

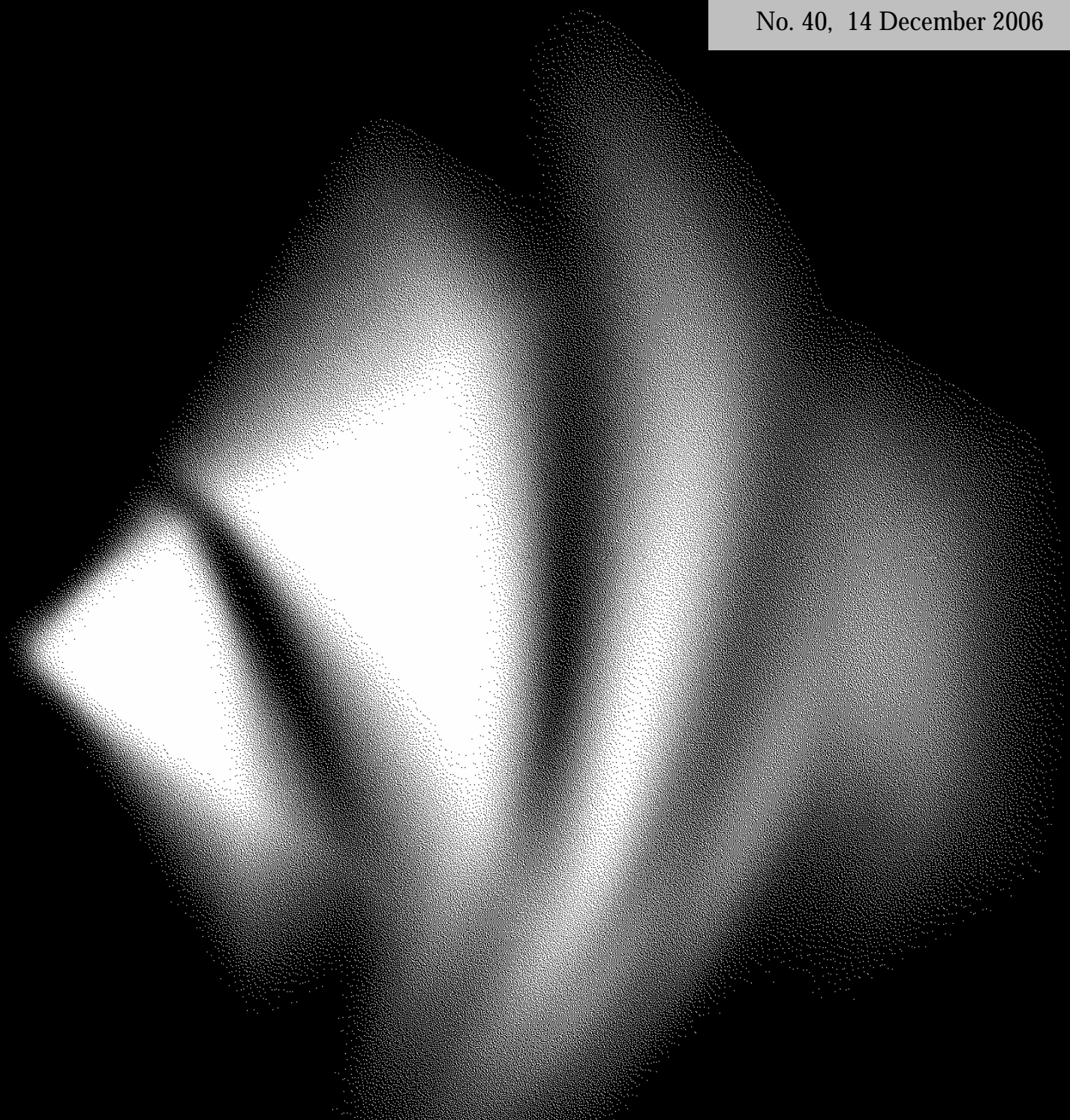


Australian Government
Productivity Commission

Review of Price Regulation of Airports Services

Productivity
Commission
Inquiry Report

No. 40, 14 December 2006



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Publications Inquiries:

Media and Publications
Productivity Commission
Locked Bag 2 Collins Street East
Melbourne VIC 8003

Tel: (03) 9653 2244
Fax: (03) 9653 2303
Email: maps@pc.gov.au

General Inquiries:

Tel: (03) 9653 2100 or (02) 6240 3200

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The Productivity Commission

The Productivity Commission, an independent agency, is the Australian Government's principal review and advisory body on microeconomic policy and regulation. It conducts public inquiries and research into a broad range of economic and social issues affecting the welfare of Australians.

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Terms of reference

I, PETER COSTELLO, Treasurer, pursuant to Parts 2 and 3 of the *Productivity Commission Act 1998*, hereby refer current price regulation arrangements for airport services to the Commission for inquiry and report within nine months of receipt of this reference. The Commission is to hold hearings for the purpose of the inquiry.

Background

In 2002, the Government introduced a light-handed approach to price regulation of airport services with market power in line with recommendations made by the Commission in its 2002 Report on Airport Price Regulation. Under the Government's policy, price notification and price caps under the *Prices Surveillance Act* were discontinued for all airports (with the exception of regional air services at Sydney airport), and price monitoring for Adelaide, Brisbane, Canberra, Darwin, Melbourne, Perth, and Sydney airports was introduced for a five year period and with a review of the arrangements to be conducted at the end of this period. The Government reserved the right to bring forward the review if there was evidence of unjustifiable price increases.

The purpose of this inquiry is to examine the effectiveness of the current light-handed regulatory regime for airport pricing and to advise on any changes to the regime.

Scope of Inquiry

1. The Commission is to report on whether airport operators have acted in a manner consistent with the Government's Review Principles and on effectiveness of the current form of prices regulation of airports having regard to the objectives that the regulatory regime should:
 - a) promote the economically efficient operation of airports;
 - b) minimise compliance costs on airport operators and the Government; and
 - c) facilitate commercially negotiated outcomes in airport operations, benchmarking comparisons between airports and competition in the provision of services within airports (especially protecting against discrimination in relation to small users and new entrants).

-
2. In undertaking its assessment, the Commission is to have regard to the Government's Review Principles which are:
- a) At airports without significant capacity constraints, efficient prices broadly should generate expected revenue that is not significantly above the long-run costs of efficiently providing aeronautical services (on a 'dual-till' basis). Prices should allow a return on (appropriately defined and valued) assets (including land) commensurate with the regulatory and commercial risks involved.
 - b) Price discrimination and multi-part pricing that promotes efficient use of the airport is permitted. This may mean that some users pay a price above the long-run average costs of providing aeronautical services, whereas more price-sensitive users pay a price closer to marginal cost.
 - c) At airports with significant capacity constraints, efficient peak/off-peak prices may generate revenues that exceed the production costs incurred by the airport. Such demand management pricing practices should be directed toward efficient use of airport infrastructure and, when not broadly revenue neutral, any additional funding that is generated should be applied to the creation of additional capacity or undertaking necessary infrastructure improvements.
 - d) Quality of service outcomes should be consistent with user's reasonable expectations, and consultation mechanisms should be established with stakeholders to facilitate the two way provision of information on airport operations and requirements.
 - e) It is expected that airlines and airports will primarily operate under commercial agreements and in a commercial manner, and that airport operators and users will negotiate arrangements for access to airport services.
3. The Commission is to review aeronautical asset revaluation practices and dispute resolution mechanisms at each of the price monitored airports and advise on improvements that would be consistent with the Government's Review Principles.

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4. In making its recommendations on future price regulation arrangements for airport services, the Commission is to:
 - a) have regard to its findings on the behaviour of airport operators and airlines and the effectiveness of the existing prices and quality of service monitoring of airports;
 - b) identify relevant alternatives to the current arrangements and the extent to which these alternatives would better achieve the Government's objectives in privatising the airports and moving to a light-handed pricing regulatory regime;
 - c) analyse and, as far as practical, quantify the benefits, costs (including compliance costs) and economic and distributional impacts of the current arrangements and the alternatives identified in b).
 5. To the extent applicable the Commission is to have regard to:
 - a) the Australian Competition Tribunal's decision of 9 December 2005 to declare the airside services at Sydney Airport and subsequent consideration of this matter by the Federal Court; and
 - b) the outcomes of the Council of Australian Government's (COAG) 2005 review of National Competition Policy.
 6. In undertaking the review, the Commission is to advertise nationally, consult with key interest groups and affected parties, and produce a report.
 7. The Government will consider the Commission's recommendations, and the Government's response will be announced as soon as possible after the receipt of the Commission's report.

PETER COSTELLO
6 April 2006

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Abbreviations

Abbreviations

AAA	Australian Airports Association
AAL	Adelaide Airport Limited
ACCC	Australian Competition and Consumer Commission
ACG	Allen Consulting Group
ACT	Australian Competition Tribunal
AER	Australian Energy Regulator
ARFF	Aviation rescue and fire fighting
ASA	Airservices Australia
ATRS	Air Transport Research Society
AUSCID	Australian Council for Infrastructure Development
BAC	Brisbane Airport Corporation
BARA	Board of Airline Representatives of Australia
BTRE	Bureau of Transport and Regional Economics
CASA	Civil Aviation Safety Authority
CBD	Central business district
COAG	Council of Australian Governments
CPI	Consumer Price Index
DOTARS	Department of Transport and Regional Services
EBITA	Earnings before interest, tax and amortisation
FAC	Federal Airports Corporation
GA	General aviation
IATA	International Air Transport Association

ICAO	International Civil Aviation Organization
JUHI	Joint user hydrant installation
LCC	Low cost carrier
MTOW	Maximum take-off weight
NCC	National Competition Council
NNI	Necessary new investment
RAAA	Regional Aviation Association of Australia
RPI	Retail price index
RPT	Regular public transport
SACL	Sydney Airport Corporation Limited
SRMC	Short-run marginal cost
TPA	Trade Practices Act 1974
TRL	Transport Research Laboratory
VFR	Visiting friends and relatives
WAC	Westralia Airports Corporation
WACC	Weighted average cost of capital

OVERVIEW

Key points

- Price monitoring, as part of a light handed regulatory approach, has delivered some important benefits.
- It has been easier to undertake the investment necessary to sustain and enhance airport services in the face of growing demand for air travel.
- Airports' productivity performance has been high by international standards, and service quality has been satisfactory to good.
- Moreover, though it is too early to fully judge the effectiveness of the light handed approach in constraining airport charges, price outcomes to date do not appear to have been excessive.
- However, some non-price outcomes have been less satisfactory and commercial relationships between certain airports and their customers have been strained.
- More generally, some of the 'market' constraints on airports' behaviour — such as the countervailing power of airlines — have not been as strong as was envisaged. Also, some 'systemic' shortcomings have detracted from the effectiveness of price monitoring and the light handed approach as a whole.
- Policy guidance on the valuation of airport assets for pricing purposes is lacking.
- There is no clarity on when further investigation of an airport's conduct is required, and no process for initiating such investigation.
- These systemic shortcomings can be addressed without sacrificing the benefits of a light handed approach. Hence, a further period of price monitoring would be preferable to a reversion to stricter price controls, with all of its attendant costs.
- However, a recent Federal Court decision that potentially makes the Part IIIA national access regime a more intrusive regulatory instrument, has raised questions about the sustainability of the light handed approach for airports and poses risks for investment in infrastructure more generally. A 'remedial' legislative amendment to Part IIIA should be considered.
- Provided that Part IIIA does not come to 'supplant' the light handed approach, price monitoring should be extended for a further six years when the current arrangements end in 2007. This new monitoring regime should:
 - apply to Adelaide, Brisbane, Melbourne, Perth and Sydney Airports;
 - embody a new process for triggering further investigation of an airport's conduct where there is prima facie evidence of significant misuse of market power; and
 - exclude revaluations to airports' monitored asset bases made after 30 June 2005.
- Though introduction of an airport-specific arbitration mechanism would be counterproductive, the parties should be expected to negotiate and resolve disputes within an appropriate commercial framework, and be assessed accordingly under the new oversighting arrangements.

Overview

In 1997, the Australian Government commenced the privatisation of airports then operated by the Federal Airports Corporation. In doing so, the Government recognised that some had significant market power. Accordingly, it also introduced price regulation at all capital city and some regional airports.

However, following a Productivity Commission review in 2002, the breadth and stringency of this regulation was eased. Under this more light handed approach, direct regulatory ‘involvement’ in price setting is now limited to the monitoring of charges for aeronautical and related services at Adelaide, Brisbane, Canberra, Darwin, Melbourne, Perth and Sydney Airports (see box 1) — though these airports have been put on notice that stricter controls may be re-introduced if they misuse their market power. The monitored airports are also potentially subject to the Part IIIA national access regime.

This inquiry was established to assess how well the light handed approach has worked to date, whether it should continue after 2007 when the current price monitoring regime is due to end and, if so, what improvements might be made to it. (The full terms of reference are reproduced at the front of this report.)

What was light handed regulation intended to achieve?

Until 2002, charges for aeronautical services at the major privatised airports were determined primarily by the regulator, rather than on the basis of commercial negotiations between the parties. Indeed, even agreements reached between airports and airlines on appropriate charges for new infrastructure and the like were sometimes over-ruled by the regulator.

In removing such regulatory intrusion, the switch to a light handed approach was intended to facilitate investment and innovation by airports — while retaining a constraint on misuse of market power in their dealings with airlines and other customers. By providing greater opportunities for the parties to negotiate and build commercial relationships, the ultimate objective was that provision of aeronautical services would be determined primarily through commercial negotiations.

Box 1 How does price monitoring operate?

Provisions in the Trade Practices Act (Part VIIA) and the Airports Act provide for the Australian Competition and Consumer Commission (ACCC) to monitor the prices, costs and financial returns relating to the supply of aeronautical and related services at Adelaide, Brisbane, Canberra, Darwin, Melbourne, Perth and Sydney Airports.

Though the service coverage of the two regulatory instruments differs slightly, in broad terms, the services subject to oversight are those related to: aircraft movements; passenger processing (including security); the provision of landside vehicle access to terminals; transport to and from an airport (such as car parking); and aircraft maintenance. Prices and profits earned by an airport from services such as retailing, corporate parks and factory outlets — or from the rental of space for the provision of such services by third parties — are not monitored under this ‘dual till’ approach.

The information assembled by the ACCC is intended to help inform judgements by the Government on whether there has been any misuse of market power by the monitored airports. If monitoring indicates that further investigation is required, then under Part VIIA, the Government can direct the ACCC to undertake a public inquiry. Potentially, this could lead to the reintroduction of stricter price controls at particular airports.

Quality of service monitoring

The ACCC is also required to report on service quality at the price monitored airports — in part to reinforce commercial incentives for those airports to maintain appropriate service standards. In doing so, the ACCC draws on information from several sources, including: airport operators; airlines; passenger surveys; AirServices Australia and the Australian Customs Service.

Part IIIA

In introducing price monitoring, the Government left open the option for airlines to seek ‘declaration’ of airports under the Part IIIA national access regime when commercial agreements cannot be reached. As discussed later, a recent Federal Court decision has potentially rendered Part IIIA a more ‘accessible’ regulatory instrument, with possible ramifications for both the sustainability of a light handed approach in the airports area, and for efficient investment in, and delivery of, infrastructure services more generally.

What have been the outcomes to date?*Some significant benefits*

Against a number of performance indicators, the current arrangements have measured up well.

First and foremost, the light handed approach has made it easier for airports and airlines to agree on what new investment is required and the charges necessary to pay for it. For capital intensive airport services, investment plays a pivotal role in sustaining and enhancing service availability and quality. Thus it is not surprising that the removal of the regulator from investment decision making is widely viewed as a major advantage of the light handed approach. With a number of the airports looking to embark on major new upgrades, this more timely and responsive investment environment is likely to be a source of even greater benefit in the future.

In addition:

- the recent productivity performance of the monitored airports has been high by international standards — with one study suggesting that this may be partly due to Australia’s less intrusive regulatory approach;
- service quality continues to be rated by the ACCC as satisfactory to good, with the monitored airports appearing to offer ‘reasonable value for money’ by international standards;
- for the larger monitored airports in particular, compliance costs have been quite modest; and
- at most of the monitored airports, commercial relationships between the parties have been developing — though some particular issues have impeded progress on this front (see later).

Price outcomes do not appear to have been excessive

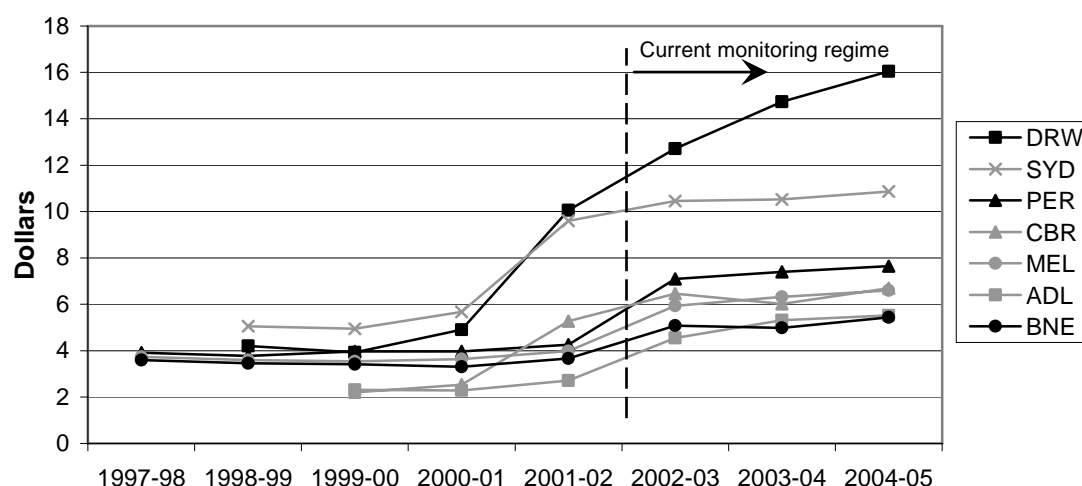
Airport charges rose substantially immediately prior to, or at the outset of, the light handed regime (see figure 1). But these increases were either formally approved by the ACCC, or closely followed its regulated pricing ‘template’. Indeed, at the time, significant increases in the charges inherited from the days of government service provision were widely accepted as necessary to put airport operations on a sustainable longer term footing.

Since then, increases at most of the monitored airports have been relatively modest. Moreover, some of these subsequent price increases have been to pay for security upgrades, and/or for additional new investments. These factors — together with the continued unwinding of the previous charging regime — have been important at Darwin Airport, the outlier as far as recent price rises are concerned.

Any conclusion on whether charges at the price monitored airports are now excessive in relation to costs cannot rely on single, and inevitably imperfect, indicators. However, taken together, the following considerations suggest that charging outcomes so far have not been outside the boundaries that would have

been envisaged when the light handed approach was introduced — implying that there has been no systematic misuse of market power in this regard.

Figure 1 **Recent movements in charges at the monitored airports^a**



^a Measured as aeronautical revenue per passenger.

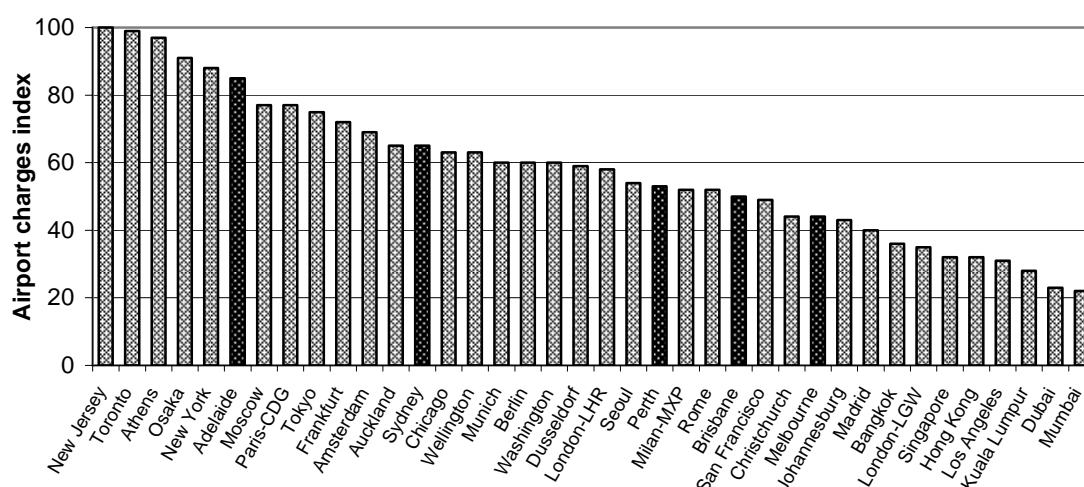
- Charges at Australia's major airports are, for the most part, mid-range by international standards (see figure 2). While it is important not to draw too much from such comparisons given the 'apples and pears' issues that arise, equally it is hard to dismiss the broad picture that emerges as irrelevant.
- As noted above, the approach used by the ACCC to determine allowable charging levels at Sydney Airport in 2001 had a major influence on the charges resulting from the first round of negotiated agreements at the other monitored airports. Hence, current price levels may not be all that different from those that would have prevailed had stricter controls been retained.
- Strong growth in aeronautical revenues, and generally high airport profitability by international standards, seem to have primarily reflected larger increases in passenger traffic than was anticipated when current charges were struck.

The latter two observations in turn highlight that the scope for price monitoring (and the other elements of the light handed approach) to constrain prices will be better and more readily judged once the next round of agreements has been concluded. Negotiations on a number of these agreements are currently underway.

But there have also been some negatives

While the light handed approach has delivered some significant benefits and price levels that do not appear to be excessive, there have been some problems.

Figure 2 How do charges measure up internationally?^a



^a Charges are for 2005 and for international aircraft movements. The difference in Adelaide Airport's ranking among the Australian airports compared to figure 1 reflects its low volume of international traffic and hence lesser capacity to spread specific infrastructure and security costs.

- The behaviour of airports as a group in regard to the determination of non-price terms and conditions has arguably been less satisfactory. These terms and conditions — which cover matters such as the allocation of gate and aircraft parking positions, and the right of an airport to vary its conditions of use — can be as important for airlines as the general level of charges.
- Relationships between some airports and airlines have been strained. At Sydney Airport, where the domestic airside service has been declared under the Part IIIA national access regime (see later), negotiations on both price and non-price matters have been protracted.

More generally, with the benefit of hindsight, it has become apparent that some of the 'market' constraints on airports' behaviour are not as strong as was previously envisaged. For example, airlines generally have only modest countervailing power in dealing with the major airports. Also, the negative impact of higher charges for aeronautical services on passenger traffic, and hence on airports' non-aeronautical revenues, does not appear to be significant.

Hence, price monitoring and the threat of re-regulation must carry more of the burden in preventing misuse of market power.

However, some 'systemic' shortcomings have detracted from the effectiveness of price monitoring and the light handed approach as a whole in performing this role.

- There is little policy guidance available to airports and their customers on how airport assets should be valued for pricing purposes. As discussed below, this has

been a major source of disputation between the parties and is impeding the development of commercial relationships.

- There is currently no clarity as to when further investigation of an airport's conduct should be undertaken, and no process for initiating it. While such investigations *may* not have been warranted on the basis of outcomes to date, it has not been possible to differentiate between 'determined' and 'passive' policy inaction. This gap in the current arrangements is contributing to perceptions in some quarters that the threat of re-regulation, if there is misuse of market power by airports, is not a credible one.

What should happen next?

A further period of price monitoring would be desirable

The effectiveness of the light handed approach in constraining misuse of market power by airports has yet to be fully tested.

However, as outlined below, the systemic weaknesses in the current framework can be addressed without sacrificing the benefits that the light handed approach has delivered. With the proposed modifications in place, a further period of price monitoring when the current arrangements end in June 2007 would be preferable to a reversion to stricter price controls.

A return to the previous arrangements would make it more difficult for airports to undertake the new investments required to cater for strongly growing demand for air travel. This in turn would impede the development of tourism and other Australian industries reliant on accessible and efficient airport services. Indeed, with several of the monitored airports now entering a new phase of the investment cycle, a return to a more heavy handed regulatory regime could be costly.

A reversion to stricter price controls would also put at risk the good productivity performance of Australian airports which seems at least partly attributable to the more light handed regulatory approach. Amongst other things, considerable managerial resources would once again be diverted into dealing with the regulator and seeking ways to 'game' the system.

But the potentially greater influence of Part IIIA complicates matters

As noted earlier, the Part IIIA national access regime was always intended to be an operative part of the light handed approach for overseeing airport behaviour — in essence, a mechanism of 'last resort' for resolving serious and protracted disputes.

However, a recent Federal Court determination upholding the Part IIIA declaration of the domestic airside service at Sydney Airport has the potential to render Part IIIA a more active regulatory instrument. Specifically, a new interpretation by the Court of the meaning of the ‘promotion of competition test’ — the key criterion in determining whether a nationally significant infrastructure service should be declared — is likely to make it easier to satisfy this criterion in future declaration cases (see box 2).

In turn, a more readily accessible Part IIIA regime could conceivably supplant price monitoring (and the underlying threat of re-regulation) as the operative regulatory instrument governing terms and conditions at the monitored airports. This might in practice be much the same as a reversion to explicit price regulation, meaning that there would be little point in continuing with monitoring as the information collected would be of no particular policy relevance.

Moreover, even if subsequent judgements reveal that the Court’s interpretation has not substantially lowered the Part IIIA ‘entry bar’, the decision has introduced a new and undesirable source of uncertainty to the infrastructure policy environment.

