, AIRPORTS REGULATIONS

7.02A Meaning of aeronautical services and facilities

(1) For this Part, aeronautical services and facilities means those services and facilities at an airport that are necessary for the operation and maintenance of civil aviation at the airport, and includes each service or facility that is:

(a) mentioned in an item in Table 1 (aircraft-related); or

(b) mentioned in an item in Table 2 (passenger-related).

Table 1 Aircraft-related services and facilities

Item	Services and facilities
1	Runways, taxiways, aprons, airside roads and airside grounds
2	Airfield and airside lighting
3	Aircraft parking sites
4	Ground handling (including equipment storage and refuelling)
5	Aircraft refuelling (including a system of fixed storage tanks, pipelines and hydrant distribution equipment known as a Joint User Hydrant Installation or JUHI)
6	Airside freight handling and staging areas essential for aircraft loading and unloading
7	Navigation on an airfield (including nose-in guidance systems and other visual navigation aids)
8	Airside safety and security services and facilities (including rescue and fire-fighting services and perimeter fencing)
9	Environmental hazard control
10	Services and facilities to ensure compliance with environmental laws
11	Sites and buildings used for light or emergency aircraft maintenance

Table 2 Passenger-related services and facilities

Item	Services and facilities
1	Public areas in terminals, public amenities, lifts, escalators and moving walkways
2	Necessary departure and holding lounges, and related facilities
3	Aerobridges and buses used in airside areas
4	Flight information and public-address systems
5	Facilities to enable the processing of passengers through customs, immigration and quarantine

6	Check-in counters and related facilities (including any associated queuing areas)
7	Terminal access roads and facilities in landside areas (including lighting and covered walkways)
8	Security systems and services (including closed circuit surveillance systems)
9	Baggage make-up, handling and reclaiming facilities
10	Space and facilities, whether in landside or airside areas, that are necessary for the efficient handling of arriving and departing aircraft (e.g. airline crew-rooms and airline operations centres)

(2) In this regulation, airside area and landside area have the respective meanings given in section 9 of the *Aviation Transport Security Act 2004*.

(3) To avoid doubt, ***aeronautical services and facilities*** does not include services or facilities:

(a) relating to the provision of a high-quality service to certain passengers; or

(b) that are not necessary for the efficient operation of civil aviation.

APPENDIX B – ACCC PRICE INQUIRIES SINCE 2015

Date Commenced	Industry	Final Report
13.04.15	East coast gas inquiry	22.04.16
27.10.16	Dairy industry	30.04.18
27.03.17	Electricity supply & prices	11.07.18
19.04.17	Supply of and demand for wholesale gas in Australia	30.04.20[49]
25.05.17	Residential building (home), contents & strata insurance in Northern Australia	30.11.20[50]
04.12.17	Digital platforms	03.06.19

[49] Interim reports must be submitted no less frequently than every 6 months, with the first report issued on 25.09.17. Three subsequent interim reports have also been issued.
[50] Interim reports must be submitted on 30.11.18 and 30.11.19

MICHAEL O'BRYAN QC
Barrister

MEMORANDUM

To: **Aldo Nicotra and Michele Laidlaw**

Johnson Winter & Slattery

Re: **Economic Regulation of Airports – Productivity Commission Issues Paper**

Date: **7 September 2018**

Dear Aldo and Michele,

As requested, I have conducted a 'peer review' of the memorandum of advice prepared by you dated 5 September 2018 concerning appropriate regulatory means to curb the use of monopoly power by airport operators.

I confirm that I agree with the conclusions expressed in the executive summary to the memorandum.

Yours sincerely,

Michael O'Bryan QC

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