An amendment to Part IIIA should be considered for wider policy reasons

The question marks over the sustainability of a light handed approach in the airports area could be resolved by a specific amendment to Part IIIA to ensure that it effectively remains a ‘last resort’ mechanism.

But the case for such an amendment is a general rather than airport-specific one. There are good reasons why the entry bar for declaration under the regime should be set at a high level and why the Government recently sought to raise that level further. Of particular concern is the potential for access regulation to deter investment necessary to sustain services over the longer term (see box 3).

There are factors militating against such a ‘pre-emptive amendment’. Apart from any further developments ensuing from Sydney Airport’s application for leave to appeal the decision in the High Court, immediate legislative action would raise concerns about prejudging how decision makers might respond to the changed Part IIIA landscape.

However, clarification through the judicial/decision making process is unlikely to happen quickly. The uncertainty thereby created may of itself impact adversely on investment in infrastructure services. Accordingly, the Commission considers that there is a case for a pre-emptive legislative amendment to ensure that the Part IIIA entry bar remains at a high level.

Box 2 **The Federal Court decision**

In October 2006, the full Federal Court dismissed an appeal by Sydney Airport against the Australian Competition Tribunal's decision to declare the airport's domestic airside service under the Part IIIA national access regime. This means that until December 2010, and subject to the outcome of Sydney Airport's application to the High Court for leave to appeal the decision, domestic airlines unable to reach agreement with the airport over charges or terms and conditions will be able to seek either legally binding private arbitration, or arbitration by the ACCC.

One of the key Part IIIA declaration criteria requires that access to a nationally significant infrastructure service must 'promote competition' in a related market. Prior to the Federal Court decision, this criterion had essentially been interpreted by decision makers as meaning that the act of declaration, and the access that would flow from such declaration, would promote competition. However, the Court found that consideration of conduct 'with and without' declaration is not a pre-condition for satisfaction of the competition test; all that is required is a judgement that the nature of the infrastructure service is such that access (or increased access) will promote competition. As most of the other declaration criteria focus on structural or factual matters, this interpretation has *prima facie* lowered the Part IIIA entry bar.

There is of course a need for caution in concluding at this juncture on precisely how the Federal Court's interpretation might impact on future declaration cases. Further developments ensuing from any consideration of the matter by the High Court (see above) are relevant in this context. So too are recent amendments to Part IIIA to strengthen the promotion of competition test and to require decision makers to have regard to an objects clause focussing on the efficiency implications of declaration.

Moreover, the Federal Court did not rule out the relevance of a service provider's conduct to the decision to declare.

But under the Court's interpretations, such considerations will seemingly now come into play primarily through the residual discretion available to Part IIIA decision makers. Hence, even if it transpires that the exercise of such discretion operates to limit the magnitude of any bar lowering, it will add to uncertainty about regulatory outcomes. As noted in the text, the effects of that uncertainty on investment may be little different from those resulting from a lowering of the entry bar.

A 'conditional' approach for post-2007 airport policy

In the light of the above, the Commission considers that there must necessarily be some policy flexibility in regard to the future of prices oversight at the major airports after the current arrangements end in June 2007.

In a broad policy sense, it is strongly of the view that the continuation of a (modified) light handed approach, backed by Part IIIA operating, in practice, as a mechanism of last resort, is the best way forward.

Box 3 The impact of access regulation on investment

Though it is very difficult to establish after the event precisely how investment might have differed in the absence of access regulation, it is widely acknowledged that potential exposure to such regulation can impede investment in essential facilities in two ways:

- It will increase the risks and thereby the costs of such investment — especially as assets, once in place, are largely sunk.
- Investment will also be deterred if prospective terms and conditions under regulated access are not seen as providing a sufficient return to infrastructure owners. A particular issue here is that the possibility of earning higher than normal returns on successful projects may be required to balance the possibility that some projects will fail. If regulatory pricing arrangements inadvertently appropriate upside returns on successful projects (so-called ‘regulatory truncation’), then overall investment levels are likely to be reduced.

Some such investment impacts are unavoidable if efficient access to nationally significant infrastructure services is to be provided. But if access regulation is overly stringent, those impacts will potentially be significant and outweigh the offsetting benefits that appropriately configured access regulation can deliver.

However, in the absence of an amendment to Part IIIA, this relationship between the two instruments cannot be guaranteed. In these circumstances, though it would be premature to immediately terminate the light handed approach, there should be a readiness to do so in the future if it becomes clear that Part IIIA, left unamended, has become the operative regulatory instrument for the major airports and thereby rendered price monitoring redundant.

The foundations for the post-2007 light handed approach

The post-2007 price monitoring arrangements must continue to provide for a degree of latitude on outcomes if they are to foster commercial relationships between airports and their customers and thereby place reliance primarily on negotiations to set charges and terms and conditions.

Nonetheless, the Commission sees the need for some ‘framework’ changes to facilitate such negotiations and to enhance the credibility of the light handed approach as a means to constrain misuse of market power by the major airports.

A process for triggering further investigation of conduct

A key element of the light handed approach is the ultimate threat of re-regulation if there is significant misuse of market power by airports. As well as offering the prospect of remedial action if airports behave inappropriately, the threat is also designed to condition negotiations between the parties.

This in turn requires that there is an effective process for initiating further investigation of an airport's conduct in circumstances where there is prima facie evidence of significant misuse of market power. As noted above, there is no explicit process of this sort in the current arrangements. Accordingly, the Commission is recommending introduction of an arrangement whereby the Minister for Transport and Regional Services — drawing on price monitoring reports and any other relevant information — would be required to publicly indicate each year either that:

- for the period covered by the relevant monitoring reports, no further investigation of any airport's conduct is warranted; or
- one or more airports will be asked to 'show cause' why their conduct should not be subject to more detailed scrutiny through a Part VIIA price inquiry, or other appropriate investigative mechanism.

This requirement would remove the possibility of 'passive' rather than 'determined' inaction. In so doing, it would both enhance the credibility of the threat of re-regulation, and reinforce the notion that price monitoring is simply intended to be a screening mechanism — an initial step in the light handed regulatory approach. As such, the proposed new process should not put at risk the latitude on outcomes necessary to allow commercial negotiations to develop.

A circuit breaker on asset valuation

Since acquiring the leases, most of the price monitored airports have revalued their above ground assets, sometimes significantly, with the focus of revaluation now shifting towards land — especially at those airports located closer to city centres.

Such revaluations will not automatically or immediately be reflected in airport charges. However, one important effect is to provide a possible justification for higher charges over time. Not surprisingly, therefore, the revaluation issue has been a source of considerable dispute and tension between airports and airlines, with both sides in agreement that resolving the issue is a high policy priority.

From an efficiency perspective, the case for sanctioning higher charges based on changes in the 'optimised replacement value' of above ground assets, or the value of land in alternative uses, is weak.

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- Airport assets are effectively sunk and, under the terms of the leases, land cannot be redeployed into higher value uses outside of the airport precincts. This means that continued provision of services is unlikely to be put at risk if higher charges based on asset revaluations are not sanctioned.
 - Future investment at the airports is also unlikely to be discouraged — provided it is clear that, for monitoring purposes, new investments will be incorporated into the monitored asset base at their ‘acquisition’ values.
 - In overall terms, the proportionate impacts on ticket prices — and therefore on demand for air travel — of any undercharging against an unconstrained ‘opportunity cost’ benchmark, are likely to be small. Hence, longer term decisions on airport location and the timing of capacity upgrades are unlikely to be materially affected.

However, the policy stance adopted on this issue will have implications for the profitability of the airports and the airlines.

Sanctioning asset revaluation practices that redistributed income from airlines and air travellers to airports would not be helpful in engendering public confidence in the light handed regulatory approach.

But especially in the early phases of the airport privatisation process, there was some ambiguity in the signals given to bidders about both appropriate ‘starting’ asset values, and the scope to raise charges based on periodic asset revaluations (including for land) without triggering a regulatory response. Hence, bids may well have been framed on the expectation that there would be some scope for revaluations and flow through to charges.

There is no easy solution. Yet a way forward must be found — both to render the post-2007 price monitoring regime credible, and to remove a major blocker to the further development of commercial relationships between the parties.

Significantly, most of the airports seem to have accepted that the practice of raising charges on the basis of periodic asset revaluations should not be sanctioned under a future price monitoring regime and, by implication, that a line in the sand on previous revaluations must be drawn. While such a line will inevitably involve an element of ‘rough justice’, the Commission considers that a cut-off date of 30 June 2005 for revaluations to the monitored asset base represents a reasonable compromise between the competing interests.

Better guidance on expected outcomes

When introducing the light handed approach, the Government specified a number of overarching ‘Review Principles’, intended to provide some broad guidance to the parties, as well as to this review, on appropriate outcomes under the new arrangements. Amongst other things, these principles specify that: at non-capacity constrained airports, prices should not be significantly above long run costs (including an appropriate return on assets); price discrimination that promotes the efficient use of airports is permitted; and that airports and airlines should operate primarily under commercially negotiated agreements (see the Terms of Reference at the front of the report).

In the Commission’s view, some augmentation to, and elaboration of, the current principles could enhance their usefulness and thereby the credibility of the light handed approach, without unduly ‘directing’ the outcomes of commercial negotiations. Specifically, there should be three new principles:

- proscribing further asset revaluations as a basis for increasing airport charges;
- specifying that the parties should negotiate in ‘good faith’ to achieve outcomes consistent with the principles, including through the negotiation of processes for resolving disputes in a commercial manner; and
- providing for a reasonable sharing of risks and returns between airports and their customers (including those relating to productivity improvements and changes in passenger traffic).

This expanded set of principles would continue to provide guidance to the parties as envisaged when the existing ‘Review Principles’ were established. Under the proposed new price monitoring regime they would also have an additional role to play — namely, to provide some reference points for any triggering of the requirement for an airport to ‘show cause’ as to why its conduct should not be subject to further scrutiny (see above).

No airport-specific arbitration mechanism

As intended, the light handed approach has led to considerably more negotiation between airports and airlines.

However, many airlines have argued that the monitored airports negotiate from a position of strength and can therefore ‘impose’ outcomes on their customers. Given the cost and time involved in seeking to resolve disputes via the Part IIIA process, several airlines proposed that a future price monitoring regime be ‘augmented’ with an airport-specific arbitration mechanism.

It is obviously the case that the major airports have considerable bargaining power. Indeed, this is precisely why they continue to be subject to oversight.

But, in the Commission's view, introduction of an airport-specific arbitration mechanism could fundamentally undermine the light handed regulatory approach. That is, it is difficult to conceive of an arbitration mechanism that would provide both airports and airlines with strong incentives to engage in genuine commercial negotiations. Certainly, none of the proposals put forward by the airlines in response to an invitation from the Commission would embody such incentives. Rather, it seems likely that arbitration would come to be viewed by airlines as the default option, with negotiations increasingly centred in a narrow band around previously arbitrated outcomes. The net effect would therefore be a return to 'institutionalised' determination of charges and conditions for airport services, with its attendant costs.

As well, the 'framework' changes that the Commission is recommending to the light handed approach reduce further the case for an arbitration mechanism.

- Introduction of an explicit process for triggering further investigation of inappropriate airport behaviour should partly address users' concerns about the consequences of imbalance in bargaining power.
- Resolving the asset valuation issue should considerably narrow the negotiating divide between the parties.
- Augmentation of the overarching principles to make it explicit that the parties are expected to negotiate mechanisms for resolving disputes, should encourage the further development of commercial arbitration/mediation processes, tailored to the particular needs of individual airports and their customers.

With these changes in place, the key stakeholders should then be given the opportunity to show that through constructive negotiation they can deliver effective outcomes, with their performance judged accordingly under the new overseeing arrangements.

Implementing the new price monitoring regime

A smaller group of airports

There is no case for extending the airport coverage of the post-2007 monitoring regime. All of the larger non-monitored airports either face significant competition from other airports or other modes of travel, and/or must negotiate with airlines

which have considerably more bargaining power than in their dealings with the major airports.

The Commission also considers that monitoring of Darwin and Canberra Airports is no longer necessary.

- They are relatively small airports dealing with some major airlines that can withdraw services (and have done so), and hence have some countervailing power.
- Both face some competition from other airports and/or other modes of transport.
- And both have less passenger traffic than some of the larger non-monitored airports.

Moreover, though charges at Darwin Airport have risen steadily under the light handed regime, these increases appear justifiable in terms of the cost of new investments and security upgrades, and the unwinding of previously uncommercial charging arrangements.

A slightly wider group of services

The monitoring regime should encompass all services for which airports are likely to have significant market power. On this basis, the Commission considers that the coverage in the proposal from the Department of Transport and Regional Services to align the relevant parts of the two sets of regulations governing the scope of price monitoring, is generally appropriate. Amongst other things, this would see monitoring extend to:

- all, rather than only some, revenue streams associated with the provision of refuelling services — including those from fuel throughput levies;
- revenues from common-use check-in facilities and terminal space; and
- revenues from ground handling and airside freight handling services.

However, airports are unlikely to enjoy any significant market power in providing two services included in the Department's proposal — office space used by airline staff and telecommunications infrastructure. Hence, these services should not be encompassed by the new monitoring regime. Terminal space covered by long-term leases to airlines that were signed prior to privatisation, should also be excluded.

Adoption of the Department's proposal would mean that car parking charges, and charges imposed on taxis, would no longer be subject to monitoring. While airports have some market power in setting these charges, that power is constrained by the availability of off-airport parking, and by other options for travelling to and from

airports. A comparison of car parking charges at the monitored airports with those at central city locations where a premium is also paid for parking convenience, suggests that these constraints have been influential.

Streamlined monitoring of service quality

Some monitoring of service quality is necessary to guard against misuse of market power through either degrading service standards or ‘gold plating’ services. Quality monitoring can also help to put price changes in context.

However, the value added by some aspects of the current quality monitoring arrangements is questionable. There is also some duplication in the information collected from the various stakeholders.

A proposed amendment to the Airports Act currently before the Parliament will give the ACCC scope to streamline and rationalise the current arrangements. In doing so, the ACCC should give particular attention to the possibility of:

- dispensing with commentary and qualitative survey results from the Australian Customs Service and relying on other existing and less contentious indicators of airport performance in enabling provision of these services; and
- rationalising airline satisfaction surveys to remove quality matters included in passenger surveys, or covered by other quantitative indicators.

It should also consider whether greater use of comparative passenger satisfaction results from reputable international benchmarking exercises could help to enhance the usefulness of quality monitoring.

To further streamline current processes, and to help put price changes in context, the Commission is also recommending that price and quality monitoring reports be combined.

Duration and review arrangements

Unless ‘supplanted’ by the Part IIIA national access regime (see above), the new price monitoring regime should operate for six years ending on 30 June 2013. This would allow an end-of-period review to have regard to the outcomes of the scheduled 2011 review of the national access regime.

Continuing with a light handed approach is the best way forward

Though the light handed approach has not been without problems, there are good reasons for continuing with it; namely, to provide an environment that will facilitate investment, innovation and productivity improvement at the major airports, and encourage the further development of commercial relationships between the airports and their customers.

The Commission's recommendations seek to address some systemic deficiencies in the current arrangements, so as to make the light handed approach more effective in constraining misuse of market power by the airports. Thus the proposed changes should provide greater assurance to the community that any inappropriate behaviour by airports will be kept in check, while continuing to avoid the costs of more intrusive price regulation.

The Commission has also addressed, without making recommendations, some other relevant aspects of the regulatory framework, including the arrangements in place at Sydney Airport to ensure access for regional airlines, and charges for services provided at the major airports by government entities.

Recommendations

RECOMMENDATION 3.1

To ensure that the operation of the Part IIIA national access regime leaves open the option of using price monitoring and other light handed approaches for regulating major infrastructure provision (including at airports), the Government should consider amending Part IIIA to restore the prevailing interpretation of s 44H(4)(a) prior to the Federal Court decision upholding the declaration of the domestic airside service at Sydney Airport.

RECOMMENDATION 3.2

There should be a further period of price monitoring (see recommendation 5.5) at Australia's major airports when the current arrangements end in June 2007.

However, if it becomes apparent that Part IIIA has become the operative regulatory instrument governing charges and terms and conditions at major airports, and no corrective action is considered appropriate before the scheduled review of Part IIIA in 2011, then price monitoring should be discontinued.

In that event, the possible reintroduction of monitoring should be considered in the light of the outcomes of the review of Part IIIA.

RECOMMENDATION 4.1

Under the new price monitoring regime, the Minister for Transport and Regional Services, having regard to monitoring reports and other relevant information, should each year be required to publicly indicate either that:

- no further scrutiny of the conduct of the monitored airports is necessary; or*
- that one or more airports will be asked to 'show cause' why their conduct should not be subject to more detailed scrutiny through a Part VIIA price inquiry, or other appropriate investigative mechanism.*

RECOMMENDATION 4.2

Under the new price monitoring regime, the value of an airport's asset base for monitoring purposes should be:

- the value of tangible (non-current) aeronautical assets reported to the Australian Competition and Consumer Commission as at 30 June 2005,*

adjusted as necessary to reflect the proposed service coverage of the new regime (see recommendation 5.2);

- *plus new investment;*
- *less depreciation and disposals.*

RECOMMENDATION 4.3

In giving effect to this basis for valuation, the Australian Competition and Consumer Commission should consult with airports and airlines on how best to accommodate differences in statutory and regulatory reporting requirements within the new price monitoring regime.

RECOMMENDATION 4.4

Assessments of airport behaviour during the next period of price monitoring should be governed by an overarching set of principles. All of the current ‘Review Principles’ should be retained. In addition, there should be three new principles specifying that:

- *further asset revaluations should not generally provide a basis for higher charges for monitored aeronautical services;*
- *the parties should negotiate in ‘good faith’ to achieve outcomes consistent with the principles, including through the negotiation of processes for resolving disputes in a commercial manner; and*
- *there should be a reasonable sharing of risks and returns between airports and their customers (including those relating to productivity improvements and changes in passenger traffic).*

RECOMMENDATION 4.5

Neither an airport-specific arbitration regime, nor mandatory information disclosure requirements for airports, should be introduced at this time.

RECOMMENDATION 5.1

The new price monitoring regime should apply to Adelaide, Brisbane, Melbourne, Perth and Sydney Airports. Darwin and Canberra Airports should not be subject to monitoring once the current arrangements end.

RECOMMENDATION 5.2

Price monitoring should apply to all of those services for which airports have significant market power. Consistent with this, the service coverage of the new monitoring regime should be that specified in the current proposal from the Department of Transport and Regional Services to align the relevant parts of the

Airports Act and the directions pursuant to the Trade Practices Act giving effect to airport price monitoring, subject to the exclusion of:

- *office space used by airline staff; and*
- *telecommunications infrastructure.*

Also, the definition of terminal space and related facilities in the Departmental proposal should be clarified to explicitly exclude dedicated terminal space, under long-term lease to airlines.

RECOMMENDATION 5.3

In examining opportunities to improve and streamline quality monitoring, the Australian Competition and Consumer Commission should give particular attention to:

- *whether it remains necessary to report survey responses from the Australian Customs Service;*
- *how best to eliminate overlap between the airline and passenger satisfaction surveys, and between these surveys and other quantitative indicators; and*
- *whether greater emphasis should be placed on comparative passenger satisfaction results contained in authoritative international benchmarking exercises.*

RECOMMENDATION 5.4

Under the new price monitoring regime, price and service quality outcomes should be presented in a single report, published annually.

RECOMMENDATION 5.5

Unless ‘supplanted’ at an earlier date by Part IIIA (see recommendation 3.2), the new price monitoring regime should operate for six years ending on 30 June 2013. The new regime should be reviewed in 2012, with that review having regard to the outcomes of the scheduled 2011 review of the national access regime.

1 Background and context

Key points

- The focus of this inquiry is on the provision of services to airlines at airports with significant market power. As such:
 - issues relating to general aviation and freight services are not specifically examined; and
 - the discussion in the report relates mainly to the price monitored airports.
- In considering future arrangements, the Commission has taken account of:
 - the continuing influence of the previous regulatory price setting arrangements, which makes it more difficult to assess the likely future effectiveness of the light handed approach;
 - the expected continuation of strong growth in passenger traffic at the monitored airports, which will be a source of downward pressure on charges for the use of existing airport infrastructure, and will put a premium on policy settings that encourage appropriate types and levels of investment in new facilities; and
 - the implications of a recent Federal Court decision, which has potentially increased the role of the Part IIIA national access regime in establishing terms and conditions at the major airports.

1.1 Background to the inquiry

Historically, most of Australia's major airports were owned and operated by the Australian Government. Under public ownership, aeronautical services were significantly underpriced. There was also considerable cross-subsidisation — both across airports, and of aeronautical services by revenues from non-aeronautical services (such as car parking).

In 1997, the Government began the process of privatising its airport holdings through the sale of long term leases (50 years with an option to renew for a further 49 years). This process was completed with the sale of the leases for the remaining Sydney-basin airports in 2003.

In privatising these airports, the Government recognised that some had significant market power, which they could potentially use to raise prices for their services

above those that would prevail in a more contestable market. Accordingly, it introduced price regulation at all capital city and some regional airports.

Initially, this price regulation involved a mix of price notification, price monitoring and price cap arrangements. However, in the light of a downturn in global air traffic and the ensuing falls in airport revenues following terrorist attacks and the demise of Ansett in 2001, the coverage and stringency of this regulation was subsequently eased. In line with proposals put forward by the Commission in a report in 2002 (PC 2002), price regulation is now essentially limited to the monitoring of charges (and quality) for aeronautical and related services at seven airports — Adelaide, Brisbane, Canberra, Darwin, Melbourne, Perth and Sydney (see box 1.1). (Charges for airport services provided to regional airlines at Sydney Airport remain subject to price notification.)

Also, the airports continue to be subject to the general provisions of Part IIIA of the *Trade Practices Act 1974* (TPA) — the national access regime. This regime provides legislative mechanisms for third parties to seek access to the services of nationally significant infrastructure in situations where a commercial agreement cannot be negotiated with the facility owner.

The price monitoring arrangements were introduced for five years, with a review to be conducted by the end of this period. However, the Government reserved the right to bring forward the review if there was evidence of unjustifiable price increases.

In undertaking the review for the Government, the Commission has been asked to examine how well price monitoring as part of a light handed regulatory approach has worked and whether it, or some other form of airport-specific prices oversight, should continue after 2007. The full terms of reference are reproduced at the front of this report.

How has the Commission approached its task?

In making its assessments, the Commission has drawn heavily on the extensive input from participants (see appendix A). It has also had regard to the *Productivity Commission Act 1998*, which requires the Commission to take an economy-wide view, balancing the various interests involved on any particular issue, in order to produce the best outcome for the community as a whole.

As well, the Commission has been mindful of the Government's objectives in moving to light handed prices oversight and the associated 'Review Principles' spelt out in the terms of reference.

Box 1.1 **How does the price monitoring regime operate?**

Direction 27 of the Prices Surveillance Act 1983 (now under Part VIIA of the *Trade Practices Act 1974*) stipulates that the Australian Competition and Consumer Commission (ACCC) is to monitor the prices, costs and profits relating to the supply of aeronautical and related services at Adelaide, Brisbane, Canberra, Darwin, Melbourne, Perth and Sydney airports. Related provisions in the *Airports Act 1996* require these airports to provide the ACCC with annual financial accounts, which the ACCC may publish.

Monitoring operates on a 'dual till' basis whereby only the costs of, and revenues from, providing aeronautical and aeronautical-related services are formally subject to oversight. Though the service coverage of the two enabling regulatory instruments differs slightly (see appendix D, table D.2 for further details), in broad terms, the services subject to monitoring are:

- *aeronautical services* relating to aircraft movement facilities and activities, and passenger processing facilities (other than check-in counters) and activities, including security services; and
- *aeronautical-related services* encompassing the provision of landside vehicle access to terminals, landside vehicle services (including public and staff car parking, and taxi holding and feeder rank services on airport), check-in counters and related facilities, and aircraft maintenance sites and buildings.

Hence, prices and profits earned by an airport from *non-aeronautical* services such as retailing, hotel accommodation, corporate parks and factory outlets — or from the rental of space for the provision of such services by third parties — are not monitored.

The ACCC does not draw conclusions as to whether the prices and profit levels for monitored services reported to it by the seven airports are evidence of 'taking advantage of monopoly power' (ACCC 2006a, p. 17).

However, the information assembled by the ACCC helps to inform judgements by the Government on the effectiveness of the price monitoring regime in preventing such behaviour. If monitoring indicates that further investigation is required, then under Part VIIA, the Government can direct the ACCC to undertake a public inquiry. Potentially, this could lead to the re-introduction of stricter price controls at specific airports.

Quality of service monitoring

The ACCC is also required to report on service quality at the price monitored (as well as other) airports — in part to reinforce commercial incentives for those airports to maintain appropriate service standards. In doing so, the ACCC draws on information from several sources, including from: airport operators; airlines; passenger surveys; AirServices Australia and the Australian Customs Service.

Price notification

Sydney Airport must notify the ACCC if it intends to increase charges for aeronautical services to regional airlines using the airport. A related regulatory direction limits increases in average charges to these airlines to no more than the CPI.

The Government's intent in introducing price monitoring was to retain a constraint on the misuse of market power while avoiding unnecessary regulatory intrusion. Such intrusion under the price cap regime was widely acknowledged to have inhibited investment, diverted management resources to dealing with the regulator and impeded the development of normal commercial relationships between airports and airlines. At the time that price monitoring was introduced, the Government commented that it:

... considers that lighter-handed regulation of airports is now appropriate. ... The threat of possible re-regulation will encourage negotiated pricing outcomes based on efficient costs and an adequate return on capital ... 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 controls. (Anderson and Costello 2002, p. 3)

In indicating that commercial negotiations should generally be the basis for establishing prices and terms and conditions of access to airports' services, the Government's 'Review Principles' recognise that prices should be sufficient to recover the costs of service provision and also encourage the more efficient use of existing infrastructure. At the same time they also state that, unless there are significant capacity constraints, 'efficient prices should generate expected revenue that is not significantly above the long-run costs of efficiently providing aeronautical services (on a 'dual-till' basis)'.

Some boundaries for the inquiry

The focus of the inquiry is on the provision of services to regular passenger transport (RPT) activities by those airports with significant market power. Hence:

- specific general aviation (GA) issues and those relating to freight services do not receive detailed consideration in this report; and
- the discussion in the report mainly relates to those airports that are currently subject to price monitoring (see box 1.2). Nonetheless, the Commission has considered whether any other airports have sufficient market power to warrant inclusion in a future prices oversight or regulatory regime.

As well, with the emphasis on the price monitoring arrangements, the inquiry is concerned with only one part of the regulatory regime governing the operations of Australian airports as a whole (see appendix B). That said, at various places in the report, the Commission has drawn attention to relevant linkages between these other

regulations and the pricing of airport services, and/or the operation of price monitoring.

Box 1.2 The Australian airport sector

Australian RPT airports can be categorised into four broad groups — the seven price monitored airports; other major city airports (such as Hobart, Cairns, Gold Coast and Alice Springs); major regional airports (such as Launceston, Dubbo and Albury); and smaller regional community airports. In addition, there are some GA-only airports (such as Bankstown and Essendon).

The facilities under the control of these airports are used to provide a range of essential operational services. They include handling services, both to aircraft (ground handling and refuelling services) and for the processing of passengers, baggage and freight through the terminals and on/off the aircraft. Also, there are various facilities outside terminals, such as perimeter roads, car parks, and taxi, bus and rail points linked to the terminals by walkways.

At many airports, the operators provide relatively few services themselves, but rather maintain facilities that are then used by other entities. These include government agencies such as Airservices Australia and the Australian Customs Service, airlines (and other specialist providers of operational and handling services) and concession holders.

The price monitored airports

In 2004-05, the seven price monitored airports accounted for 83 per cent of scheduled passenger movements, with Sydney, Melbourne and Brisbane alone accounting for two-thirds of total traffic. The seven airports are each owned by unlisted companies. Investment and fund management companies are major shareholders, with public sector entities and overseas airport operators also having an interest in some. These ownership arrangements are subject to provisions in the Airports Act, which require majority Australian ownership and impose cross-ownership limits for Sydney/Melbourne, Sydney/Brisbane and Sydney/Perth Airports.

The operations of the seven airports are subject to a range of regulation additional to price monitoring, such as that relating to: building and construction and environmental management at airports; the provision of mandatory government services at airports (such as air navigation and customs services); slot management at Sydney Airport; and commitments encompassed by the various international agreements to which Australia is a signatory (see appendix B). They are also subject to conditions and obligations specified in the respective leases. The latter cover such things as access, maintenance of the airport in good repair and the future development of airports at the operator's cost.

1.2 Factors bearing on the Commission's analysis

The continuing influence of the previous regulatory regime

While price monitoring has now been in place for four years, the previous regulatory price setting arrangements continue to exert a considerable influence on current charges and on the expectations and attitudes of airport operators and users more generally. As well as impacting on the development of commercial relationships between airports and airlines, the continuing influence of the previous regime makes it more difficult to ascertain precisely how price monitoring has affected outcomes so far, and what outcomes would be likely under a further period of price monitoring as the influence of the pre-2002 arrangements diminishes. The fact that it will be some time before the precise implications of the recent developments in regard to the Part IIIA national access regime become apparent (see below), adds further uncertainty to the analysis of appropriate policy settings post-2007.

Strong market growth

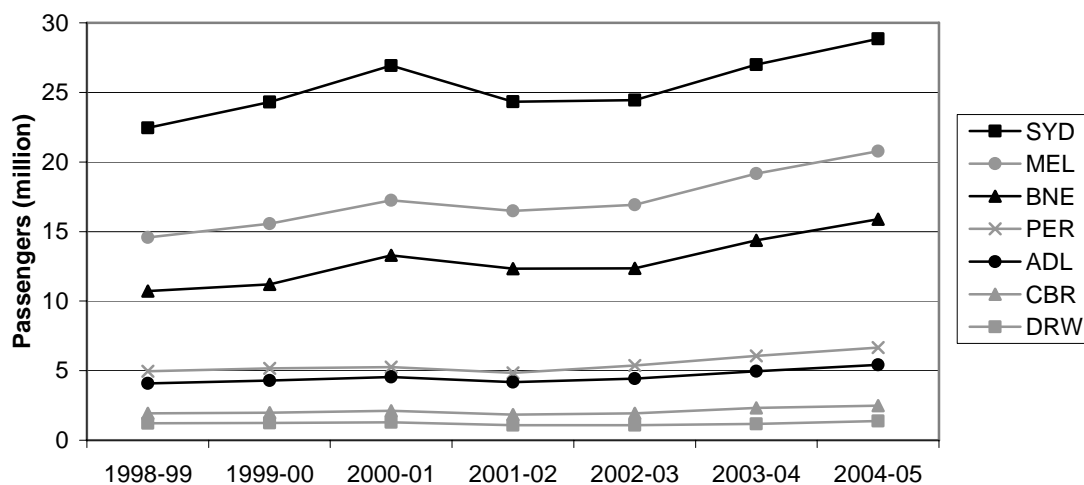
Passenger numbers at the price monitored airports have been growing strongly, and this trend is expected to continue.

- From 1998-99 to 2004-05, total passenger numbers grew by 36 per cent, despite the events of 2001-02 (see figure 1.1). In the three year period following the commencement of price monitoring in July 2002, passenger numbers at the seven monitored airports grew at an average annual rate of 7.8 per cent — ranging from 5.8 per cent at Sydney Airport to 11.2 per cent at Perth Airport.
- Forecasts through to 2023-24 suggest that total traffic will continue to grow at an annual average rate of over 4 per cent (figure 1.2).

In allowing the large fixed costs of airport infrastructure to be amortised over a greater passenger base, this growth should be a source of downward pressure on charges for the use of existing facilities (see chapter 2). It also means that future policy will need to facilitate the investment required to cater for a much greater number of passengers. For airlines, getting necessary investment in place in a timely fashion may be as important as the level of charges for the services they receive.

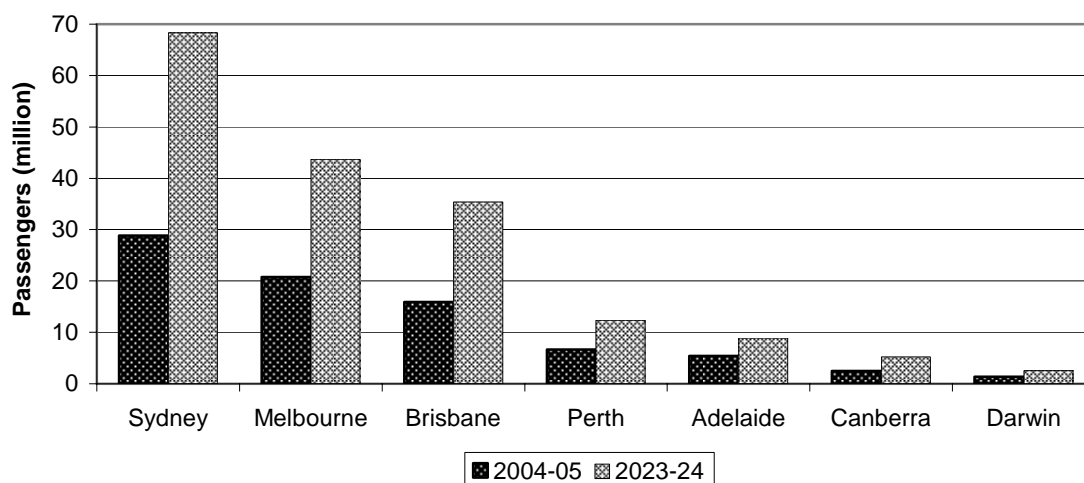
Further information on market trends and airport revenues and profitability is contained in chapter 2 and appendix D.

Figure 1.1 Passenger demand at the price monitored airports, 1998-99 to 2004-05



Data source: ACCC (2006a).

Figure 1.2 Forecasts of passenger demand at the price monitored airports, 2004-05 (actual) to 2023-24^a



^a Brisbane Airport's forecast is for 2022-23.

Data sources: Master Plans for each price monitored airport (AAL 2004; APAC 2005b; BAC 2004; CAG 2005; NTAL 2004; SACL 2004; and WAC 2004).

Part IIIA and the Federal Court decision

As noted above, when introducing price monitoring the Government left open the possibility that airports could be subject to action under the Part IIIA national access regime (see box 1.3). These provisions have, in fact, been invoked since price monitoring commenced, with the declaration by the Australian Competition Tribunal in 2005 of domestic airside services at Sydney Airport for a five year period until December 2010 (see appendix C).

This declaration was subject to an appeal by Sydney Airport Corporation to the Federal Court, which was rejected in a decision announced subsequent to the release of the Commission's Draft Report. Importantly, in rejecting the appeal, the Federal Court also placed a new interpretation on the meaning of one of the key declaration criteria — the 'promotion of competition' test — which may make it easier in the future for access seekers (including airlines) to secure declaration.

The precise impact will not be clear for some time. As well as any developments ensuing from the Sydney Airport Corporation's application for leave to appeal the Federal Court's decision to the High Court, future declaration applications will have to be assessed in the light of recent legislative amendments to Part IIIA, which included changes intended to strengthen the same 'promotion of competition' test. Nonetheless, the Federal Court decision and accompanying interpretations have required the Commission to carefully consider the relationship between any future monitoring regime for airports and Part IIIA.

Box 1.3 **The Part IIIA national access regime**

A key premise underpinning the current price monitoring arrangements is that access to airport services and the price of those services should generally be commercially negotiated between the parties.

However, if agreement cannot be reached, the party seeking access to a particular airport service potentially has recourse to the generic national access regime. Through Part IIIA of the TPA, this regime provides for access in prescribed circumstances, and under agreed or determined conditions (including prices), to the services of nationally significant essential facilities.

The regime provides several avenues for gaining access on 'reasonable' terms and conditions, including having the service 'declared'. This gives an access-seeker the right to negotiate with the service provider, with provision for arbitration if those negotiations prove unsuccessful.

Subsequent to the introduction of price monitoring, Part IIIA has been invoked through the declaration of domestic airside services at Sydney Airport for a period of five years to December 2010 (see text).

1.3 A guide to the rest of the report

The remainder of this report is divided into two parts, consistent with the terms of reference.

The first part (chapter 2) looks at the outcomes under the current price monitoring regime, including: the level and structure of charges for airport services; costs of service delivery; rates of return; quality of service; investment levels; non-price terms and conditions; and compliance costs.

The second part looks at what should happen after June 2007 when the current arrangements are due to end:

- Chapter 3 sets out the Commission's reasons for recommending a further period of price monitoring at the major airports.
- Chapter 4 looks at some key requirements for this new monitoring regime, including: provision for an explicit process for invoking further investigation of an airport's conduct if there is *prima facie* evidence of significant misuse of market power; a means to resolve the contentious issue of asset valuation; and provision of greater guidance to stakeholders on expected outcomes through an augmented set of 'overarching principles'.
- Chapter 5 spells out the detailed basis on which that modified price monitoring regime should operate, including what airports and services it should cover, and what reporting and review arrangements should apply.
- Chapter 6 canvasses some other relevant issues, including the arrangements applying to regional airlines at Sydney Airport and the provision of services provided by government entities at the major airports.

Further relevant information is provided in appendixes to the report.

2 Price and quality monitoring outcomes

Key points

- Price outcomes, and the rates of return earned by the monitored airports, do not appear to have been excessive.
 - Indeed, airport charges have been heavily influenced by the previous regulated model.
 - Increasing revenue compared to costs is seemingly more a function of unexpectedly strong growth in passenger numbers than a deliberate exercise of market power.
- However, given the influence of the previous regulatory regime on charging outcomes to date, outcomes under the next round of contracts will provide a better indicator of the effectiveness of the light handed regulatory arrangements in constraining the market power of the major airports.
 - Excess capacity at the monitored airports, together with continued growth in passenger numbers, should put downward pressure on airport charges negotiated under these new contracts.
- Overall quality of service has been rated as satisfactory to good.
- All of the evidence points to a more favourable (easier and more timely) investment environment under price monitoring than under the previous price cap and 'necessary new investment' provisions.
 - With many airports now embarking on a new phase of capital spending, this more favourable investment environment will assume even greater significance in the future.
- The behaviour of airports in relation to the negotiation of non-price terms and conditions has arguably been less satisfactory. This may partly be because such matters are not explicitly included in the monitoring process.
- Compliance costs have been relatively modest, especially for the larger monitored airports.

The current monitoring regime involves the Australian Competition and Consumer Commission (ACCC) collecting and reporting information on prices, costs, profits and service quality at the seven monitored airports.

As set out in chapter 1, the monitoring process is intended to assist the Government to determine whether there has been any misuse of market power by any of the monitored airports, and hence whether a return to stricter price controls, for all or some airports, might be warranted. The information collected and reported through this process may also help airport users in their commercial dealings with airport operators.

To further aid the evaluation of airports' behaviour, the Government spelt out a set of Review Principles (see the Terms of Reference). Among other things, these specify that:

... efficient prices broadly should generate expected revenue that is not significantly above the long-run costs of efficiently providing aeronautical services.

The Review Principles also provide for price discrimination between users of airport services that 'promotes efficient use of the airport' and for congestion pricing at capacity-constrained airports.

This chapter looks at information on the monitored airports' prices, costs and rates of return, as well as at a variety of non-price outcomes. It draws on both monitoring reports and on comments from participants, together with a range of international benchmarking material.

The Commission has not undertaken a detailed analysis of the outcomes at each of the monitored airports. Indeed, as the discussion makes clear, such a 'forensic' analysis is fraught with problems. Rather, the Commission has sought to provide an indicative picture of what has happened under the light-handed price monitoring regime, with a focus on ascertaining whether outcomes are broadly within the boundaries that might have been expected when the regime was put in place.

These assessments provide the backdrop for the Commission's consideration, in chapter 3, of what should happen post-2007.

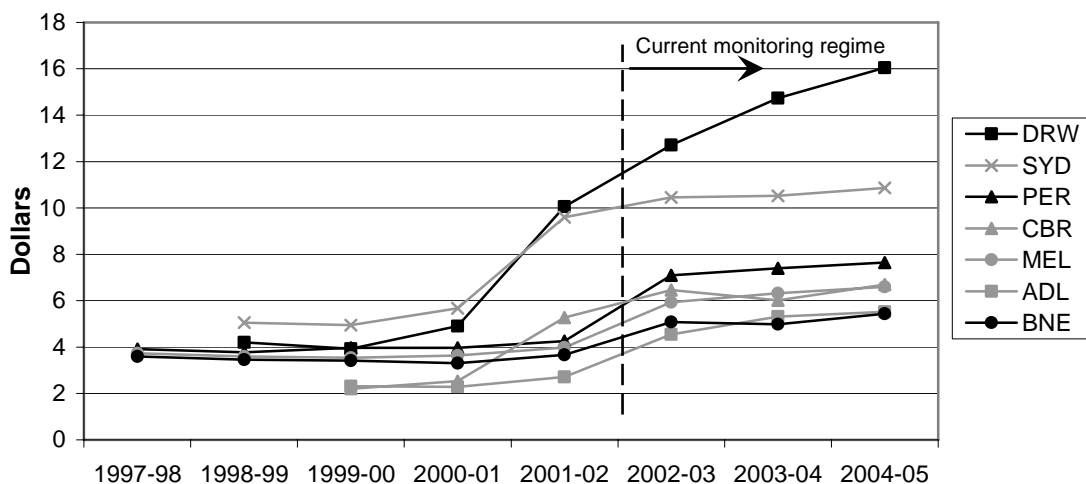
2.1 Prices

The level of prices

A realignment of aeronautical charges

In 2001-02 and 2002-03, aeronautical charges — and consequently average aeronautical prices (measured as aeronautical revenue per passenger) — rose significantly at the price monitored airports (figure 2.1, and appendix table D3).

Figure 2.1 **Movements in aeronautical charges^a at price monitored airports; 1997-98 to 2004-05**



^a Aeronautical revenue per passenger. Since the introduction of price monitoring, the ACCC has used this as its measure of average price movements. The previous measure, based on the weighted average change in airport charges, was abandoned as being too complex (ACCC 2004, p. 95).

Data source: Commission estimates based on information in ACCC (2006a).

These increases were, in part, a response to the unexpected downturn in airport traffic following the collapse of Ansett and the September 11, 2001 terrorist attack in New York. They were also part of the transition from single-till price regulation to dual-till price monitoring, involving an unwinding of the previous cross-subsidisation of aeronautical charges from significantly more profitable non-aeronautical operations.

The pattern of charges emerging from the CPI-X price setting arrangements in the early years of privatisation was looked at in some detail in the Productivity Commission's 2002 airport pricing review (PC 2002). The Commission concluded that the starting prices for the price caps were unlikely to be a good basis for

efficient pricing, as the prices were not adjusted to remove economically inefficient cross subsidies (PC 2002, p. 226).

The Commission went on to note that these shortcomings would lead to the inefficient use of aeronautical assets and distort signals for investment. It also observed that:

... even if price caps were to be maintained (in any form), aeronautical charges would still need to rise to encourage efficient long-run service provision. (PC 2002, p. 357)

Similarly, in commenting on the price increases at the time of the move to price monitoring, SACL's submission to this inquiry (sub. DR70, p. 29) noted that:

...the Government has publicly stated that price increases were expected in line with the Review Principles. For example, the spokesman for the then Federal Transport Minister, John Anderson, in responding to the ACCC airport price monitoring and financial report for 2002-03 stated that : "we were expecting to see price increases because they had been held artificially low over the last few years".

The precise timing of this re-alignment of charges varied among the airports, mainly as a result of the 'staged' abolition of price caps. In the case of Sydney Airport, which operated under separate price notification arrangements, the ACCC approved, in May 2001, a 97 per cent increase in aeronautical revenue.

The increase in charges was particularly pronounced at the smaller airports as a result of the unwinding of 'network pricing' inherited from the days of government service provision. As noted by Northern Territory Airports (sub. 37, p. 6), this effectively meant that users of these smaller airports had been cross-subsidised by those using the larger airports.

More modest increases since then

Since this realignment of charges, subsequent increases in average aeronautical prices have been more modest (table 2.1) and have been influenced by a range of factors, particularly:

- new investments which have resulted in agreed 'add-ons' to the underlying set of negotiated charges for existing infrastructure; and
- the pass-through of the cost of mandatory security upgrades. Such security expenses have risen significantly in recent years — more than doubling as a share of total aeronautical expenses at most of the monitored airports between 1998-99 and 2004-05, with further increases since.

Table 2.1 **Changes in aeronautical charges^a; 2003-04 and 2004-05**
Per cent

	<i>Adelaide</i>	<i>Brisbane</i>	<i>Canberra</i>	<i>Darwin</i>	<i>Melbourne</i>	<i>Perth</i>	<i>Sydney</i>
2003-04	13	-2	-7	16	4	0	1
2004-05	3	9	11	9	3	4	3

^a Aeronautical revenue per passenger.

Sources: ACCC (2004; 2006a).

Indeed, the ability of airports to vary prices year on year since the introduction of price monitoring has been heavily constrained, as prices for their services are largely set through longer-term contracts (typically 5 years) primarily negotiated with the major airlines at the time price monitoring was introduced. The current round of contracts, which have determined prices since the lifting of price controls, are only now beginning to expire. Thus, any year on year change in prices provides at best only limited guidance as to whether any airport operators are taking advantage of their market power.

It is also far from clear that aeronautical prices would have been significantly different had direct price regulation continued subsequent to an unwinding of single till and network pricing arrangements.

- As mentioned earlier, the ACCC approved a 97 per cent increase in revenue for Sydney Airport in 2001 and set maximum revenue paths until 2004-05, which have determined base charges at Sydney Airport over the current period of price monitoring.
- Melbourne Airport (sub. 13, p. 37) surmised that, if price regulation had continued after 2002, the building block approach to setting prices would have resulted in price increases at the airport of 65 per cent, compared to the actual increase of around 50 per cent.
- Brisbane Airport (sub 35, p. 10) said that, in 2001, it based charges on the commonly used building block methodology and negotiated charges with the airlines that were lower than those ‘allowable’ using that methodology.

Structure of charges

In addition to the principle governing the relationship between revenues and cost outlined earlier, the Government’s Review Principles also state that:

- *Price discrimination and multi-part pricing are permitted to the extent that they promote efficient use of the airport.* This may mean that some users pay a price

above the long-run average costs of providing aeronautical services, whereas more price-sensitive users pay a price closer to marginal cost.

- *At airports with significant capacity constraints, efficient peak/off-peak prices may generate revenues that exceed the production costs incurred by the airport.* Such demand management pricing practices should be directed toward efficient use of airport infrastructure and, when not broadly revenue neutral, any additional funding that is generated should be applied to the creation of additional capacity or undertaking necessary infrastructure improvements.

Price discrimination

The structure of charges at the price monitored airports varies. Airports levy aeronautical and aeronautical-related charges on a number of different bases, such as the number of passengers, maximum take-off weight and duration of service use. In addition, while charges at some airports have several separate components, at others they are specified for service bundles.

‘Posted’ charges do not, however, usually differentiate between airlines, with the airlines frequently insisting on ‘terms no less favourable’ than those offered to competitors. Indeed, Melbourne Airport (sub. 13, p. 19) said that:

Airlines have historically resisted airport efforts to price discriminate and indeed, certain ICAO conventions prohibit airport price discrimination that favours home international carriers over foreign carriers, irrespective of whether such conduct is efficient.

Similarly, Northern Territory Airports (trans. pp 47–8), amongst others, indicated that, while it provides incentive schemes particularly for new entrants, such schemes are available for any airline to take-up, resulting in one pricing regime, whether it is discount or standard, for all airlines.

That said, the Australian Airports Association (AAA, sub. 38, pp. 1, 4) saw commercial incentives, including volume rebates, discounts and new carrier incentives which have emerged during the recent regulatory period as the early stages of price discrimination. However, Melbourne Airport (sub. 13, p. 24) said that such differentiation has been disguised to some degree:

... for a range of reasons, including commercial confidentiality, appearance of non-discrimination and “keeping the sanctity of posted prices”, [price discounts] are often treated as marketing expenses in airport accounts rather than revenue reductions.

While price discrimination is rarely used by airports — either on the basis of airport user characteristics or on the basis of time of day (see next section) — this is a

common practice among the airlines, which discriminate between passengers based on the price sensitivity of particular groups and on the basis of flight schedule times.

Congestion charging

Most of the price monitored airports are operating with considerable excess capacity in relation to their existing runway infrastructure. Even at Sydney Airport, traffic limits are only being reached or approached for a few hours each weekday. Accordingly, congestion charging, though allowed for by the Review Principles, has not been an issue at the monitored airports. Indeed, there is currently no differentiation of charges at any of these airports between peak and non-peak times.

Nonetheless, congestion charging is an issue that airports consider to be an option for the future. For example, Westralia Airports Corporation (trans. p. 86) commented on a significant increase in regional and mining flights to and from Perth Airport, saying that this is creating certain peak period timing issues. It went on to say that it is looking at using discounts (rather than a peak period surcharge) to encourage more flexible airport users to operate outside of peak periods.

Passenger-based aeronautical charges

The most significant change that has occurred in charging structures since the lifting of price controls has been the shift towards passenger-based charges for airside services.

Previously, maximum take-off weight (MTOW) was the standard method of charging for these services in Australia. However, only Brisbane Airport continues to levy landing charges exclusively on this basis (ACCC 2006a, p. 7), and is proposing to set the domestic landing charge for 2007 on a per-passenger basis 'if supported by the airlines and through commercial negotiations' (BAC, sub. 35, p. 29). Adelaide Airport allows airlines to choose between an MTOW and a passenger-based charge.

This shift to passenger-based charging has been a contentious issue, particularly for Virgin Blue. It argued (sub. 27, p. 4 and subsequently in sub. DR62, pp. 26-38) that weight-based charges are the most efficient basis for charging for the use of runways and similar facilities in terms of the cost drivers for that investment. In addition, it considered that the shift to passenger-based charging has discriminated in favour of full service carriers, such as Qantas. Acceptance of these arguments by the Australian Competition Tribunal was a key factor in its decision to declare domestic airside services at Sydney Airport under the Part IIIA national access regime (see appendix C).

These views were disputed by some of the airports (including SACL, sub. 26, appendixes A and B; and Melbourne Airport, sub. 13, pp. 58-66), which essentially queried the strength of the relationship between aircraft weight and runway investment requirements, compared to using passenger numbers as a reasonable proxy. They also questioned the extent to which low cost carriers are actually disadvantaged by such a charging regime.

These arguments are quite technical and heavily dependent on parameters such as the type of aircraft used in the analysis and load factors which can change over time. As well, there is more to the structure of charges than simply the most ‘technically efficient’ way of covering the cost of capital investment. Marketing strategies and risk sharing are also important considerations, with per-passenger charging being a means to share the traffic risk between an airport and its airline customers. As Regional Express (sub. DR64, p. 3) said:

In this manner, both the airline and airport are subject to similar risks in terms of passenger demand and its relationship with revenue.

Also, differences in airlines’ business models (or indeed differences in their internal cost structures) mean that airport charging structures will almost inevitably affect individual airlines differently. As such, these differential effects cannot, of themselves, be reasonably construed as an example of the misuse of market power.

In any event, the light handed price monitoring regime was not intended to dictate precisely how charges should be set. Rather, in seeking to assist the identification of any misuse of market power, its focus is on the relationship between overall revenues and costs.

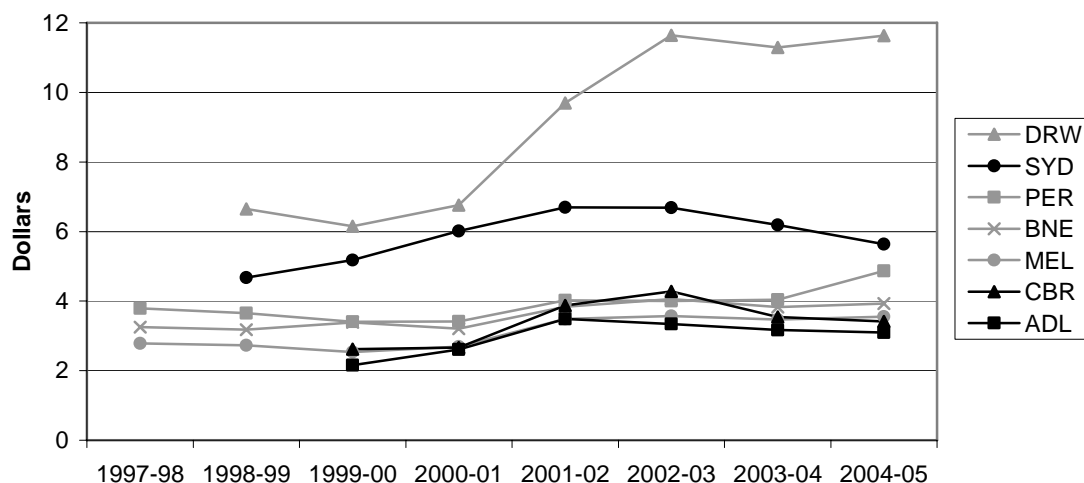
2.2 Costs and rates of return

Costs

In looking at the reasonableness of aeronautical charges, movements in costs are an important consideration. Indeed, this is explicit in the first of the Review Principles outlined at the beginning of this chapter.

The ACCC reports on aeronautical costs per passenger at the price monitored airports. Following large one-off increases in 2001-02 as a result of the significant downturn in air travel at that time, these costs have generally been stable or trending down (figure 2.2).

Figure 2.2 **Changes in aeronautical costs per passenger; 1997-98 to 2004-05**



Data source: ACCC (2006a).

This underlying stability in costs over time is to be expected, given the capital intensive nature of airport services and the long lives of most of the assets employed in their delivery. Indeed, with significant excess capacity at most of the airports, recent growth in passenger numbers would have put downward pressure on average unit costs. However, there have been offsets, particularly requirements to improve airport security and the need to fund major new investment at some airports.

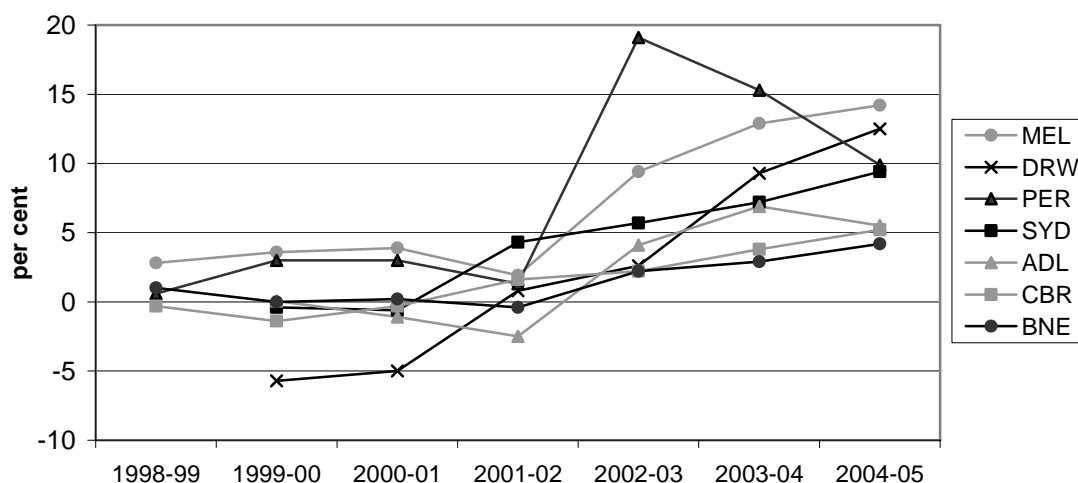
Such considerations mean that the cost data alone provide only limited insights into the reasonableness of airport charges. As both the ACCC (sub. 39, p. 72) and BARA (sub. DR48, p. 16) commented, the appropriate test is whether the ex-post rate of return on aeronautical assets has been 'reasonable' relative to the risks involved.

Rates of return

Under the previous price cap regime, rates of return for aeronautical services (when measured separately from airports' non-aeronautical activities) were low and often negative (figure 2.3).

Subsequent price increases, in combination with cost reductions from, amongst other things, strong growth in passenger numbers, have translated into higher rates of return for the operators of the price monitored airports. In 2004-05, (pre-tax) rates of return on aeronautical assets reported to the ACCC ranged from 4.2 per cent at Brisbane Airport to 14.2 per cent at Melbourne Airport.

Figure 2.3 Rates of return^a on aeronautical services at price monitored airports; 1998-99 to 2004-05



^a Earnings before interest, tax and amortisation expenses (EBITA) on average tangible non-current assets.
Data source: ACCC (2006a).

That said, in most cases, the reported rates of return in 2004-05 were still below the benchmark rates determined by the ACCC for each airport under the previous regulatory regime, or proposed by the airports at the time of those determinations (see table 2.2).

However, drawing strong conclusions from this rate of return data on the reasonableness of airports' charges — and thus, whether there has been any misuse of market power — is not straightforward.

In particular, reported returns are critically dependent on the values ascribed by the airports to their aeronautical assets. Several of the airports have 'booked' sizeable asset revaluations — most notably Canberra Airport, where the revaluation has been almost 200 per cent — which have the effect of reducing the rate of return presented in the price monitoring reports. As discussed in chapter 4, asset values have been a matter of considerable debate between airports and airlines.

Also, rates of return are likely to vary according to the stage of the investment cycle. Much airport investment is large and lumpy, meaning that there is usually initial excess capacity in major new infrastructure. With smoothing of prices, revenues and rates of return will tend to increase as capacity utilisation improves (see Melbourne Airport, sub. 13, p. 17).

Table 2.2 Comparison of reported rates of return with previous 'benchmark' rates

Per cent

<i>Airport</i>	<i>EBITA on aeronautical assets^a, 2004-05</i>	<i>ACCC benchmark rate of return (various years 1999 to 2001)^b</i>	<i>Benchmark rate proposed by airport operators^c</i>
Adelaide	5.5	10.5	11.0
Brisbane	4.2	10.8	12.1
Canberra	5.2	10.9	10.9
Darwin	12.5	11.5	na
Melbourne	14.2	11.5	na
Perth	9.9	11.6	13.1
Sydney	9.4	8.7 ^d	10.4

^a Average tangible non-current aeronautical assets, as reported to the ACCC for price monitoring purposes.

^b Nominal Weighted Average Cost of Capital (WACC) used by the ACCC in regulatory decisions relating to that airport. ^c Nominal WACC proposed by the airport at the time of the ACCC decision concerned. ^d The lower benchmark rate for Sydney Airport reflected the ACCC's view that the airport's risk premium was considerably lower than elsewhere. As evidenced by its proposed rate, Sydney Airport disputed this assessment.

Sources: ACCC (2006a; various pricing decision reports).

Such investment cycle effects, in turn, mean that the reasonableness of rates of return and underlying charges can only be fully assessed over the longer term — a point recognised by the ACCC (sub. 39, p. 74). This creates considerable problems for a monitoring regime required to report annually on profitability. Thus, as the AAA (sub. 38, p. 9) emphasised, it is important that assessments of behaviour based on price monitoring data acknowledge that:

... airport returns may temporarily increase above their long-run average as airports reach the peak of their capacity cycles.

2.3 How do charges, costs and returns compare with those at other airports?

Comparisons of charges, costs and rates of return at the price monitored airports with those at international airports, or at the larger non-monitored airports in Australia, can provide additional insights into the reasonableness of outcomes under the light handed approach. However, such comparisons must be treated with caution. As several participants pointed out (box 2.1), the characteristics of airports, and the market environment in which they operate, differ considerably. Equally, it is hard to dismiss the broad picture emerging from such comparisons as irrelevant.

Box 2.1 Some participants' comments on international benchmarking and airport performance

International

Virgin Blue (sub. DR62, p. 22) commented that costs and traffic mixes are not the same across airports, so comparisons of prices are not appropriate, while Regional Express (sub. DR64, p. 2) said that there are also substantial differences in regulatory arrangements. The latter went on to argue that:

Just because the level of profit in Australia might accord with levels elsewhere, does not necessarily mean it is justifiable. IATA, in particular, remains highly critical of airport charges and profit levels, especially in Europe.

Similarly, Qantas (sub. DR60, p. 13) commented that:

All or some of the 38 airports sampled ... may misuse market power, implying the Australian price-monitored airports are simply in the middle of a 'bad bunch'.

And in examining information on the five most expensive international airports depicted in figure 2.4, BARA (sub. DR48, p. 15) concluded that:

'there was no explicit (even light handed) form of economic regulation;
users had little input into pricing decisions;
users were provided with very little information on costs and profits; and
excessive profits were often extracted from government-owned airports to fund unrelated infrastructure, such a sea ports.'

Conversely, Melbourne Airport (trans. p. 7), which presented much of the international comparison data, commented that, while not perfect, there is no other data brought forward to contest the analysis.

Australian non-monitored airports

IATA (sub. DR59, p. 5) considered '... comparisons with non-monitored airports to be useless.' More specifically, BARA (sub. DR48, p. 16), said that airports with traffic volumes less than the large price monitored airports tend to have higher charges because of their smaller size — a view shared by Virgin Blue (sub. DR62, p. 22) and Regional Express (sub. DR64, pp. 2-3). Thus, Regional Express concluded that, if charges at the monitored airports are similar to those of the smaller non-monitored airports, it:

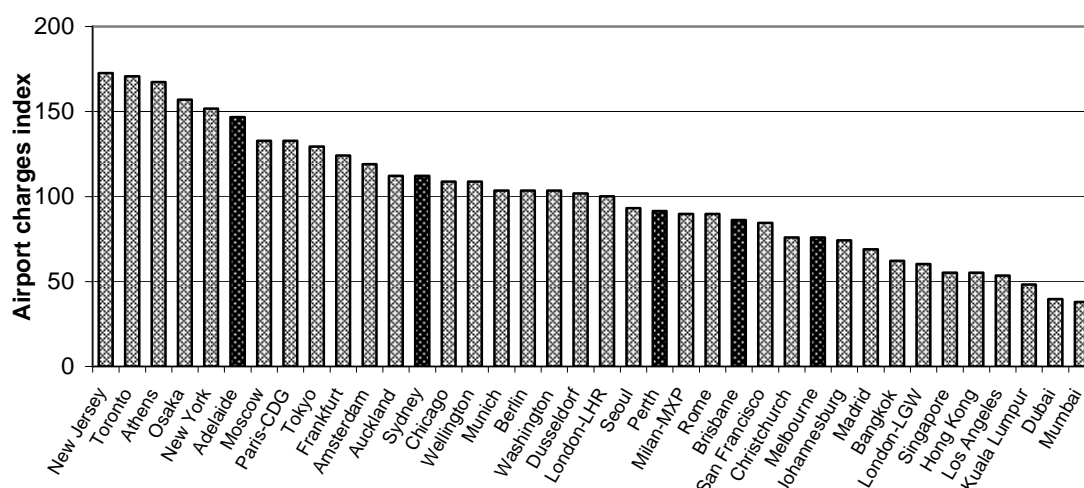
... clearly shows that the larger airports are using their market power and position of privilege to increase unit charges in an environment of steeply rising passengers and throughput.

Charges

Charges at the monitored airports in Australia appear to be well within the range of those at major overseas airports.

- A 2006 UK-based Transport Research Laboratory (TRL) study showed charges for international passengers at the five largest monitored airports in Australia as ranging from 40 to 80 per cent of the most expensive overseas airports (figure 2.4). Moreover, the relatively high charges at Adelaide Airport presumably reflect its low international traffic volumes and hence its limited capacity to spread ‘dedicated’ fixed costs.

Figure 2.4 Charges at selected international airports, 2005^a

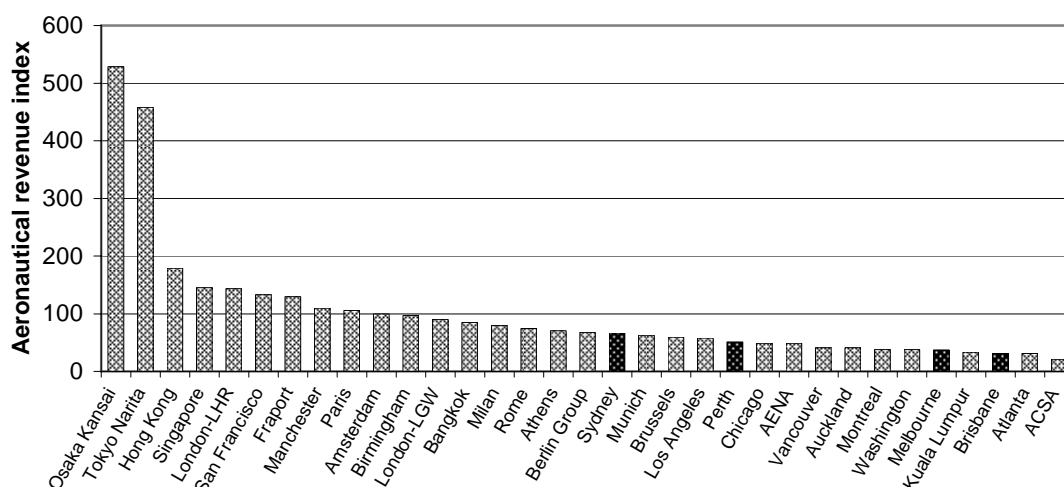


^a Calculated on the basis of the total charges for international carriers for landing, parking, passenger facilitation, navigation and security services for a sample of eight different aircraft types. Sample average = 100

Data source: TRL (2006b).

- A survey by the Canadian-based Air Transport Research Society (ATRS 2005) of total revenue per passenger in 2003 indicated that Sydney, Adelaide, Perth and Brisbane airports were at the low end compared with Asian and European airports, but comparable with US airports.
- This finding was supported by the TRL (2006b) study which showed that, in 2004, aeronautical revenue per air traffic movement at Australian airports was generally lower than for Asian and European airports, and comparable with that at North American airports (figure 2.5).

Figure 2.5 **Aeronautical revenue per air traffic movement ^a, 2004**



^a Revenue from aeronautical services including the provision of runways, taxiways and aprons. Includes all international and domestic flights. Sample average = 100.

Data source: TRL (2004).

The Commission also looked at how charges at the smaller monitored airports compared with those of the larger non-monitored airports in Australia. While the information needs to be treated cautiously as the size of the airports differs, there does not appear to be any systematic difference in charges across the two groups (table 2.3).

Table 2.3 **Comparison of listed charges^a at selected monitored and non-monitored Australian airports; 2006**

	Indexed charges (Hobart = 100)		Passenger numbers, 2004-05 ('000)	
	Domestic	International	Domestic	International
<i>Non-monitored</i>				
Hobart	100	-	1 150	-
Cairns	105	279	2 619	1 070
Gold Coast	173	185	2 944	250
<i>Monitored</i>				
Adelaide	148	299	5 028	325
Canberra	110	-	2 484	-
Darwin	207	207	1 105	160
Perth	112	151	4 678	1 977

^a Data on aeronautical revenue per passenger is not available for the non-monitored airports. Hence, the Commission has used listed charges for the purposes of this price comparison. These exclude security charges. Also, discounts and rebates serve to reduce the actual prices paid by airlines at some airports.

Source: Commission estimates based on information provided by airports in submissions and on their websites.

Costs

By international standards, cost levels at the major Australian airports appear to be low and productivity performance high (box 2.2).

Box 2.2 How do costs and productivity at Australian airports measure up internationally?

A recent study, undertaken by TRL (2006a) for Melbourne Airport, benchmarked various aspects of the performance of Brisbane, Melbourne, Perth and Sydney Airports against a selection of international airports. It found that while these Australian airports have relatively high fixed assets per passenger — reflecting generally greater excess capacity than in northern hemisphere airports — their total aeronautical costs per passenger are lower.

Another recent study, undertaken by ATRS (2005), indicated that Australian airports have significantly higher variable (ie. non-capital) factor productivity than other airports in the Asia-Pacific region.

In summarising the outcomes of the latest study undertaken by TRL (2006a), the AAA (sub. 38, pp. 8-9) said that:

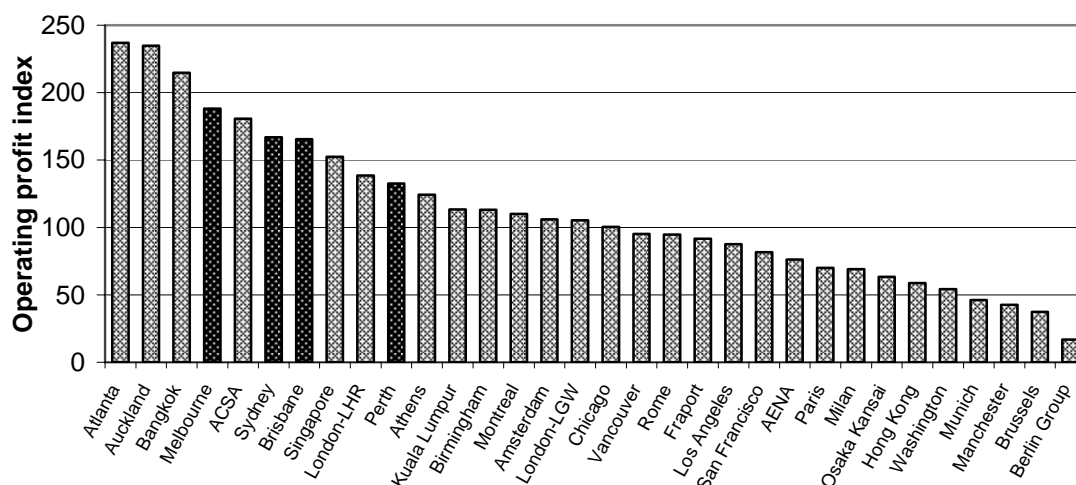
When comparing relevant measures of operational efficiency with international airport peers of a comparable size, Australian airports have better controlled the scale of cost increases experienced internationally. Across seven overseas peers selected for their similar size, average operating costs increased by 3.6% per annum between 2002 and 2005. Over the same period, Australian airports' costs increased by 2.7%.

Moreover, a study by ATRS (2005) comparing productivity levels across airports, concluded that high productivity at Australian airports may be partly a result of the light-handed regulatory regime now in place.

Profitability

A combination of 'mid range' airport charges and relatively low costs has meant that, by international standards, Australian airports are quite profitable. Indeed, the 2006 TRL study indicated that Australian airports are among '...the most profitable airports in the sample' (figure 2.6).

Figure 2.6 **Comparison of operating profit at selected international airports, 2004^a**



^a Sample average = 100.

Data source: TRL (2004).

2.4 Have price and rate of return outcomes been reasonable?

Given the difficulties in measuring and assessing airport performance, it is not surprising that views on the reasonableness of charging outcomes under the light handed approach have been diverse and to an extent predictable.

Airports saw price levels as reasonable, and even, to a degree, still lagging behind what they considered are warranted to establish a reasonable return on their investments (see for example Northern Territory Airports sub. 37, p. 11, and Brisbane Airport sub. 35, p. 13). As noted earlier, they also said that current charges are similar to those that would have been observed under a more direct price setting regime.

And, while suggesting that the lifting of price controls had resulted in a fairly substantial rent transfer to the airports, BARA (trans. p. 61) indicated that:

... the prices that are in place as at 1 July 2006 represent the appropriate basis for providing an adequate return to all the airport operators on their existing assets.

However, the major domestic airlines considered that the airports, to varying degrees, are taking advantage of their market power to impose excessive charges, resulting in a situation where (especially as a result of the strong recent growth in passenger traffic) those charges are over-recovering the cost of efficient service

delivery. Further, Virgin Blue (sub. 27, p. 4) contended that excessive margins have been largely disguised through unwarranted asset revaluations.

To support its views, Virgin Blue commissioned the Allen Consulting Group (ACG) to review each of the monitored airports' charges to assess whether they are significantly above the long-run costs of efficiently providing aeronautical services. The ACG (2006) report concluded that:

A common theme across all of the airports is that, over the period since the removal of formal price controls on the airports, actual revenue has risen substantially above 'total cost' and, if aeronautical prices remain as they are, this gap would be expected to continue to grow. (attachment to sub. 27, p. 13)

Central to this conclusion was the use (other than at Sydney Airport) of asset values derived from the revenue earned during the previous price control regime (box 2.3). Because no explicit values were put on aeronautical assets at the time the monitored airports were sold (see chapter 4), asset values for such a calculation must necessarily be estimated indirectly.

Box 2.3 Summary of the methodology used in the Allen Consulting Group report

The specific methodology employed by the Allen Consulting Group was as follows.

With the exception of Sydney Airport, the regulatory value for each airport's assets was derived as the asset value that was consistent with the revenue earned during the previous price control regime, using standard regulatory approaches for calculating 'long run cost'. Once an initial asset value was locked in, this calculation of 'long run cost' was then extended over the period since price monitoring was introduced, taking account of actual operating expenditure and new investment over that period.

For Sydney Airport, the method was more straightforward, the ACCC asset value was adopted, which was determined as \$1404 million as at 1 July 2000. 'Long run cost' was then calculated for that time forward, again using standard regulatory approaches and taking account of actual operating expenditure and revenue over the period.

Source: ACG (2006, p. 9).

However, the basis for valuation used by the Allen Consulting Group is problematic, leading to asset values which the Commission considers to be too low. Essentially, the approach rejects the conclusions drawn in the Commission's 2002 review, that the prices under the previous price cap regime were unlikely to be a good basis for efficient pricing (PC 2002, p. 357). Among other things, ACG's asset values imputed from the previous regulatory regime's prices, are based on the single till and 'networked' charges existing at the time, meaning that they do not directly relate to the actual cost of providing aeronautical services at each of the monitored airports — a point also made by Brisbane Airport (trans. p. 170).

In addition, as mentioned earlier, current charges at the price monitored airports are essentially set by long term contracts based on the best knowledge, at the time of contracting, about such things as market growth and expected cost movements. A more rapid than expected growth in the market, as appears to have occurred at most of the monitored airports, will result in higher than expected revenues and returns because costs do not increase commensurately. Conversely, had the market grown less than anticipated, revenues and profitability would not have met expectations. It would thus be inappropriate to automatically infer misuse of market power from an outcome favourable to the airports that results from unforeseen circumstances. While some adjustment to charges has been made at some airports to allow for the impact of unanticipated passenger growth, in the broad, this is more an issue for adjustment at the subsequent round of contract negotiations.

The Commission further notes that, while it is important not to draw too much from international comparisons given the differences between airports and their regulatory regimes, the benchmarking information reported above indicates that charges for international carriers at Australian airports are, for the most part, mid-range by international standards.

And, while some Australian airports are more profitable by international standards, this is itself not a bad thing. Australia's future airport needs will not be well served if airports have insufficient funds to invest.

In summary, the Commission considers that it would be reasonable to conclude that price and rate of return outcomes are not outside the boundaries that might have been expected when monitoring was introduced. Prices have risen, but the bulk of these were endorsed by the Government in the move to a light-handed regime, in large measure, to ensure that future investment needs are properly addressed.

That said, the effectiveness of the light handed approach in constraining prices will be more apparent from the outcomes under the next round of contract negotiations, especially as the previous regime will be much less influential than at the outset of price monitoring. Moreover, given the extent of past price increases, there may be little reason for further rises, other than to pay for major new investments and any additional security upgrades. Indeed, as the airlines have pointed out, the stronger than anticipated passenger growth in recent years, and an expectation of steady growth for the foreseeable future, will enable airports to spread fixed costs over a much larger passenger base. This should put downward pressure on prices.

2.5 The impact of any overcharging

In assessing the reasonableness of price outcomes under light handed regulation, the Commission has also been mindful of the impact of any overcharging. If demand for air travel is very sensitive to the level of aeronautical charges, then even a small degree of overcharging would be a cause for concern on efficiency grounds. Conversely, if variations in aeronautical charges do not have much impact on the overall level of air travel, then there is less need to go beyond establishing that current charges are not excessive.

In this regard, airports indicated that aeronautical charges represent only a small part of the ticket prices faced by airline customers (Northern Territory Airports, trans. p. 48; Melbourne Airport, sub. 13, p. 37). The implication of this proposition is that charges — and more particularly, charges which may be somewhat above efficient costs — will have only minimal impacts on demand, with the main effect being on the profitability of airports and airlines.

Virgin Blue (sub. DR62, p. 8) strongly disputed this view, saying that aeronautical charges constitute a significant proportion of its commonly offered fares. It also said (sub. 27, p. 23) that:

... airport aeronautical charges are especially significant for LCCs [low cost carriers] such as Virgin Blue. This is because the LCC business model depends on being able to keep costs to a minimum so as to be able to stimulate additional demand for air travel through offering lower fares.

The airline submitted confidential information which suggested that even modest increases in aeronautical charges could have sizeable impacts on the volume of air travel at some airports.

However, in the Commission's view, while increases in airport charges will obviously have some effect on demand for air travel, especially in the price sensitive segments of the market, the magnitudes suggested in the confidential material supplied by Virgin Blue seemed very high. In this regard, the Commission notes that the recent sizable fuel surcharges added to ticket prices as a result of an increase in oil prices (and many times higher than any plausible airport overcharging) do not seem to have had much effect on the demand for air travel – a point which the airlines did not contest at the public hearings.

The impact of any overcharging on demand will also be mitigated by the capacity of airlines to price discriminate — that is, to charge higher prices for less price sensitive business travel, and lower prices for private and holiday travel. Thus, airport charges need not be, and in practice are not, allocated uniformly to fares, but

can be primarily recovered from those passengers less sensitive to the cost of travel, with a correspondingly reduced impact on demand.

In summary, the Commission considers that the consequences of any ‘overcharging’ for aeronautical services for the efficient level of air travel are likely to be small. Rather, the main effect will be a shift in profits between airports and airport users. While some airlines clearly do not accept this proposition, the Commission notes that there is some tension in their arguments in this context and their view that any undercharging of airport services as a result of constraining asset values, will have minimal impact on efficiency (see chapter 4).

2.6 Service quality

Quality of service monitoring was originally introduced to complement price cap regulation, and has been retained under the price monitoring arrangements to:

- reinforce commercial incentives for airports to maintain appropriate service standards; and
- enhance transparency and comparability between airports, and in so doing, assist airport users negotiating with airports and governments to address regulatory matters pertaining to airport activities (ACCC 2006b, p. 1).

In undertaking this quality monitoring at the seven price monitored airports, the ACCC focuses on those facilities and services provided by, or that could be influenced by, the airport operator, including: airside facilities such as runways, taxiways and aprons; terminal facilities; car parking; and taxi and bus pick-up and drop-off points. (Domestic terminals owned and/or operated by airlines are not included.) The ACCC draws on information from a variety of sources, including airport operators, airline passengers, airlines, Airservices Australia and the Australian Customs Service.

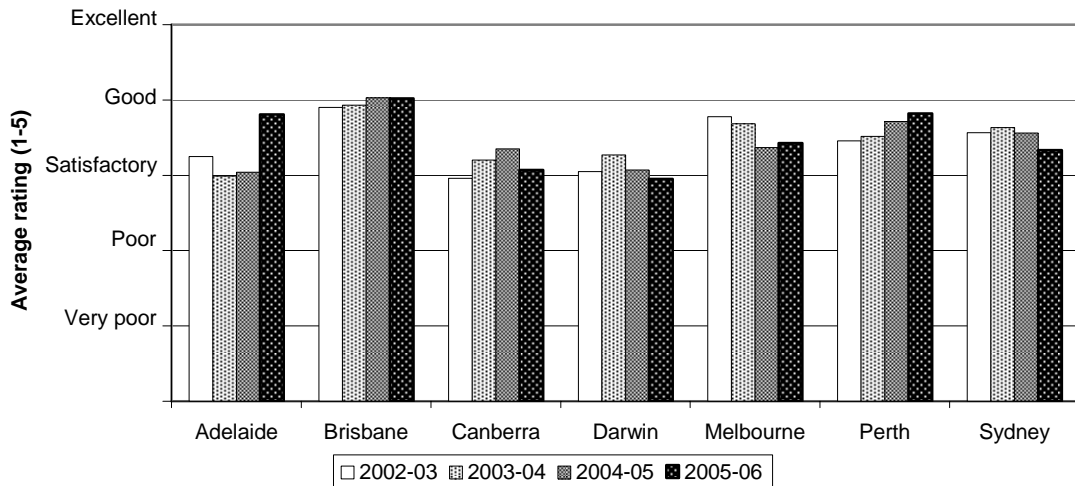
A number of specific performance indicators are prescribed in the Airports Act and associated regulations. These include both objective indicators, relating to the number, availability and adequacy of particular facilities, and some subjective satisfaction ratings by airlines and passengers.

What does quality of service monitoring reveal?

Since the introduction of the current light handed regime, overall service quality at the monitored airports has been rated by the ACCC as satisfactory to good (figure

2.7), with little variation from year to year, except for the notable increase for Adelaide in 2005-06 following the opening of its major new terminal facilities.

Figure 2.7 Service quality ratings at the price monitored airports, 2002-03 to 2005-06



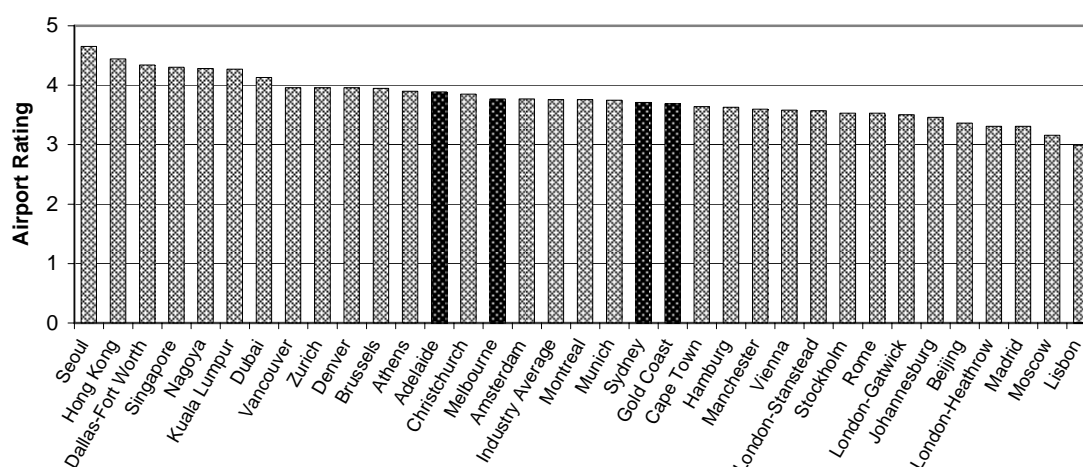
Data source: ACCC (2006b).

The information provided to the ACCC indicates more divergence in the quality of individual aeronautical services, and in the perceptions of individual stakeholders. However, this is not surprising as the specific requirements of particular airlines and their passengers will differ. For example, a quality of service which might be considered as appropriate by a full service airline might be viewed as involving an element of ‘gold plating’ by a low cost carrier.

More importantly, no evidence has been provided to the Commission suggesting that airports have sought to boost short term profitability through deliberate quality degradation. Indeed, there are indications of some improvement in overall quality levels. Moreover, according to the AAA (sub. 38, p. 14), global survey data suggests that Australian airports have been delivering international benchmark levels of quality (figure 2.8), a view that was not rebutted by airlines.

However, while quality levels themselves do not appear to be an issue for future policy, commentary from a range of participants raises questions about the intrinsic usefulness of aspects of the current quality monitoring process (see chapter 5).

Figure 2.8 Quality ratings for selected international airports, 2006



Data source: Airports Council International data obtained from AAA (sub. 38, p. 15).

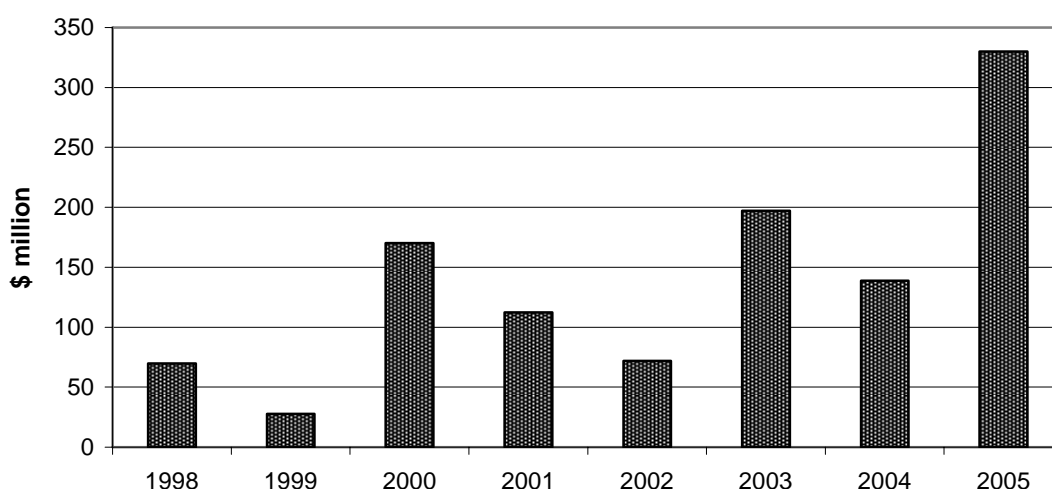
2.7 Investment

As indicated in figure 2.9, investment levels have been significantly higher since the price cap regime was abandoned. To a large extent, this has been driven by investment cycle effects and the need for runway upgrades for the A380 Airbus. Moreover, significant investment did occur under the price cap regime — such as that at Sydney Airport at the time of the Olympic Games. However, it seems clear from the evidence before the Commission that the move to a light handed price monitoring regime has made it much easier to undertake new investment and for airports to reach agreement with airlines on charges for that investment.

Under the price cap regime that applied until 2002, provision was made for separate increases in charges to fund ‘necessary new investment’ (NNI). But, undertaking such investment was not always easy, with the ACCC involved in both approving and pricing the investments concerned. Numerous concerns about the time consuming and inflexible nature of those arrangement were raised in submissions to this inquiry (for example, AAA, sub. 38, p. 15), with AUSCID (sub. 15, p. 4) noting that, on occasion, the ACCC had even overturned investment agreements reached between airports and their customers.

Synthesising the views of the airports, Westralia Airports Corporation (trans. p. 71) said that the period of light handed regulation has been very positive for capital investment, and that actual spending levels have been greater than were provided for in its agreements negotiated immediately after the price caps were removed.

Figure 2.9 **New aeronautical investment, 1998 to 2005^a**



^a Data are for the price monitored airports, excluding Canberra. Data collected by DOTARS indicate that capital expenditure at Canberra Airport between 1998 and 2005 was of the order of \$40 million. While the DOTARS data for the other monitored airports differ somewhat from that supplied by the AAA, the overall picture that emerges on investment spending is the same.

Data source: Derived from AAA (sub. 38, p. 15).

An additional benefit of removing the regulator from investment decisions, with a corresponding greater reliance on negotiation, has been that it has helped to build commercial relationships more generally and focused airport decisions on the needs of the customer.

That said, some participants contended that it was important not to overstate the benefits for investment of the move to light handed price monitoring. For example, Virgin Blue and the ACCC said some of the problems experienced under the previous price cap regime could have been ameliorated had that regime continued. In this regard, the ACCC (sub. DR54, p. 7) noted that it had ‘... identified some improvements that would have been desirable (were price cap arrangements to have continued) in its initial submission to the Productivity Commission’s previous airports inquiry’.

However, in the Commission’s view, it is not clear that such changes would have addressed the fundamental source of the difficulties posed for new investment under the price cap regime. Basically, the reason the current regime has improved the investment climate is because the regulator is no longer directly involved in decision making. Given the pivotal role of capital in enhancing and sustaining airport services, the improved investment environment delivered by the light handed approach is a very important benefit. It will be a source of further gains as a number of the major airports move into a new phase of the investment cycle.

2.8 Non-price terms and conditions

An important component of the agreements between airports and airlines are the non-price terms and conditions. These cover such things as the allocation of gates and parking bays, dispute resolution during the course of an agreement, and the right of the airport to vary such terms and conditions. Such matters can be just as important as aeronautical charges for the successful operation of an airline.

Airlines and other airport users voiced considerable concern about the imposition of what they saw as unreasonable non-price terms and condition by certain airports. Typifying these views, Qantas (sub. 28, p. 20) commented:

Agreements with airport operators regularly include (almost as a matter of course) unreasonable, non-commercial terms — the kinds of terms which one would not expect to find in a contract with anyone other than a monopolist and which shift risk from airport operators to airport users.

Some further views from Qantas on this issue are provided in box 2.4.

Box 2.4 Qantas' experience with non-price access issues

Qantas (sub. 28, p. 21) referred to airports denying or frustrating access to force acceptance of unreasonable terms and conditions. It said that, as a result, some airport users have entered into agreements that contain terms which:

- (a) provide operators with the unilateral right to increase charges for services, including aeronautical services;
- (b) have minimal (if any) service levels;
- (c) even where some service levels are included, have no penalty for the airport operator if it fails to meet those service level obligations;
- (d) contain no binding dispute resolution procedures; and
- (e) exclude the airport operator from liability for loss suffered in connection with the use of the airport or as a result of closure of the airport, even if that loss or damage is the result of the airport operator's own negligence or recklessness.

It went on to say that:

The current prices and quality of service monitoring regime is unable to address these kinds of non-price access issues, and airport users have little or no recourse when negotiating with airport operators – other than capitulating. The consequences of these access problems can be significant from an efficiency and public interest perspective.

Sydney Airport's behaviour in this area was also an important consideration in the Australian Competition Tribunal's decision to declare the airport's domestic airside services. The Tribunal (ACT 2005, para. 477) commented:

In the absence of declaration, we are satisfied that any commercial negotiations in the future as to the non price terms and conditions on which the airlines utilise the facilities

and related services at Sydney Airport are likely to continue to be protracted, inefficient and may ultimately be resolved by the use of monopoly power, producing outcomes that would be unlikely to arise in a competitive environment.

Not surprisingly, the airports disputed many of the airport users' specific claims. For instance, Sydney Airport (sub. 26, p. 19), a particular target of criticism, said that it had concluded comprehensive contracts with the majority of its customers, in most cases without undue difficulty or contention. It commented:

In SACL's view, the fact that so many airlines have accepted the Conditions of Use (with or without amendment) and agreed the terms on which they use terminal facilities demonstrates that those agreements or arrangements are far from unreasonable. It also demonstrates that airports and airlines are quite capable of achieving commercially negotiated outcomes without regulatory intervention.

That said, some airports acknowledged that not all had behaved in an exemplary fashion. For example, Westralia Airports Corporation (sub. DR58, p. 20) noted:

WAC accepts the Commission's [draft report] finding that the behaviour of airports in relation to some non-price terms and conditions of access has arguably been less than satisfactory and negotiations at Sydney Airport have been protracted.

Such diversity in airport behaviour in regard to non-price terms and conditions was also recognised by airlines and airport users. BARA (sub. 41, p. 1) said that:

At one end of the spectrum, for example, is the existing Melbourne Airport Agreement, which was at least based on a fair and reasonable assessment of what was expected by Government. At the other end of the spectrum, the ... non-price terms and conditions proposed by SACL were, in many instances, a step backwards from the previous draconian Conditions of Use document.

Furthermore, Melbourne Airport contended that there is an element of gaming in the airlines' complaints and that it is important to recognise that neither side can expect to get all it wants. By way of example, it commented (trans. p. 10) that:

... if Melbourne Airport had stood over Qantas, then why did Qantas nominate Melbourne Airport for the IATA Eagle Award in 2002, saying, "This is the sort of conduct we want"? It just beggars belief. This is the sort of gaming that we see. This is the sort of gaming that we saw in the NNI processes that the Commission rightly advised the Government to abolish.

Melbourne Airport also said (sub. DR55, p. 7) that there has been an anti-competitive element in some of the terms and conditions sought by particular airlines:

Our experience indicates that incumbents can also seek to use infrastructure issues to frustrate the entry of new competitors. ... Indeed, some of the non-price terms and conditions that have been sought by airlines have bordered on being anti-competitive. Clearly, these will be typically rejected by airports not only because of legal concerns

but also because ultimately they will lead to airport throughput being less than would otherwise be the case.

As the preceding discussion makes clear, there is a big divergence of views on the reasonableness of outcomes in this area. Non-price terms and conditions are clearly an important matter for the airlines and, to date, have often been more difficult to resolve than charging arrangements.

The fact that airport users may ultimately accept the conditions offered by the airports does not automatically imply reasonableness. As Regional Express (sub. DR64, p. 3) noted, it could simply reflect the strong bargaining position of the airports and the need for airlines to have access to services to continue to operate.

Equally, however, commercial negotiations will inevitably involve some give and take. And there may sometimes be a tension between terms and conditions that could favour incumbent airlines and those that airports might seek so as to promote competition and grow their business.

That said, given the acknowledgement by some airports that this is an area where there is some scope to improve behaviour, and given the Tribunal's concerns in relation to non-price terms and conditions at Sydney Airport, it seems reasonable to conclude that non-price outcomes under the light handed approach have been less satisfactory than charging outcomes.

2.9 Compliance costs

Complying with the price and quality monitoring regime requires the airports, and some other parties, to provide data to the ACCC. Much of the information submitted by airports will be collected in the normal course of business — including for internal management purposes, or for meeting agreed information disclosure obligations to airlines. But, according to the airports, the regime does involve additional costs in reporting some items in different formats, auditing the information submitted to the ACCC, and reviewing and commenting on the ACCC's draft reports.

Aside from Canberra Airport (see below), estimates of these additional costs for an individual airport ranged up to \$150 000 a year. While modest in terms of overall revenues for the larger airports (see Melbourne Airport sub. 13, p. 40, and Adelaide Airport sub. 23, p. 13), they are more significant for the smaller operators.

Canberra Airport (sub. 30, p. 13) claimed that it incurs much higher compliance costs, of the order of \$300 000 to \$375 000, even though its systems only allow it to

partially meet the reporting requirements. It went on to say that to introduce the information technology and baggage recording systems necessary to allow it to fully meet the current quality monitoring requirements would involve a significant capital outlay.

In the Commission's view, in an overall sense, compliance costs are low, and certainly do not appear to be a major concern for the larger monitored airports. Moreover, the Commission proposes (in chapter 5) to exclude Darwin and Canberra Airports — the two airports where compliance costs loom largest — from the post-2007 price monitoring regime. In addition, it has explored some possibilities for streamlining monitoring arrangements which could help to reduce current compliance requirements and costs.

2.10 Conclusion

Against a number of performance indicators, the light handed regulatory approach has measured up well. Most importantly, it has made it much easier for airports and airlines to agree on what new investment is required and the charges necessary to pay for it. This is in contrast to the problems acknowledged by airports and airlines alike under the previous price cap regime. In addition:

- the recent productivity performance of the airports has been high by international standards — with one study suggesting that this may be partly due to Australia's less intrusive regulatory approach;
- service quality continues to be rated by the ACCC as satisfactory to good, with the monitored airports appearing to offer 'reasonable value for money' by international standards; and
- for the larger monitored airports in particular, compliance costs have been quite modest.

At the same time, non-price outcomes — which, are not explicitly encompassed by the monitoring arrangements — appear to have been less satisfactory.

Assessing whether current charges for aeronautical services at any of the price monitored airports are generating 'excessive' revenues for airport operators requires considerable judgement, and rests on assumptions about which there is clearly not a consensus position.

That said, it is hard to sustain a case that charging outcomes to date have been clearly outside the sort of boundaries envisaged when price monitoring was introduced. Indeed, the current charges have been heavily influenced by the building block methodology developed under the regulatory regime. It may well be

the case that current price levels and revenues are not greatly different from those that would have been observed had airport charges continued to have been set under the building block approach used by the ACCC to determine allowable charging levels at Sydney Airport in 2001. The implication is that the scope for price monitoring (and the other elements of the light handed approach) to constrain prices will be better and more readily judged once successor agreements have been concluded.

3 The post-2007 policy framework

Key points

- Price monitoring, as part of a light handed regulatory approach, was intended to constrain the misuse of market power by the major airports, while greatly reducing regulatory intrusion into their commercial dealings with airlines and other customers.
- In overall terms, and against its objectives, the light handed approach has measured up well — with the emergence of a much better investment environment at the major airports being a major benefit.
- However, the ‘market’ constraints on airports’ charging levels appear to be less significant than was anticipated when price monitoring was introduced. And some systemic shortcomings have detracted from the effectiveness of price monitoring and the light handed approach more generally.
 - The monitoring arrangements do not explicitly encompass non-price terms and conditions and there is little policy guidance on the contentious issue of asset valuation at the monitored airports.
 - There is no clarity as to when further investigation of an airport’s conduct should be undertaken, and no process for initiating it.
- With modifications to address these systemic deficiencies, a further period of price monitoring when the current arrangements end in June 2007 would be preferable to a reversion to stricter price controls.
- However, a recent Federal Court decision potentially making the Part IIIA national access regime more ‘accessible’, might in future see that regime become the operative regulatory instrument at the major airports. Were this to eventuate, there would be little policy reason to continue with price monitoring.
- On wider policy grounds, there is a case for a legislative amendment to ensure that Part IIIA remains, in practice, a ‘last resort’ mechanism with a high ‘entry bar’.
 - Any significant lowering of the entry bar could have adverse ramifications for investment in a range of infrastructure services, including airports.
 - The uncertainty that has been created by the Federal Court decision may of itself deter investment, even if it ultimately transpires that the entry bar has not been significantly lowered.

In the previous chapter, the Commission examined a range of specific price and non-price outcomes since the introduction of the light handed regulatory approach to oversighting the behaviour of Australia’s major airports.

In this chapter, and against the backdrop of these outcomes, the Commission has considered what policy framework should apply after June 2007 when the current price monitoring arrangements are due to end. In so doing, it has looked explicitly at the underpinnings for, and robustness of, the light handed approach. It has also had regard to the potential implications of the recent Federal Court decision to uphold the Part IIIA declaration of the domestic airside service at Sydney Airport. As outlined later, this change in the regulatory landscape raises some questions about the sustainability of light handed regulation for infrastructure services, including those provided by the major airports.

3.1 How effective has the current approach been?

Participants' views

Airports considered that the approach has been a success

Airports said that the light handed approach to oversight of their activities and pricing behaviour has: delivered good price and quality outcomes for airlines and the travelling public; facilitated the more efficient provision of their services; created a more favourable environment for undertaking investment; and improved their customer focus.

Accordingly, they were strongly of the view that there is no case for a return to more stringent price controls, emphasising that this would discourage investment at precisely the time several of the major airports are entering a new phase of the investment cycle. Indeed, the smaller monitored airports considered that once the current arrangements end in June 2007, they should be exempted from any such future requirements.

That said, airports argued that aspects of the light handed approach require attention if the transition towards a fully commercial environment is to continue. Paramount amongst these was a perceived need to resolve the contentious issue of asset valuation, with most airports indicating that the policy vacuum in this area is the major deficiency in the light handed framework (see chapter 4).

Airport users identified significant shortcomings

Most airlines and other major airport users acknowledged that the commercial focus engendered by the light handed approach is an improvement over previous

arrangements, and that it is now easier for airports to undertake major new investment.

Airlines also recognised that they have been able to engage in productive negotiations with some airports. For example, in commenting on its relationships with individual airports, Qantas (trans. p. 113) said that:

... in some cases where the airport leadership and the airport itself adopts a reasonable position during commercial negotiations it is entirely possible to get an outcome.

Similarly, while describing relationships with some airports as ‘extremely strained’ or somewhat ‘frosty’, BARA (trans. pp. 57-58) commented that for the majority of airports, international carriers are ‘probably reasonably confident that [they] can develop a sound commercial relationship going forward’.

Nonetheless, airlines and other airport users considered that price monitoring (in conjunction with the other elements of the light handed approach) has failed to prevent significant misuse of market power by some airports. They went on to contend that, as a result, airport customers have not fully realised the potential benefits of the more commercial environment.

Some of these concerns reflected a very different perspective to airports on the reasonableness of current charges. In particular, as outlined in chapter 2, airlines considered that they should have benefited more from the unit cost reductions resulting from stronger than anticipated growth in demand at most of the monitored airports. They also pointed to perceived deficiencies in some detailed design aspects of price monitoring. For example, there were claims that inadequate service coverage has enabled airports to introduce new charges that are not subject to oversight.

In addition, airlines drew attention to what they perceived as ‘systemic’ deficiencies in the light handed approach. Like the airports, they considered that the absence of agreed aeronautical asset values, and of policy guidance on asset revaluation issues, has undermined the credibility of price monitoring, contributed to significant disputation and frustrated the development of commercial relationships more generally. But they also argued that:

- the constraining effects on aeronautical charges of airline countervailing power and the linkage between passenger throughput and airports’ non-aeronautical revenues had been overestimated;
- the regime contains no clearly defined trigger for a possible return to more stringent price control. For example, in its report for Qantas, NERA (2006, pp. 36-7) argued:

... although there have been some statements regarding the threat of re-regulation, in practice the threat has lacked credibility. This is because the line between acceptable and unacceptable changes in charges is not known, and the process of implementing re-regulation is not clear, open and transparent;

- there is no explicit mechanism for monitoring airport behaviour in relation to non-price terms and conditions; and
- there is no binding, airport-specific, dispute resolution mechanism available to airlines, with the generic Part IIIA regime being time consuming and expensive to access.

Users sought to strengthen the light handed approach

Despite these significant misgivings, aside from IATA (sub. 17, p. 3; sub. DR59, p. 3) and the Overnight Airfreighters Association (sub. 6, p. 2), there was no support from major airport users for a generalised return to explicit price-cap regulation.

Rather, airlines and other users put forward a range of proposals to strengthen the current price monitoring regime and the light handed approach more generally.

- Like the airports, they saw resolution of the asset valuation issue as being a very high priority.
- Also, and though professing support for continuation of light handed regulation, the major airlines proposed augmenting price monitoring with some sort of binding dispute resolution mechanism. As discussed in chapter 4, some of their suggested ‘negotiate-arbitrate’ models could, in time, lead to a return to heavy handed regulatory determination of charges and terms and conditions for airport services.

The Commission’s assessment

The intended outcomes

In forming a view about the results achieved under the light handed approach for overseeing the provision of aeronautical services, it is crucial to appreciate the underlying conceptual framework and objectives.

In essence, the approach was intended to constrain the misuse of market power by the major airports, while greatly reducing regulatory intrusion into their commercial dealings with airlines and other customers. It replaced a price cap regime that was widely acknowledged to have put various hurdles in the way of new investment,

diverted management resources to dealing with the regulator and impeded the development of commercial relationships between airports and airlines.

Price monitoring is a central element of the approach.

However, there was also a presumption that a range of other market and regulatory constraints would further help to curb serious misuse of market power by airports. Apart from the explicit threat of re-regulation, and the associated guidance on acceptable outcomes in the Government's 'Review Principles', other elements of the light handed approach included:

- perceived scope for airlines to exercise some countervailing power;
- incentives for airports to hold down aeronautical charges so as to increase passenger throughput and thereby boost non-aeronautical revenues; and
- the option for airlines to seek declaration of airports under the Part IIIA national access regime where commercial agreements cannot be reached.

Within this less restrictive market environment, it was expected that commercial negotiations would generally be the basis for establishing prices and terms and conditions of access for aeronautical services. Indeed, to encourage such negotiations, the arrangements explicitly provided for some latitude and flexibility in regard to price outcomes. Thus, the Review Principles specify that efficient prices *broadly* should generate expected revenue that is not *significantly* above the efficient cost of service provision (including a return on assets commensurate with the commercial and regulatory risks involved).

Some encouraging outcomes but also some problems

The Commission's analysis of specific outcomes in the previous chapter suggests that, in overall terms and against its objectives, the light handed approach has measured up well. Most importantly, it has created a more favourable investment environment at the airports. Also, while the continuing influence of the previous regulatory regime complicates assessments of price outcomes, so far charges do not appear to have been excessive, suggesting that there has not been systematic misuse of market power in this regard.

However, there have been some problems — especially in relation to non-price outcomes — and relationships between some airports and their customers have been strained.

Moreover, some systemic shortcomings in the light handed approach have detracted from its effectiveness. Apart from the fact that there is no explicit oversighting of

non-price terms and conditions, it is accepted by all of the parties that the asset valuation issue must be addressed.

But perhaps most importantly, there is no clarity as to when there should be further investigation of an airport's conduct, and no process for initiating that investigation. Based on outcomes so far, the absence of any such investigations *may* have been appropriate — though this is strongly disputed by airlines. However, it is currently not possible to differentiate between determined and passive policy inaction.

When price monitoring was introduced, the absence of such a trigger or process may have been a lesser cause for concern given expectations that various other factors (beyond the general threat of re-regulation) would constrain significant overcharging by airports. But with the benefit of hindsight, it is apparent that some of those constraints are not as strong as was previously envisaged (see box 3.1).

Significantly, this gap in the current arrangements is contributing to perceptions in some quarters that the threat of re-regulation if there is serious misuse of market power by airports is not a credible one. It has also seemingly been a major consideration in the call by airlines for the introduction of an airport-specific arbitration mechanism — something which the Commission considers would fundamentally compromise a light handed regulatory framework (see chapter 4).

3.2 The approach proposed in the Draft report

In its Draft Report, the Commission was especially mindful of the fact that only now is the capacity of the light handed approach to constrain airport charges beginning to be fully tested. And with Australia at the forefront of light handed regulation in the airports area, there is little overseas experience to draw on.

Hence, the Commission concluded that it is still too early to judge whether a (modified) light handed approach could in future:

- provide a realistic constraint on the exercise of market power as the influence of the previous regulatory regime recedes; and
- foster the trust, attitudes and commercial relationships between the parties that might in time remove the need for any form of explicit prices oversight.

It went on to argue that it would therefore be premature to dispense with price monitoring (and the accompanying threat of re-regulation) and rely solely on the Part IIIA national access regime to constrain misuse of market power — especially as at that time the likely applicability of Part IIIA in the airports area was subject to a range of uncertainties.

Box 3.1 Constraints on airport market power

In introducing light handed price monitoring, the Government accepted the proposition in the Commission's previous report on airport pricing (PC 2002) that several features of the market environment would constrain aeronautical charges.

Airline countervailing power

Like any large customer, the major airlines will potentially be able to bring a variety of pressures to bear on airports as part of negotiations on charges and other matters.

The extent of airline countervailing power in dealing with airports was a key consideration in the Australian Competition Tribunal's decision to declare the domestic airside service at Sydney Airport. In that decision, the Tribunal argued that Qantas and Virgin Blue have little ability to bypass or withdraw their services from Sydney Airport, given the airport's monopoly position and its importance nationally (ACT 2005, para. 496). This conclusion has been used by some to argue that airlines have little countervailing power in their dealings with any of the major airports.

In the Commission's view, the scope for either the domestic or international airlines to collectively withdraw large numbers of services at Sydney Airport is very low. However, there will be opportunities for adjustments at the margin.

And at some of the other larger airports — particularly those more heavily reliant on holiday traffic (and therefore in competition with other tourist destinations) — both the scope and incentives for airlines to adjust airport usage in response to changes in costs is likely to be somewhat higher than at Sydney.

Moreover, airline countervailing power does not only arise from scope to withdraw or reduce services. Airlines can, and have, relocated maintenance or administration functions. And they may also be able to influence outcomes through tying up management resources (being difficult customers), or by 'playing the media card'.

Even so, in an overall sense, airline countervailing power may well only be a modest constraint on airport charges. Indeed, the strong bargaining position of the major airports is precisely why they continue to be subject to regulatory oversight.

The influence of non-aeronautical revenues

In its previous report, the Commission (PC 2002, p. xxvii) argued that the negative impact of higher charges for aeronautical services on passenger traffic, and hence on demand for an airport's non-aeronautical services (such as retail concessions), would operate as a constraint on those charges.

While this general proposition is not disputed, the National Competition Council (NCC 2003b, p. 74), the ACCC (sub. 39 p. 23), the Australian Competition Tribunal (ACT 2005, para. 512) and airlines submitting to this inquiry have all argued that, in practice, the constraint is a very weak one. For example, Virgin Blue (sub. 27, p. 63) contended that in the case of Sydney Airport:

Continued next page

Box 3.1 continued

...assuming a demand elasticity for air travel of -1, a doubling of the current charge for the Airside Service will bring additional Airside Service revenue of \$39.68 million while only resulting in a decrease in non-aeronautical revenue of \$3.95 million ...

That airports are not responding to such apparent incentives to substantially increase charges suggests that other factors are at work, including the threat of re-regulation.

Nonetheless, the Commission accepts that the further analysis in this area since its 2002 report indicates that a desire to sustain and build non-aeronautical revenues is unlikely to be a significant constraint on aeronautical charges. Hence, as the later discussion in this chapter makes clear, the Commission's support for a further period of price monitoring is not in any way predicated on such a constraint.

Market expansion

Evidently, airports will benefit from greater use of their facilities by airlines. Thus, it is sometimes argued that the pursuit of new airline business will be a further check on aeronautical charges.

As the provision by airports of various incentives and rebates to attract new business illustrates, market expansion strategies will sometimes reduce the net charges paid by particular airlines. However, this does not mean that the fundamental commercial incentive for airports to exploit any market power, or the overall level of 'monopoly profit' potentially on offer, are diminished. Indeed, growth in the market for an airports' services will increase, not reduce, these potential profits.

Equally, the Commission emphasised that, based on the experience with the light handed approach to date, a return to stricter price controls was not warranted. It argued that such back-tracking would make it more difficult for airports to undertake the new investments needed to cater for growth in passenger traffic and to facilitate service quality improvements. It also noted that a reversion to stricter price controls would put at risk the good productivity performance of Australian airports, leading amongst other things to a return to an environment in which considerable managerial resources were employed in dealing with the regulator and seeking ways to 'game the system'.

Accordingly, it concluded that whilst not a perfect instrument, in the period ahead, price monitoring as part of a light handed approach is likely to prove a better option than either of the alternatives. It therefore proposed that monitoring at the major airports be extended for a further five-year period.

The Commission went on to suggest some changes to the service and airport coverage of price monitoring, as well as to some other more specific aspects of the current regime (see chapter 5). It also put forward two proposals directed at addressing the systemic shortcomings in the current regime outlined above.

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- The first of these involved the reconfiguration of the monitoring process to put greater emphasis on commentary from airports and airlines about the reasonableness of charging and other outcomes. The intention was to place policy makers in a better position to determine whether further investigation of an airport's behaviour might be warranted, without introducing the risk of de facto re-regulation inherent in the use of more mechanistic triggers.
 - The second involved a proscription on further asset revaluations. By taking this divisive issue off the bargaining table, the Commission's objective was to increase the likelihood that mutually acceptable outcomes can be negotiated by airports and their customers in a timely fashion.

(These two proposals, and participants' responses to them, are elaborated on in the next chapter.)

However, this suggested approach was put forward prior to a recent Federal Court decision of considerable importance to the future operation of the Part IIIA national access regime and its relationship to any further period of light handed regulation in the airports area.

3.3 The Federal Court decision

In October 2006, the full Federal Court dismissed an appeal by Sydney Airport Corporation Limited (SACL) against the Australian Competition Tribunal's decision to declare the airport's domestic airside service under the Part IIIA national access regime. This means that until December 2010, and subject to the outcome of SACL's application to the High Court for leave to appeal the decision (see appendix C), domestic airlines unable to reach agreement with the airport over charges or terms and conditions will be able to seek either legally binding private arbitration, or arbitration by the ACCC.

As noted above, 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.

However, the Federal Court's interpretation of one of the key declaration criteria may in future make it easier to secure declaration of major infrastructure services, including those provided by airports. In turn, this has the potential to see Part IIIA become a more active regulatory instrument in the airports area, and possibly even to render price monitoring redundant.

Moreover, even if subsequent judgements reveal that the Court's interpretation has not substantially lowered the Part IIIA 'entry bar', the decision has introduced a

new source of uncertainty to the infrastructure policy environment. In the short to medium term, this may discourage or delay some new infrastructure investment, including at Australia's major airports.

The Federal Court's interpretation of the 'competition' test

For a service to be declared under Part IIIA, it must meet a range of criteria (see box 3.2) effectively designed to establish that the service is provided by an 'essential' or 'bottleneck' facility and that access to the service would result in more efficient outcomes and enhance community well-being more generally. However, the criteria do not explicitly seek to establish that efficiency and well-being would be improved. Rather, promotion of competition in a 'related market' is used as a proxy for these outcomes.

As a result of amendments to Part IIIA that took effect on 1 October 2006, the competition criterion (s 44H(4)(a) of the Trade Practices Act) now requires that access (or increased access) would promote a *material* increase in competition in a related market. But the Federal Court decision was made in respect of a declaration determination under the previous requirement which was simply that access (or increased access) would promote competition in a related market.

Prior to the Federal Court decision, this criterion had essentially been interpreted by decision makers — including the Australian Competition Tribunal — as meaning that the act of declaration, and the access that would flow from such declaration, would promote competition. This in turn effectively required an assessment of conduct without declaration relative to that which might be expected with declaration.

But in upholding the Tribunal's decision to declare the domestic airside service at Sydney Airport, the Federal Court (FCAFC 2006) said that the Tribunal had 'infused an overly elaborate body of considerations' to the promotion of competition criterion (para. 94) and that:

We disagree with [the] approach, whereby 'access' becomes 'declaration under Part IIIA'. ...all s 44H(4)(a) requires is a comparison of the future state of competition in the dependent market with a right or ability to use the service and the future state of competition in the dependent market without any right or ability or with a restricted right or ability to use the service. (para. 83)

In reaching this view, the Court had regard to the Hilmer Report (Hilmer Committee 1993) which first proposed a national access regime for essential infrastructure, related COAG explanatory material, and those parts of the Competition Principles Agreement committing the Australian and State and

Territory Governments to establish such a regime. Amongst other things, the Court (para. 86) noted that:

None of this material reveals any necessity to examine the current state of access or to engage in an enquiry based on assessing the future with and without declaration. The essential precondition discussed was that access (that is in its ordinary meaning) was necessary to permit effective competition in the downstream or upstream market.

Box 3.2 The Part IIIA declaration criteria

A service can only be declared under Part IIIA if all of the following criteria are met:

- (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;
- (b) that it would be uneconomical for anyone to develop another facility to provide the service;
- (c) that the facility is of national significance, having regard to:
 - (i) the size of the facility; or
 - (ii) the importance of the facility to constitutional trade or commerce; or
 - (iii) the importance of the facility to the national economy;
- (d) that access to the service can be provided without undue risk to human health or safety;
- (e) that access to the service is not already the subject of an effective access regime;
- (f) that access (or increased access) to the service would not be contrary to the public interest. (TPA, s 44H(4))

As noted in the text, the first of these criteria was the subject of a recent amendment to ensure that access declarations are only granted 'where the expected increase in competition in an upstream or downstream market is not trivial' (Australian Government 2006, p. 3).

The Court (para. 85) did note that the conduct of the infrastructure owner might still be relevant:

For instance, if it can be demonstrated that the service has been provided in a manner that can be described as fair, even-handed and in a way most likely to maximise vigorous competition in the downstream market, that may be a powerful and relevant consideration as to why no declaration should be made.

And it further commented (para. 89) that:

In any given enquiry, there may be room in deciding whether or not to declare the service, to analyse the question whether the engagement of the regime under Part IIIA

by the declaration will have an effect on the competitive process in the dependent market.

However, it went on to reiterate that a ‘formalised’ investigation of conduct is not a pre-condition for satisfaction of the promotion of competition criterion.

Has the Part IIIA entry bar been lowered?

Several airports and airlines argued, in some cases drawing on legal opinions, that these interpretations will make it much easier to satisfy the first of the declaration criteria. Further, Melbourne Airport (sub. DR75, pp. 3-4) suggested that the public interest criterion (s 44H(4)(f)) could also be a less potent influence on future declaration decisions, observing that:

... where before a well behaving service provider could argue that declaration could lead to the risk of regulatory failure that would be contrary to the public interest, under the Court’s view of access such arguments would not be relevant to consideration of criterion (f).

But while a number of these participants went on to conclude that the Part IIIA entry bar has been lowered, possibly significantly, others were less certain that this will prove to be the case. For example, some made reference to the recent legislative amendments to Part IIIA. Apart from the change to the competition criterion to require that access will promote a material increase in competition, Part IIIA decision makers will in future need to have regard to an objects clause focusing explicitly on economic efficiency rather than the promotion of competition.

As a further point, Melbourne and Sydney Airports contended that the Federal Court’s comments on the relevance of the conduct of an infrastructure owner have greatly increased the residual administrative discretion available to those assessing declaration applications. Thus, Sydney Airport (sub. DR70, p. 20) said:

It has long been accepted that the Minister and Tribunal each have discretion ... beyond the mandatory criteria for declaration ... However, [the Court’s reasoning] impl[ies] that the scope of that discretion is extremely broad and, in fact, encompasses a potentially wide-ranging enquiry into the conduct of the infrastructure owner. ...

Melbourne Airport (sub. DR75, p. 2) went on to argue that the overall implications of the Federal Court decision are therefore less black and white. However, it also said that until the scope of decision makers’ discretion is clarified through the judicial process, the investment environment will be less certain and that:

This will necessarily give investors cause to pause, particularly those such as the owners of Melbourne Airport who face significant capital programs in the next three to

five years but need to commit to pricing and investment programmes in the next six months. (p. 11)

Some further comments from participants on these matters are provided in box 3.3.

Box 3.3 Views of participants on the Federal Court decision

Melbourne Airport (sub. DR75, pp. 5, 7)

The effect of the Court's approach, in relation to the Minister's decision as to whether to declare the relevant service, is arguably to:

- significantly increase the likelihood that the Minister will be satisfied of criterion (a);
- reduce the importance criterion (a)-(f) to this overall decision generally; and
- expand the scope of the Minister's residual discretion to take into account factors other than those listed in criterion (a)–(f).

[The legislative amendment to criterion (a)] appears [to be] relatively insignificant in the context of the Court's preferred interpretation. If the comparison is between no access to an essential upstream service and some access to that service then access is almost always likely to result in a significant increase in competition. As such it is largely irrelevant whether the test refers to the promotion of competition in the dependent market or a non trivial increase in competition in the dependent market.

SACL (sub. DR70, p. 2)

The Australian Competition Tribunal ... and subsequent Federal Court decisions in relation to Part IIIA of the Trade Practices Act ... suggest that the national access regime provides significantly easier recourse to declaration and arbitration than was considered to be the case when the light-handed regime was introduced, effectively 'lowering the bar' for declaration. The recent judicial interpretation of Part IIIA will result in uncertainty for infrastructure providers and will undermine the light-handed airports regulatory regime. The Government should consider amending Part IIIA to ensure it is operating as intended and to provide greater certainty as to its application.

Westralia Airports Corporation (trans. p. 78)

... there has been some lowering of the bar in the sense of the clarification of what the relevant subsection of section 44 means. ... [However], we also have to recognise that the decision was in the context of the Trade Practices Act that existed at the time — not the changes that have been made subsequently, and the requirements to look at the objects clause.

Qantas (sub. DR65, p. 2)

Based on this decision, it is clear that the prospect of airport services being declared under Part IIIA of the Act is greatly improved.

Virgin Blue (sub. DR71, p. 3)

The decision of the Full Federal Court has lowered the threshold for declaration under Part IIIA of the TPA. [Though] Criterion (a) has recently been amended ... this amendment does not affect the basic comparison required by criterion (a).

The Commission's assessment

As is evident from participants' comments, there is a need for caution in coming to a view at this juncture on precisely how the Federal Court's interpretation might impact on future declaration cases.

- There may be further developments ensuing from SACL's application to the High Court for leave to appeal the declaration decision.
- The recent amendments to Part IIIA intended to strengthen the promotion of competition test (criterion (a)) and to require decision makers to have regard to an objects clause focussing on the efficiency implications of declaration, must be factored into the equation.
- Also germane is the fact that the Federal Court has not ruled out the relevance of a service provider's conduct to the decision to declare.
- And, notwithstanding the recent introduction of target timeframes for various stages of the declaration process, securing a declaration will remain a costly and far from speedy process. Hence, this may inhibit some use of the regime even if the 'entry bar' has been considerably lowered.

Nonetheless, the Commission considers that the Federal Court decision is likely to make the Part IIIA declaration criteria easier to meet. Ostensibly, the decision has greatly reduced the relevance of conduct considerations to the promotion of competition test. Hence, as is the case for the 'national significance' and 'uneconomic to duplicate' tests (criteria (b) and (c)), assessments against this test seem likely, in future, to hinge primarily on structural considerations. Despite the new legislative requirement that the competition promoted by access be 'material' or 'non-trivial', it would seem to the Commission that any infrastructure service which meets criteria (b) and (c), will most likely meet criterion (a). Also, the Commission notes the legal advice provided to Melbourne Airport (see above) suggesting that the Federal Court decision has potentially reduced the role of the public interest test (criterion f) in screening out inappropriate declaration applications.

This in turn suggests that unless conduct considerations are reintroduced via the residual discretion available to the Minister, the Australian Competition Tribunal and the courts, then the Part IIIA entry bar will have been lowered. Furthermore, as precedents were established, any lowering of the bar would come to be implemented by default. That is, negotiations would take place between access providers and seekers — including airports and airlines — in the knowledge that declaration was easier to achieve and of the consequences that follow from declaration. From this perspective, the costs and time involved in invoking Part IIIA are unlikely to be a permanent offset to any significant lowering of the bar.

It may of course transpire that the exercise of residual discretion in relation to the conduct of a service provider subject to a declaration application will limit the magnitude of any bar lowering. But as discussed below, the effects of uncertainty ensuing from a greater role for discretion may be little different from those resulting from a lowering of the bar.

Any significant bar lowering would be an undesirable development

As outlined in the next section, a significant lowering of the Part IIIA entry bar could render the light handed approach for oversighting airport behaviour redundant.

However, as Part IIIA is both generally applicable and intended to provide an ‘umbrella’ under which various industry-specific access regimes operate, the Commission considers it important to explore the wider ramifications of any significant lowering of the bar.

In its 2001 review of Part IIIA, the Commission (PC 2001) emphasised that while access regimes can help to constrain the misuse of market power by those supplying monopoly infrastructure services, they also have a range of costs. Of particular concern in this regard is their potential to deter investment necessary to sustain and enhance services over the longer term (see box 3.4).

The Commission went on to argue that more needed to be done within Part IIIA to guard against the possibility of inappropriate declarations — that is, to raise the entry bar. As well as proposing the insertion of an objects clause along the lines of that recently implemented by the Government, it recommended that criterion (a) be amended such that access (or increased access) would need to offer the prospect of a *substantial* increase in competition. It also said that the impact of this more stringent test for declaration should be reviewed at a later date, to determine whether further strengthening was required.

Moreover, in proposing a strengthening of criterion (a), the Commission made it clear that it was the act of declaration — or ‘declared access’ — that had to promote a substantial increase in competition. That it did not make this explicit in its formal recommendation reflected a concern to minimise the extent of wording changes to the legislation — especially as, to that time, application of the criterion had always involved a comparison of access with and without declaration.

From these perspectives, the possible implications of the interpretation applied by the Federal Court to criterion (a) are concerning — even accepting that the precise consequences may not become apparent for some time. Unless conduct

considerations are reintroduced through the residual discretion available to decision makers, the Court's interpretation may make the Part IIIA regime a more accessible, and therefore heavy handed, regulatory instrument.

Box 3.4 The impact of access regulation on investment

The impact of access regulation on investment in essential infrastructure has been the subject of considerable debate. This is mainly because of the difficulty of establishing the counterfactual — that is, how would investment levels and the nature of that investment have differed in the absence of access regulation?

But it is widely acknowledged that potential exposure to access regulation can impede investment in essential facilities in two ways:

- It will increase the risk and thereby the cost of investments. Such risk attaches to investment in any regulated activity. However, the scale of investment in essential infrastructure, and the fact that, once in place, assets are sunk, means that regulatory risk is likely to be a more pervasive influence on decisions to invest than in many other areas.
- Investments in essential infrastructure will also be deterred if prospective terms and conditions under regulated access are not seen as providing a sufficient return to infrastructure owners. A particular issue here is that the possibility of earning higher than normal returns on successful projects may be required to balance the possibility that some projects will fail. If regulatory pricing arrangements inadvertently appropriate upside returns on successful projects (so-called 'regulatory truncation'), then overall investment levels are likely to be reduced.

Some such investment impacts are unavoidable if efficient access to essential infrastructure services is to be provided. But if access regulation is overly stringent, those impacts will potentially be significant and outweigh the offsetting benefits that appropriately configured access regulation can deliver.

Source: PC 2001.

- Such an outcome would potentially put at risk some new investments in sectors such as airports that are not subject to industry-specific access regimes and therefore directly exposed to the possibility of Part IIIA declarations.
- It would also be contrary to the intent of the proposals put forward by the Commission in its 2001 review of Part IIIA, and which were broadly endorsed by the Government when making the recent amendments to the regime.
- And to the extent that a more accessible Part IIIA regime undermined the scope to employ light handed price monitoring (see below), it would also sit somewhat uncomfortably with the recent COAG endorsement in the Competition and Infrastructure Reform Agreement (COAG 2006) of monitoring as a means of scaling back from more intrusive price regulation.

The Commission further observes that the uncertainty which has been created by this decision may of itself deter investment, even if it ultimately transpires that the final resting point for the Part IIIA entry bar has not been significantly lowered. New interpretations of complex legislation will often give rise to some uncertainty. However, in this particular case, the apparent increase in the role of residual discretion in the application of the declaration criteria is likely to amplify such uncertainty and thereby heighten the prospect of adverse investment impacts.

Moreover, in the Commission's view, a greater role for residual discretion in the application of the Part IIIA declaration arrangements would also be undesirable on wider public policy grounds. Though an element of discretion for decision makers cannot be avoided in a complex area such as this, as far as possible, the intention of the Parliament should be given explicit effect through the legislation, rather than left to those applying it to interpret.

3.4 What are the implications for airport policy?

A further period of price monitoring would be desirable

Absent the Federal Court decision, a continuation of the light handed approach after 2007 when the current monitoring arrangements end would, in the Commission's view, be the most appropriate policy choice.

Though the light handed approach has not been without problems, it has delivered some significant benefits — particularly through creating a much better investment environment at the major airports. With several of these airports now entering a new phase of the investment cycle, a return to a more heavy handed and intrusive regime could be costly.

As outlined above, the Commission accepts that the jury is still out on the extent to which price monitoring, backed by a threat of re-regulation, will constrain aeronautical charges as the influence of the previous regulatory regime recedes. The fact that the previously identified 'market' constraints on charges do not seem overly strong adds to that uncertainty.

However, the Commission considers that the introduction of an explicit process for initiating further investigation of an airport's conduct where there is prima facie evidence of significant misuse of market power would render the threat of re-regulation more credible, without sacrificing the benefits of a light handed monitoring approach. Some augmentation to, and elaboration of, the current overarching 'Review Principles' governing the operation of the light handed

approach could further enhance its effectiveness without unduly ‘directing’ commercial negotiations. And, as generally acknowledged by participants, action to settle the asset valuation issue would help greatly to facilitate negotiations and the further development of commercial relationships between airports and airlines. With these changes in place (see chapter 4), a further period of light handed price monitoring would be preferable to a return to explicit price regulation.

But the sustainability of a light handed approach is now uncertain

Though the precise implications of the recent Federal Court decision are unlikely to be clear for some time, the decision nevertheless raises questions about the sustainability of the light handed approach. That is, a more readily accessible Part IIIA regime *could* come to supplant price monitoring (and the underlying threat of re-regulation) as the operative regulatory instrument governing charges and terms and conditions at the major airports.

Indeed, airlines have already indicated a preparedness to test the new Part IIIA environment. Thus, in a submission immediately following the Federal Court decision, Qantas (sub. 65, p. 4) said that if the Commission did not recommend adoption of its ‘Core Principle’ — which includes provision for binding independent dispute resolution (see chapter 4) — it will be in ‘a position of being forced into pursuing declaration under Part IIIA of the Act’.

If Part IIIA were to become the operative regulatory instrument for airports, there would be little point in continuing with price monitoring, as the information collected would be of no particular policy relevance.

An amendment to Part IIIA should be considered for wider policy reasons

These question marks over the sustainability of a light handed approach in the airports area could be resolved by a further specific amendment to Part IIIA to ensure that it effectively remains a mechanism of ‘last resort’.

But the case for such an amendment is a general rather than airport-specific one. As discussed above, there are good reasons why the entry bar for declaration under the regime should be a high one and why the Government recently sought to raise that bar further.

It may be that the combined effect of the recent legislative changes, the now ostensibly greater scope for Part IIIA decision makers to employ residual discretion, and developments ensuing from SACL’s appeal to the High Court, will

keep the bar at an acceptably high level. However, early announcement of a legislative amendment would remove the uncertainty about how these factors will play out and thereby prevent any build up in investors' minds that the level of regulatory risk has increased significantly. Even if subsequently shown to be unfounded, such perceptions could still be damaging for infrastructure investment in the short to medium term.

In considering what sort of amendment to Part IIIA might be appropriate, the Commission is not attracted to the option put forward by Melbourne Airport (sub. DR55, p. 19) of requiring Part IIIA decision makers to take account of relevant sector-specific policies. While potentially removing the 'double jeopardy' for a monitored airport compliant with the overarching principles, it does not address the more fundamental need to ensure that the Part IIIA entry bar remains a high one. In the Commission's view, a better approach would be to amend criterion (a) to restore the essence of the previous interpretation — namely, that the act of declaration must promote a material increase in competition.

The Commission acknowledges that there are several factors militating against such a 'pre-emptive amendment'. Most obviously, if SACL is granted leave to appeal to the High Court, then the Federal Court's decision will be subject to further judicial consideration. And even if leave is not granted, immediate legislative action would raise concerns about prejudging how decision makers might respond to the changed Part IIIA landscape.

However, clarification through the judicial/decision making process is unlikely to happen quickly. For example, even if SACL is granted leave to appeal, it could be some time before the appeal is heard and a decision announced. Accordingly, and given the potentially adverse implications of the recent Federal Court interpretations for infrastructure investment, the Commission considers that there is a case for a pre-emptive legislative amendment to ensure that the Part IIIA entry bar remains at a high level.

What if Part IIIA is not amended?

As noted above, if Part IIIA is not amended, it is possible that it will in time become the operative regulatory instrument for airports — thereby rendering price monitoring redundant as a policy lever.

Were developments to suggest that this could happen reasonably quickly, there would be an argument for terminating price monitoring when the current arrangements end, and thereafter leaving airports and airlines to negotiate agreements against the backdrop of a more accessible Part IIIA regime. Any early

testing by the airlines of the new Part IIIA environment (see above) would be relevant in this context.

However, in the Commission's view, given the considerable uncertainty about how an unamended Part IIIA could play out, it is much too early to be contemplating abandoning the light handed airport regime. Though the Part IIIA entry bar may well have been lowered, it is only through subsequent test cases that this can be verified and the magnitude of any change assessed.

The Commission also notes that a general review of Part IIIA is scheduled for 2011. That review would provide a further opportunity to consider changes to criterion (a) if an amendment of the sort canvassed above is not introduced beforehand.

A conditional set of recommendations for post-2007 airport policy

In the light of all of the above, the Commission considers that there must necessarily be some policy flexibility in regard to the future of prices oversight at the major airports after the current arrangements end in June 2007.

In a broad policy sense, it is strongly of the view that the continuation of a (modified) light handed approach, backed by Part IIIA operating, in practice, as a mechanism of last resort, is the best way forward.

However, in the absence of an amendment to Part IIIA, this relationship between the two instruments cannot be guaranteed. In these circumstances, though it would be premature to immediately terminate the light handed approach, there should be a readiness to do so in the future if it becomes clear that Part IIIA, left unamended, has become the operative regulatory instrument for the major airports and thereby rendered monitoring redundant.

RECOMMENDATION 3.1

To ensure that the operation of the Part IIIA national access regime leaves open the option of using price monitoring and other light handed approaches for regulating major infrastructure provision (including at airports), the Government should consider amending Part IIIA to restore the prevailing interpretation of s 44H(4)(a) prior to the Federal Court decision upholding the declaration of the domestic airside service at Sydney Airport.

There should be a further period of price monitoring (see recommendation 5.5) at Australia's major airports when the current arrangements end in June 2007.

However, if it becomes apparent that Part IIIA has become the operative regulatory instrument governing charges and terms and conditions at major airports, and no corrective action is considered appropriate before the scheduled review of Part IIIA in 2011, then price monitoring should be discontinued.

In that event, the possible reintroduction of monitoring should be considered in the light of the outcomes of the review of Part IIIA.

The next two chapters spell out how a new price monitoring regime should be configured and operate. In essence, the proposals in those chapters seek to address the shortcomings in the current regime, whilst still preserving a light handed approach that would allow commercial negotiations to flourish.

4 Key foundations for a new price monitoring regime

Key points

- If commercial negotiations between airports and their customers are to develop, the post-2007 price monitoring arrangements must provide a degree of latitude and flexibility in regard to charges, rates of return and other outcomes.
- Nonetheless, the absence of a well-defined process for triggering further investigation of an airport's conduct where there is prima facie evidence of significant misuse of market power should be addressed.
 - Having assessed the price monitoring reports and other relevant information, the Minister for Transport and Regional Services should be required to publicly indicate whether any further investigation of a monitored airport's conduct is warranted.
- Disputes over asset valuations have been a significant impediment to the development of commercial relationships between airports and their customers. A circuit breaker is therefore needed.
 - Previous 'booked' revaluations in the aeronautical asset base submitted by airports for price monitoring purposes should be allowed to stand, but any made after 30 June 2005 should be netted out of this asset base.
- To provide guidance to the review of the next period of price monitoring, and to assist negotiations between airports and their customers, the current overarching principles should be retained. There should also be three new principles:
 - proscribing further asset revaluations as the basis for increasing airport charges;
 - specifying that negotiations should occur in good faith to achieve outcomes consistent with the principles, including through agreed processes for dispute resolution; and
 - providing for reasonable sharing of risks and returns between airports and their customers.
- A readily accessible airport-specific arbitration mechanism would fundamentally undermine incentives for the parties to negotiate outcomes, effectively leading to a return to heavy-handed determination of charges and conditions for airport services.
 - With the proposed changes to improve the effectiveness of light handed regulation in place, the key stakeholders should then be given the opportunity to show that through constructive negotiation they can deliver effective outcomes, with their performance judged accordingly under the new oversighting arrangements.

As outlined in the previous chapter, the Commission has concluded that a light handed price monitoring regime should continue to be employed at Australia's major airports when the current arrangements end in 2007. It has also suggested that the Government consider amending Part IIIA to ensure that the Federal Court's recent interpretation of the competition test does not compromise the sustainability of such a light handed approach or, more generally, undermine the Government's objectives in establishing the Part IIIA national access regime.

In the next chapter, the Commission has set out its views on how the airport and service coverage of the current monitoring regime should be modified; how quality monitoring might be streamlined; what the duration of the new monitoring arrangements should be (presuming that price monitoring is not 'supplanted' by Part IIIA); and what reporting and review arrangements should apply.

However, as a prelude to that discussion on the details of the new regime, this chapter sets out some key foundations for that regime — aimed at allowing commercial negotiations between the parties to develop and flourish, while at the same time addressing the key 'systemic' deficiencies in the current arrangements. Thus, after outlining why the new regime should provide for genuine latitude in regard to price and other outcomes, the Commission has:

- set out an explicit process for invoking further investigation of an airport's conduct if there is prima facie evidence of significant misuse of market power;
- detailed how the divide over asset valuation issues would be best addressed; and
- identified some additional overarching principles that could help to enhance the effectiveness of the light handed approach.

It has then explained why this reconfigured and more credible light handed regime should not be augmented with an airport-specific arbitration mechanism.

4.1 The need for latitude on outcomes

The post-2007 price monitoring arrangements must continue to operate in a light handed way if they are to foster commercial relationships between airports and their customers and thereby place reliance primarily on commercial negotiations to determine charges and terms and conditions for aeronautical services.

This in turn requires that there is a degree of latitude and flexibility in regard to charges, rates of return and other outcomes. Put simply, without some latitude, there will be nothing for the parties to negotiate about.

In the Commission's view, there is still a considerable way to go in achieving a mindset accepting of latitude in both directions.

- Airlines have sought tight prescription of the price outcomes that negotiations should deliver. Virgin Blue called for the ACCC to issue 'detailed pricing and costing guidelines for the airport sector' (sub. 27, p. 6). BARA's suggested Review Principles (sub. DR 48, p. 3) included specification of asset values which, if implemented, could effectively dictate a very precise level of 'allowable' revenue for Sydney Airport and cap revenues at the other monitored airports.
- And, in strongly endorsing latitude upwards, airports have sought support from the Commission for various 'safe-harbours' for charging behaviour that would increase the level of revenue that would pass as reasonable under the monitoring process.

That there continues to be an attachment to regulatory prescription is not particularly surprising. However, in the Commission's view, this continuing legacy of the previous regulatory arrangements reinforces the need for a more credible process for invoking further investigation of an airport's conduct if there is prima facie evidence of significant misuse of market power. In particular, with a more credible process in place, airlines might be more willing to move beyond seeking outcomes closely linked to what the previous regulatory regime might have delivered.

4.2 A process for triggering further investigation of conduct

While price monitoring is designed to provide some latitude on charging outcomes, a key element of the light handed approach is the threat of re-regulation if there is misuse of market power.

The role of this threat is twofold. Firstly, and most obviously, it offers the prospect of remedial action if airports behave inappropriately. Secondly, to at least some extent, it will condition commercial negotiations between airports and their customers — in effect, strengthening the bargaining position of airlines and other airport users.

It is important that this threat only be exercised if an airport has clearly misused its power, and that the consequences of that misuse are significant.

- Given the range of issues arising in negotiations between airports and airlines, and the trade-offs involved, the potential for misdiagnosis of misuse of market

power is considerable. Hence, the possibility of re-regulation should not come into play unless a prima facie case of inappropriate behaviour has been clearly established.

- And, given the potential costs of regulatory intervention — especially through impeding investment and stifling innovation — invoking the threat of re-regulation for more minor ‘indiscretions’ could be counterproductive. Indeed, a perception that the Government was prepared to reimpose prescriptive controls in the face of minor indiscretions by airports could create a more uncertain environment than would exist under formal price regulation.

At the same time, the threat of re-regulation if circumstances warrant must be a credible one. This is especially the case given that other factors potentially constraining the misuse of market power by airports — such as the influence of non-aeronautical revenue and airline countervailing power — are clearly not as strong as was envisaged when price monitoring was introduced.

As outlined in the previous chapter, the Commission concurs with those participants who argued that the credibility of the current light handed regime is diminished by the lack of an explicit process for bringing the threat of re-regulation into play. More specifically, while the option of inquiries under Part VIIA of the Trade Practices Act is open to the Government, there is no clarity on the circumstances in which such an inquiry might be initiated, and how that inquiry process is to be progressed.

The approach proposed in the Draft Report

In considering this matter in the Draft Report, the Commission highlighted two major drawbacks with using mechanistic indicators to trigger further inquiry.

- Establishing appropriate indicators would not be easy, given the difficulties of making provision for such things as the impact of the investment cycle on an airport’s rate of return.
- More fundamentally such indicators, once in place, would tend to prescribe what outcomes commercial negotiations between the parties should deliver. As the ACCC (sub. 39, p. 92) described it, the indicators would effectively constitute ‘shadow heavy-handed regulation’.

Instead, the Commission suggested that there be greater reliance on commentary from the stakeholders to put the numerical outcomes of the monitoring process in proper context, and to allow for the airing of any more general issues pertaining to the effectiveness of price monitoring and related arrangements. It went on to suggest that, informed by such commentary, policy makers would be in a better

position to judge whether any further investigation of airports' conduct was needed. However, the Commission stopped short of putting any onus on policy makers to explicitly signal what conclusions had been drawn from the available information.

Responses to the Draft Report proposal

Aside from Air New Zealand (sub. DR52, p. 4), the general view of participants was that the Commission's proposed commentary-driven approach would do little to improve on the current situation — either in the general sense of helping to put the numerical monitoring outcomes in proper context, or as a means of rendering the threat of re-regulation more credible.

In particular, and highlighting the lack of trust which still pervades commercial relationships in this sector, both airports and airlines expressed concern about the other party 'gaming' the commentary process. For instance, Westralia Airports Corporation (sub. DR58, p. 18) responded that:

... the [Commission's proposed approach] incorrectly assumes that airlines are impartial and objective observers of airport behaviour. In fact, the airlines' commercial interests may tend to encourage less than fully substantiated negative comments and claims of market power abuses.

And typifying the views of the airlines, BARA (sub. DR48, p. 20) submitted that:

Under the PC's draft proposal there is no framework or criteria established to guide commentary on pricing outcomes. Instead, airports and airlines are left to 'put pricing outcomes in perspective'. The ability of some airport operators to write the most glowing account of their conduct regardless of actual behaviour is well documented in the submissions to the PC in this inquiry.

Some airlines also questioned whether eliciting commentary from the stakeholders as part of the monitoring process would in fact increase the information available to policy makers. They noted that the parties already can and do make representations directly to the Government on the outcomes of the current arrangements. For example, Virgin Blue (sub. DR62, p. 14) said that it:

... does not see how the provision of commentary to the ACCC by stakeholders and the inclusion of that commentary in the ACCC's price monitoring reports will make any difference to the credibility of the threat of re-regulation or the development of commercial relationships between airports and their customers.

Accordingly, Virgin Blue (sub. DR62, p. 12) restated its preference for clear outcomes-based criteria for triggering sanctions.

However, others endorsed the sentiments in the Draft Report on the drawbacks of such mechanistic triggers. For example, Melbourne Airport (trans. p. 14) stated that:

...the idea that you end up in a world of picking apart every last nut and bolt of cost, really leaves you in a world which looks a bit like what we see in telecommunications and that's highly undesirable.

It went on to suggest (trans. p. 17) that while there will inevitably be some grey areas in the identification of misuse of market power, where behaviour is clearly inappropriate, 'when you see it, you know it'. At the same time, it contended (trans. p. 14) that in this regard there is a procedural deficiency in the current light handed regime:

So the real issue here is — and it's almost a fundamental issue in the design of a monitoring framework — that there remains an administrative element to it, that there must be an administrative decision taken on the basis of the monitoring information that some further step is required. People say, with some justification, that it doesn't appear that there is another step. The constable is still in the cupboard; the question is, when does he come out.

To help address this problem, the airport alluded again to a proposal in its initial submission (sub. 13, pp. 70-72) for a dispute resolution mechanism based around a Part VIIA price inquiry (see section 4.5). BARA (sub. DR48, p. 22) similarly referred to its initial Part VIIA dispute resolution proposal — suggesting that it was in some senses little more than a process for triggering further investigation and, by implication, that it should not be regarded in the same way as the more embracing arbitration proposals put forward by some others.

The Commission's assessment

In the Commission's view, the absence of a well-defined process for triggering further investigation of an airport's conduct where there is prima facie evidence of significant misuse of market power should be addressed. Amongst other things, this deficiency in the current regime is:

- undermining confidence in the credibility of the light handed approach;
- seemingly a key concern underlying calls for an airport-specific arbitration mechanism — something that the Commission views as incompatible with light handed regulation (see section 4.5); and
- likely to increase the probability that airlines will seek to use a potentially more accessible Part IIIA mechanism in lieu of commercial negotiations.

The Commission accepts that its proposal in the Draft Report for a commentary-driven monitoring process is probably not workable in the current environment. Although the approach has some in-principle attractions, the Commission is no longer confident that commentary would assist the Government to make better

informed judgements about whether airports have been behaving appropriately. And clearly there is little appetite for such an approach from either airlines or airports.

Equally, the Commission remains of the view that the use of mechanistic triggers prescribing when further investigation of conduct should occur would be undesirable. Such triggers would effectively put defined upper bounds on charging outcomes and would therefore be little different from the previous price cap regime.

Also, it is not attracted to a dispute-driven Part VIIA inquiry process. It acknowledges that the proposals put forward by BARA and Melbourne Airport may be less damaging to commercial negotiation than some of the other negotiate-arbitrate approaches suggested by participants (see section 4.5). Nonetheless, these proposals would still be focussed on using Part VIIA to resolve particular disputes, rather than to assess the conduct of an airport more broadly. Given that airports deal with many airlines and have to reach agreement with their customers on a wide range of issues, and that re-regulation would impact on all such negotiations, claims that an airport has seriously misused its market power should be assessed in this wider context.

Instead, the Commission will recommend that the Government be required to make an explicit judgement on whether the conduct of any of the monitored airports warrants further scrutiny. Specifically, this would entail the responsible Minister — having assessed the monitoring reports and other relevant information — publicly indicating either that no further investigation of conduct is warranted, or alternatively that one or more airports will be asked to ‘show cause’ why further investigation into their conduct should not take place.

While the absence of further investigations during the first four years of monitoring *may* in fact have been appropriate, the Commission’s proposed approach would remove the possibility of ‘passive’ rather than determined non-action. In so doing, it would both enhance the credibility of the threat of re-regulation, and reinforce the notion that price monitoring is simply intended to be a screening mechanism — an initial step in the light handed regulatory approach. Accordingly, it should not put at risk the latitude on outcomes necessary to allow commercial negotiations to develop.

Under this proposed process, more detailed investigation of an airport which failed to show cause why it should not be subject to further scrutiny could take the form of an inquiry under Part VIIA, originated by the Treasurer on advice from the Minister for Transport and Regional Services. Although focussed on pricing issues, Part VIIA allows the Treasurer to require the ACCC — or other body — to conduct a public inquiry into any specified matter. As such, any terms and conditions issues arising in relation to the conduct of a monitored airport could potentially be

investigated under Part VIIA. Additionally, the Treasurer can specify the duration of the inquiry, thereby signalling the expected degree of detail of the inquiry process. During the period of such an inquiry, the airport in question would not be able to alter its prices, terms or conditions.

However, the Commission considers that the Government should be able to employ an ‘intermediate’ investigative mechanism if circumstances warrant. For example, a Departmental investigation might sometimes be more cost-effective than a full public inquiry under Part VIIA. Indeed, the Commission emphasises that the key requirement is to address the absence of an explicit process for initiating further investigation, rather than tightly prescribing what form any such investigation might take.

The Commission recognises that its proposed approach could be seen as increasing the extent of overlap with the Part IIIA provisions — and with it the incentives for forum shopping by airlines. But, it emphasises that the proposed strengthening of the light handed regime is not a dispute-based trigger for further investigation of airport conduct and so will play a different role than Part IIIA. In addition, a strengthened light handed regime should reduce the likelihood that airlines will seek arbitrated outcomes via declaration under Part IIIA as an alternative to commercial negotiation. Acceptance by the Government of the case for an early amendment to Part IIIA to ensure it remains a mechanism of last resort (see chapter 3) would further reduce any overlap between the two instruments.

Finally, the Commission notes that as a generalised process encompassing non-price terms and conditions, a strengthened process for initiating further investigation of airport conduct would also address the concern that under the current arrangements, these terms and conditions ‘slip through the net’.

RECOMMENDATION 4.1

Under the new price monitoring regime, the Minister for Transport and Regional Services, having regard to monitoring reports and other relevant information, should each year be required to publicly indicate either that:

- ***no further scrutiny of the conduct of the monitored airports is necessary; or***
- ***that one or more airports will be asked to ‘show cause’ why their conduct should not be subject to more detailed scrutiny through a Part VIIA price inquiry, or other appropriate investigative mechanism.***

4.3 A circuit breaker on asset valuation

The provision of aeronautical services is capital intensive. Hence, charges for these services depend heavily on the costs of financing and maintaining the asset base.

The latitude on outcomes inherent in the light handed price monitoring approach reduces the need for scrutiny of whether charges precisely match estimated costs and whether the asset values underlying those costs are ‘appropriate’.

However, if monitoring is to provide meaningful insights into whether charging levels are suggestive of misuse of market power, some such scrutiny cannot be avoided. Hence, the Government’s Review Principles state that ‘[p]rices should allow a return on (appropriately defined and valued) assets (including land) commensurate with the regulatory and commercial risks involved.’

What is at issue?

Evidently, such assessments must be underpinned by a set of aeronautical asset values. However, in privatising its airport holdings, the Government did not put an explicit value on the assets it was selling. Rather, the airports were sold as a total package with bids reflecting the expected revenue flows from the provision of both aeronautical and non-aeronautical services.

At Sydney Airport, the regulatory determination of charges by the ACCC in 2001 put a definitive value on the airport’s aeronautical assets close to the time of sale — though aspects of this valuation were disputed by the operator.

But the other monitored airports were privatised when the previous price cap regime was still in force. Under these price setting arrangements, no delineation of an aeronautical asset base was required. And while asset values were specified in the books inherited from the Federal Airports Corporation (FAC), those values did not always reflect the economic worth of the infrastructure and land involved.

At the time of sale, Melbourne Airport revalued its land and physical assets. Since then, the operators of most of the other monitored airports have followed suit — in some cases, revaluing by more than 100 per cent. Moreover, most of these revaluations have involved above ground assets, with further revaluations mooted as the focus shifts to land, especially at those airports closer to city centres.

Not all of the revaluations to date have been ‘booked’ in the accounts submitted to the ACCC for price monitoring purposes or translated into higher aeronautical charges. Indeed, airports said that revaluations can occur for a range of ‘non-price’ reasons — for example, to boost borrowing capacity. However, there is little doubt

that the intention is often to provide a justification for higher charges at some stage in the future.

The validity of predicating higher aeronautical charges on asset revaluations, and whether by implication price monitoring should sanction this practice, has become a particularly divisive issue — not only in Australia, but also in New Zealand where airports are similarly subject to a light handed regime. (See, for example, Air New Zealand, sub. DR52, pp. 6-7 and Wellington International Airport, sub. DR72, p. 6.) Reflecting the inability of the parties to resolve the issue through commercial negotiation, the terms of reference direct the Commission to review aeronautical asset revaluation practices at each of the price monitored airports and advise on improvements that would be consistent with the Government's Review Principles.

The opposing views

In their initial submissions to the inquiry, most airports (and those representing investors in the airports) argued that unless charges reflect the economic value of the assets employed to deliver aeronautical services, efficient use of, and investment in, those services will be compromised. Specifically, they contended that:

- there may be excessive use of aeronautical services and hence air travel; and
- longer term decisions on the size and location of airports will be less well informed about true willingness to pay for airline travel and its underlying costs.

The implication of this argument is that the asset base should reflect 'opportunity cost' — measured on the presumption that land can be moved out of the sector if higher returns are available elsewhere — and that the base and charges should periodically be adjusted if the value of land or other assets changes.

These participants also contended that bids for airports were premised on a well-founded belief that the reasonableness of charges would not be determined with reference to the asset values inherited from the FAC. This implies that if previous revaluations are unwound, and/or future revaluations are not sanctioned for price setting purposes, then airport operators could experience a windfall loss. Some went on to draw attention to the ramifications for the perceived risk of operating airports in Australia and hence the willingness to invest in the airport sector.

Conversely, airlines argued that price increases consequent upon asset revaluations will have few efficiency benefits, and are simply a means for airport operators to increase profits without exposing themselves to claims of misuse of market power. Amongst other things, they contended that:

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- any underpricing relative to a notional ‘opportunity cost’ benchmark will have minimal impact on the availability of airline services;
 - under the lease arrangements, airport operators must use assets to provide airport services, meaning that the value of land in other uses is in fact irrelevant; and
 - there is evidence that bids for the airports did not presume that there would be the opportunity to use asset revaluations as a means to achieve sanctioned increases in charges.

The position of the airlines on revaluation was endorsed by the Department of Transport and Regional Services (sub. 24, p. 10) and also by the ACCC (sub. 39, pp. 62-63) — though the latter was careful to draw a distinction between the need to establish an acceptable starting asset base and subsequent revaluations to that base. This same distinction was also made by Melbourne Airport (sub. 13, pp. 57-58), which argued that while the asset values inherited from the FAC were not sustainable in a commercial environment, once commercial asset values have been determined, no further revaluations should occur for the duration of the leases.

Consensus on the need for a resolution

However, notwithstanding these very divergent views, there was agreement in initial submissions that, through this review, a way forward on the asset valuation issue must be found. Thus Melbourne Airport (sub. 13, p. 52) observed:

... it is an essential outcome of this review that the Principles in future explicitly address how the Government will address asset valuation issues when considering whether an airport has complied with the Principles. This is the area of greatest contention in the current framework and the absence of such a clear statement its greatest weakness.

Similarly, Qantas (sub. 28, p. 34) observed that:

Constructive engagement will not be able to flourish unless there is guidance as to what is ‘appropriate’ in terms of the proper principles of valuation of aeronautical assets.

And, in echoing comments by Brisbane Airport, Perth Airport said that asset valuation has been a key point of contention which, if resolved, would lead to reduced disputation between airport operators and airlines in the future (trans. pp. 74, 89).

The Draft Report approach and proposals

In the Draft Report, the Commission concluded that the efficiency benefits ensuing from asset revaluations and flow through to aeronautical charges would be small (see box 4.1).

However, it went on to argue that the distributive impacts of alternative approaches in this area are also an important consideration — with asset valuation issues inhibiting current negotiations on charges at particular airports and impeding the further development of commercial relationships between the parties more generally. Accordingly, the Commission emphasised that there is much more at stake than the transfer of income between airports, airlines and air travellers.

The Commission observed that a redistribution of income from airlines and air travellers to airports resulting from asset revaluations and sanctioned flow through to charges would not be helpful in engendering public confidence in a light handed regulatory approach. And it further argued that any financial benefits ensuing from increased land values should ordinarily flow to the Government as the land owner, rather than to the lessee.

But it also said that it would be unreasonable to penalise airport operators by changing the ‘rules of the game’ subsequent to the sale process, noting that the rules in relation to asset valuation were not clearly specified at the outset of the privatisation process. Hence, it concluded that whether bidders for the price monitored airports could reasonably have factored in scope for asset revaluations with flow through to charges can only be adduced from less specific and sometimes conflicting evidence and statements of intent (see box 4.2).

In the light of these various considerations, and the need to take this highly divisive issue off the bargaining table, the Commission argued that a degree of pragmatism was called for. It therefore proposed that:

- previous ‘booked’ revaluations in the aeronautical asset base submitted by airports for price monitoring purposes be allowed to stand, but that a line now be drawn in the sand, with any revaluations made after 30 June 2005 netted out of the asset base used to monitor rates of return; and
- a stipulation be included in the principles governing the operation and end-of-period review of the new monitoring regime to the effect that, unless agreed with customers, future asset revaluations should not provide a basis for higher charges.

Box 4.1 The implications of asset valuations for economic efficiency

In arguing in the Draft Report that the efficiency benefits ensuing from asset revaluations and flow through to aeronautical charges will generally be small, the Commission made the following observations.

- Most of the assets used to deliver aeronautical services, once in place, are effectively ‘sunk’ and cannot be used in other activities.
- While airport land could in principle be reallocated to non-airport uses, this is largely precluded by conditions in the operating leases. Similarly, the movement of land within airport precincts is constrained by the aeronautical service commitments in those same leases.
- Accordingly, any undervaluation of existing aeronautical assets relative to ‘unconstrained’ opportunity cost, need not threaten the continued availability of services. That is, operators will continue to provide airport services so long as revenues at least cover incremental costs.
- Provided there is appropriate valuation of new investment for pricing and monitoring purposes, the policy stance adopted in relation to the valuation of existing assets is unlikely to alter investment levels to any great extent.
- In overall terms, the proportionate impacts on ticket prices — and therefore on demand for air travel — of any undercharging against an unconstrained ‘opportunity cost’ benchmark, are likely to be small. Hence, longer term decisions on airport location and the timing of capacity upgrades are unlikely to be materially affected.
- This in turn means that longer term decisions on where to locate airports, and the timing of augmentations to airport capacity, are also unlikely to be materially affected by the values ascribed to existing assets. Indeed, given the range of other considerations that compromise efficient price signals, levels of airline travel and airport location decisions, the intrinsic contribution of ‘correct’ asset valuations to such decision making is open to question.

The Commission went on to acknowledge that some of these views may be seen as at odds with the broad principles enunciated in its previous report on airport price regulation (PC 2002, p. 255). However, it emphasised that while these principles continue to be relevant, this inquiry has provided the opportunity for the Commission to undertake a more detailed assessment — leading to a conclusion that, in practice, the theoretical efficiency benefits of employing opportunity cost/replacement cost revaluations for land and other existing aeronautical assets are unlikely to be large.

Source: PC 2006, pp. 90-91.

Box 4.2 The expectations of bidders for the airports

In the Draft Report, the Commission set out a range of competing considerations that may have influenced the expectations of those bidding for the monitored airports on the scope to revalue assets and increase charges accordingly.

On the one hand:

- Pricing oversight guidelines issued at the outset of the sale process indicated the Government's intention to continue to constrain any misuse of market power by airports in the setting of charges. Implicit in this was arguably a signal to bidders that increased charges based on 'costless' revaluations of already purchased airport assets would not be viewed as reasonable.
- The privatised airports were leased on a long term basis to be operated as airports. Hence, it should have been clear to bidders that 'underperforming' airport land could not be sold off for higher value residential or industrial use.

On the other:

- At the outset of the privatisation process, the Government indicated that price cap regulation was intended to apply only for five years as a transitional mechanism. Thereafter, the presumption was that there would be a less intrusive surveillance mechanism. While the precise nature of this mechanism was not specified at that time, there may well have been a reasonable expectation that the result would be more latitude on pricing outcomes.
- Such expectations would have been reinforced by general acceptance that charges for aeronautical services at the time of privatisation were unsustainably low. Indeed, a concern to put the operation of airports on a commercial footing, and thereby provide for the investment needed to sustain service delivery over the longer term, was a primary reason for privatisation.

The Commission also noted the contention from a number of the airports that the sale process occurred against a backdrop of various statements by policy bodies, including the ACCC, that opportunity cost/optimised replacement cost was an appropriate basis for valuing regulated infrastructure assets.

However, given that most of these statements appear to have been made after the sale of all of the major airports except Sydney, the Commission concluded that they were not particularly relevant to the issue at hand. It also alluded to the fact that the successful bid prospectus for Sydney Airport indicated that the bid was formulated on the basis that assessments of charging outcomes would be premised on the land (and other asset) values established under the ACCC's 2001 pricing determination.

Source: PC 2006, pp. 93-94.

The Commission acknowledged that this less than perfect solution would differentially affect individual airports depending on: the extent to which they have previously revalued their assets and booked those revaluations in the accounts

submitted to the ACCC; and the degree to which the asset base for monitoring purposes dictates the values actually used in negotiations on charges. In this regard, it made particular mention of Melbourne Airport which has not booked its more recent revaluations, and Sydney Airport which though strongly advocating ‘opportunity cost’ valuation of land, has yet to revalue its land assets on this basis. (Such a revaluation, if fully reflected in charges, would currently add more than \$20 million a year to the airport’s aeronautical revenue).

Responses to the Draft Report

In responses to the Draft Report, there was some reiteration of positions put in original submissions. In particular, a few participants suggested that the Commission had understated the efficiency impacts of choices made in regard to asset values. For example, both Canberra Airport (sub. DR67, p. 2) and SACL (sub. DR70, p. 5) claimed that the valuation of airport land will affect the distribution of that land between aeronautical and non-aeronautical uses. More generally, Virgin Blue (sub. DR62, pp. 6-7) contended that aeronautical charges (and by implication asset valuations) will materially affect the demand for air travel. (The Commission’s views on this matter were set out in section 2.5.)

However, there was widespread acceptance that the sort of line in the sand approach proposed in the Draft Report was not an unreasonable way to close off this issue and thereby facilitate more fruitful negotiations between the parties. Accordingly, most of the responses in this area focussed on whether the particular line in the sand put forward by the Commission was the most appropriate one.

- Some participants thought that this line of booked values at 30 June 2005 was a reasonable one, or were prepared to live with it at least until the time of the next review. (See for example, Adelaide Airport, sub. DR61, pp. 2-3; Canberra Airport, sub. DR67, p. 22; RAAA, sub. DR53, Annex B; SACL, sub. DR70, pp. 5-7; and Westralia Airports Corporation, sub. DR58, p. 8.)
- Others, while supporting the spirit of the draft proposal, were concerned that Brisbane and Canberra Airports in particular would be unfairly and significantly advantaged. (See for example, BARA, sub. DR48, pp. 17-18; IATA, sub. DR59, p. 7; Melbourne Airport, sub. DR55 pp. 15-17; and Qantas, sub. DR60, p. 16.) Some of these participants went on to argue that a more ‘reasonable and equitable’ set of asset values should be determined on an airport-by-airport basis.
- Brisbane Airport (sub. DR69, p. 10) disputed the contention that it would be a major beneficiary from the Commission’s proposed line in the sand, claiming that the asset value that emerged would, if fully passed on in charges, only increase its aeronautical revenues by around \$6 million a year (or around 7 per

cent). Nonetheless, and while prepared to support the Commission's 'compromise solution', it suggested (p. 4) several possible cut-off dates, and that a 'line in the sand' valuation for each of the price monitored airports be undertaken on a depreciated optimised replacement cost basis.

- Virgin Blue (sub. DR62, p. 46) reiterated its view that current charges are over-recovering for existing assets (chapter 2) and argued that the use of an arbitrary cut-off point is inappropriate. It suggested that instead, the starting asset values used for price monitoring should be imputed from the prices and revenue flows under the previous price cap regime.

At a more detailed level, several participants sought clarification of, or raised concerns about, the reference in the Commission's draft proposals to the incorporation of new investment 'at values agreed with customers' and to the possibility of future asset revaluations if 'agreed with customers'. On the one hand, Qantas (sub. DR60, p. 17) questioned whether 'agreement' would be deemed simply by an airline's use of an airport. On the other, Adelaide Airport (sub. DR61, p. 3), Brisbane Airport (sub. DR69, p. 5) and Westralia Airports Corporation (sub. DR58, p. 9) said that securing agreement from customers on the asset values to be ascribed to new investment could be problematic, and could even be used by particular airlines to block airport expansion as a means of keeping new competition out of the market. Brisbane Airport went on to propose an alternative formulation along the lines 'at fair values supported by independent cost consultants', while Westralia Airports Corporation suggested that the reference simply be removed.

The Commission's assessment

The Commission reiterates that, in its view, the asset revaluation issue is primarily a distributional one. At the margin, variations in aeronautical charges associated with different starting asset bases, or ensuing from different policy stances on subsequent asset revaluations, will affect demand for air travel, the pattern of land use within the airport precinct etc. However, as discussed in chapter 2, the Commission considers that the overall effect on airline travel is unlikely to be significant. And, in any event, it remains unconvinced that any changes in airline travel that result from different policy choices in regard to the valuation of existing assets will be particularly influential in longer term decisions on the location of airports or augmentation of airport capacity.

Accordingly, the Commission sees no reason to change its basic position that periodic asset revaluations to provide a platform for increases in aeronautical charges are inappropriate. Moreover, it notes that most of the airports seem to have

accepted that this practice should not be sanctioned under a future price monitoring regime.

But acceptance of this principle does not remove the immediate problem at hand — namely, what the starting asset values for monitoring purposes should be at each of the price monitored airports. As noted above, if this matter is not removed from the bargaining table, it will continue to frustrate the further development of commercial relationships and thereby the effectiveness of the light handed approach. Indeed, to the extent that the recent Federal Court decision has rendered the Part IIIA national access regime a more readily accessible instrument for airlines, the threat posed to the light handed approach by the divide on asset valuation will have increased.

As the parties generally agree, there is no easy answer, with an element of pragmatism called for. And any line in the sand, no matter how carefully crafted, will inevitably involve some ‘rough justice’.

That said, it is important to recognise that such a line in the sand is not intended to prescribe a methodology or a set of asset values that must be used by airports and airlines when negotiating charges. Rather, its purpose is simply to establish asset values to facilitate the monitoring of rates of return — and thereby help inform the Government on the reasonableness of charging outcomes and whether more detailed investigation might be required. While the two are obviously related, some rough justice for particular parties under a compromise line in the sand approach for monitoring purposes is seemingly of lesser importance than were the approach being used to set regulated prices.

Furthermore, while recognising that a variety of cut-off dates for revaluations could be used, the Commission is not convinced that there is a clearly preferable alternative to the 30 June 2005 cut-off proposed in the Draft Report. A significantly later date could lead to a ‘rush to revalue’. And a significantly earlier date would undermine the compromise deliberately inherent in the draft proposal.

The Commission did examine the alternative approach suggested by several participants of imputing asset values from aeronautical charges at each of the monitored airports at some particular date. But while *prima facie* being more theoretically ‘robust’, in practice, the Commission considers that there would be few advantages to set against the added complexity of the approach (see box 4.3).

Box 4.3 The imputation alternative

Relative to simply using ‘booked’ asset values at each of the monitored airports at a particular date, the imputation of asset values from aeronautical charges has the apparent advantage of greater theoretical robustness.

However, it is clearly a more complex approach. Also, as charges and more particularly passenger levels will vary over time, the need to choose a date to conduct the imputation exercise is not avoided. In turn, this makes the approach no less prone to concerns about ‘rough justice’ and disputation over the appropriateness of the date used.

Given that, in practice, there might be few benefits to set against the added complexity, the Commission has not pursued the approach in any detail.

But it notes that were the approach to be employed, it would not be appropriate, as suggested by Virgin Blue (sub. DR 62), to impute asset values from actual revenues under the price cap regime immediately prior to the introduction of price monitoring.

- Even if such a date for the calculation was used, then the asset values should be based on the revenues that were expected to result from the charges prevailing at the time, rather than on actual revenues. As outlined in chapter 2, the unanticipated downturn in passenger traffic in 2001 means that the Virgin Blue approach will tend to understate the appropriate revenue level for imputing asset values and thereby undervalue the assets concerned.
- Moreover, imputation from revenue flows under the price cap regime would see asset values struck on the basis of charges that were widely accepted as being commercially unsustainable and below the not unreasonable expectations of those bidding for the airports (see text).

Accordingly, the Commission considers that under this sort of approach, asset values would be best imputed on the basis of charges prevailing at the end of the first post-price cap agreements, and of expected traffic flows at the time those agreements were negotiated. In effect, the underlying presumption would be that charges negotiated immediately following the lifting of price caps should have been sufficient to provide a reasonable return on existing assets.

In sum, the Commission sees no reason to change the substance of either its ‘line in the sand’, or its suggested general proscription on future asset revaluations. That said, it accepts that the riders in the draft proposals relating to ‘agreement with customers’ on the asset values attaching to new investment/or to possible future revaluations, could have unintended and unwanted effects and are in any event probably unnecessary.

- Any differences in views on the values of assets related to new investment are something that would be more properly addressed in a more detailed investigation of an airport’s charging practices, rather than as part of a

monitoring process designed to assist the Government in deciding whether further investigation is warranted.

- Airlines can make any fundamental disagreement with such valuations, or of any future revaluations sought by airports as part of the negotiation process, directly known to Government.

Hence, the Commission has removed these riders from its final recommendations (see below).

Other matters

The treatment of intangibles

In reporting rates of return for the price monitored airports, the ACCC excludes intangibles from the asset bases. This is because of concerns that such intangibles may reflect an expectation at the time of sale of scope to earn monopoly rents.

Of course, some of these intangibles will almost certainly reflect factors that would have value in a more contestable market — for example, perceived opportunities at the time of airport purchase to increase the efficiency of service provision. In principle, such intangibles should be included in the asset base used for monitoring purposes.

But identifying and separating out ‘legitimate’ intangibles would be well nigh impossible. Accordingly, the Commission considers that under its proposed post-2007 price monitoring regime, the current treatment of intangibles should continue. In this regard, it notes that in responses to the Draft Report, there was no substantive opposition to a continuation of current practice in this area.

Amortisation and indexation

Amortisation of airport assets over the duration of the operating leases will tend to increase reported rates of return even if charges and margins are not rising. Such impacts will be most pronounced in relation to airport land which does not depreciate in value like a normal asset. This means that its amortised value and its ‘intrinsic’ value in the delivery of aeronautical services will progressively diverge over the life of the lease.

Conceptually, an adjustment to the asset base to offset the impact of land amortisation would remove one complication in interpreting the rates of return

emerging from the monitoring process. That is, a source of trend increase in rates of return unrelated to an airport's conduct or performance would be removed.

However, in practical terms, the amortisation impact will be of little consequence during the proposed further period of price monitoring.

- At most of the price monitored airports, land accounts for a small proportion of total aeronautical assets.
- In 2013, at the end of the proposed further period of price monitoring (see chapter 5), less than one-sixth of the land value at the monitored airports will have been amortised.

Thus, in the Commission's view, the 'interpretation benefit' from providing for an amortisation adjustment would not be sufficient to justify adding to the divergence between the airports' statutory and regulatory accounts (see below).

While there were no objections raised in responses to the Draft Report to this line of reasoning, several submissions sought clarification of the Commission's views on the related matter of the indexation of the asset base. In this regard:

- Westralia Airports Corporation (sub. DR58, p. 29) observed that if performance is being assessed using a real cost of capital then indexation of the asset base is appropriate. A similar observation was also made by Air New Zealand (sub. DR52, p. 6).
- More broadly, SACL (sub. DR.70, p. 6) said that the use of a written down historical asset base for monitoring purposes will see apparent returns increase over time, 'wrongly implying improper returns.' It went on to argue that the Commission's line in the sand approach should therefore provide for indexation of the asset base.

In a mechanistic sense, if the reasonableness of an airport's charges were to be assessed against a real rate of return benchmark, then the use of an indexed asset base would be appropriate. That said, the current practice is to report nominal rates of return for monitoring purposes and it is not clear what would be gained by increasing the value of the asset base and correspondingly reducing the rate of return which might be judged as acceptable. Moreover, the rates of return emerging from the monitoring process in the next few years would not be greatly affected by provision for indexation. The Commission also notes comments from the ACCC that once a starting aeronautical asset base is established for regulatory purposes, further indexation of that asset base should not occur (sub. 39, p. 63).

While the Commission does not see a need for indexation for price monitoring purposes, in a price setting context, indexation may be preferred by the negotiating

parties to avoid significant increases in the asset base (and charges) when new investment is required. Again, this serves to highlight the distinction between some simple asset valuation rules for monitoring purposes and the more complex valuation considerations that will often underlie the negotiation of charges between airports and their customers. Of course, if indexation is used for price setting purposes, then charges should be set to achieve an agreed real, rather than nominal, rate of return.

The divergence between statutory and regulatory accounts

As several airports pointed out, the line in the sand approach proposed by the Commission will add to an already emerging difference between monitored airports' statutory and regulatory accounts.

Such divergences are not unusual where price regulation or price oversight of infrastructure services is involved. What is important in this particular case is to establish reporting rules for monitored assets that maximise the usefulness of price monitoring in indicating whether airports are behaving appropriately when setting charges for their services.

Equally, such divergences do impose costs on airports and, in this context, will add to those attaching to Australia's recent adoption of the new International Financial Reporting Standards. As such, the Commission concurs with Melbourne Airport (sub. DR55, pp. 12-13) that the detailed implementation of its recommendations on asset valuation may require consultation with airports and airlines on how statutory and regulatory reporting requirements can be most cost-effectively 'meshed'. And, as noted by Westralia Airports Corporation (sub. DR58, p. 21), implementation may also require additional guidance by the ACCC on the degree of divergence permissible in the regulatory accounts submitted for monitoring purposes.

RECOMMENDATION 4.2

Under the new price monitoring regime, the value of an airport's asset base for monitoring purposes should be:

- ***the value of tangible (non-current) aeronautical assets reported to the Australian Competition and Consumer Commission as at 30 June 2005, adjusted as necessary to reflect the proposed service coverage of the new regime (see recommendation 5.2);***
- ***plus new investment;***
- ***less depreciation and disposals.***

In giving effect to this basis for valuation, the Australian Competition and Consumer Commission should consult with airports and airlines on how best to accommodate differences in statutory and regulatory reporting requirements within the new price monitoring regime.

The Commission is also proposing that a proscription on further asset revaluations as a basis for higher charges be included in the overarching principles for the new light handed regime (see recommendation 4.4 below).

Some cost of capital considerations

In the Draft Report, the Commission noted that the rate of return that airport operators might reasonably expect to earn continues to be the subject of some debate among the parties. It went on to suggest that the risks attaching to airport operations may have increased in recent years — pointing to the series of external shocks that have affected airports' operations and revenues, and to the impact on underlying traffic risk of the emergence of low cost carriers flying point to point and withdrawing services if they are not profitable.

In their responses to the Draft Report, all of the major airlines raised concerns about both the way in which the Commission had raised this issue, and about the lack of supporting analysis for its specific comments on the levels of risk confronting airport operators. For example, BARA (sub. DR48, p. 11) said that the Commission:

... has justified cost of capital increases in favour of airport operators based on a few broad brush statements over passenger volatility. This approach would go a long way to ensuring that no commercial agreements are reached with airport operators as part of the current price negotiations.

And in its report for Virgin Blue, the Allen Consulting Group (ACG 2006, p. 13) argued that:

... it is not obvious that the increase in the variability in passenger numbers has any relevance for the cost of capital associated with the provision of aeronautical services. ... what is important for asset betas is the *co-variability* of economic returns with the returns to the sharemarket as a whole.

Therefore, ... the relevant consideration is whether there has been some structural change that now implies that the returns from the provision of aeronautical services are now more closely correlated with overall market returns.

We do not find it convincing that the two underlying reasons for passenger variability suggested by the Commission — external shocks and low cost carrier entry — to have caused such an increased correlation with the market

Moreover, while agreeing with the proposition in the Draft Report that the ‘relative’ degree of risk in operating major airports in Australia has increased in recent years, Brisbane Airport (trans. p. 95) questioned whether it was helpful to elevate this matter at the present time:

[We] tend to agree with [BARA] that it will create more tension between airports and airlines; and whilst not suggesting that should never be looked at, [we] think that may be something to be more appropriately looked at in five years' time and take an area of dispute off the table.

For its part, the Commission accepts that the way it raised this issue in the Draft Report was unhelpful in the current environment and that more detailed investigation would be required to sustain a case that, relative to the market as a whole, risks in the airport sector are now higher or for that matter lower than five years ago.

That said, the Commission emphasises that the benchmark rates of return established by the ACCC for all of the monitored airports under the previous price cap regime should not be viewed as set in stone. In a genuinely commercial environment, asset betas and related cost of capital issues would reasonably be a consideration in negotiations between airports and airlines on charges.

4.4 Providing better guidance on expected outcomes

To provide guidance to the review of the next period of price monitoring (see chapter 5), and to airports and their customers in the preceding period, the Government should again specify a set of overarching principles.

All of the current Review Principles — covering efficient pricing structures, the need for prices to provide an appropriate return on assets, quality of service outcomes, and the expectation that airports and airlines will operate primarily under commercial agreements — are broadly accepted and endorsed by key stakeholders and should be retained.

In its Draft Report, the Commission proposed two additional overarching principles. The first involved a general proscription on the use of asset revaluations as a platform for higher aeronautical charges — an issue discussed at length in the preceding section. The second related to the sharing of productivity gains in the provision of aeronautical services between airport operators and their customers.

The rationale behind this second proposed principle was to help ensure that there are appropriate incentives for airports to innovate and improve the efficiency of their operations. That is, the principle was intended to provide scope for a monitored airport to earn ‘above normal’ returns if its productivity performance is consistently better than that of its counterparts, without being found to have misused its market power.

As noted in chapter 3, such latitude is already implicit in the light handed monitoring approach. Moreover, the general principle that airports should benefit from operational improvements was generally accepted by airport users. As Virgin Blue (sub. DR62, p. 41) noted:

... it is important for infrastructure providers to be provided with financial incentives to be efficient in the provision of the relevant services ... Permitting infrastructure providers to retain a share of the benefits they create through their initiatives and, symmetrically, bearing a share of the dis-benefits created by a lapse in attention to cost containment and other decision making, are a possible means of providing such incentives.

Responses to the Draft Report proposals on overarching principles

As discussed above, there was general acceptance of the line in the sand approach to asset valuation — although there was some disagreement over where the line should be drawn.

The consensus on the suggested principle relating to the sharing of productivity gains was that, while the concept was sound, the very general wording proposed by the Commission could lead to a variety of problems and disputes between airlines and airports. A particular concern for airlines was the likely difficulty of separating out cost savings generated by the actions of an airport, on the one hand, and reductions in unit costs arising from passenger growth, on the other. According to Virgin Blue (sub. DR62, p. 41):

... a principle that refers to improved productivity growth would permit airport owners to retain the ‘benefits’ that would arise irrespective of any actions or initiatives of the airports, and hence merely deliver windfall gains in circumstances where passenger numbers are growing rapidly... This growth in the usage of airports is attributable to the efforts of airlines and has little to do with the efforts of the airports.

Similarly, Qantas (sub. DR60, p. 16) considered that ‘... measurement of ‘productivity gains’ and determination of a mechanism for equitably sharing those gains would seem to be practically problematic’.

More broadly, several participants urged the Commission to develop a more specific set of pricing principles. The most detailed proposal was put forward by

BARA (box 4.4). Others, such as Melbourne Airport, suggested that additional pricing principles could be developed from the observation that the current level of airport charges is broadly appropriate and that passenger growth should exert downward pressure on future prices. That said, Melbourne Airport (sub. DR55, p. 17) also warned of the dangers in being too prescriptive in relation to future price movements.

Box 4.4 BARA's proposed Review Principles

'In negotiating future aeronautical pricing agreements with customers, the [Australian] Government considers that:

- for Sydney Airport, appropriately defined and valued aeronautical assets are those determined by the Australian Competition and Consumer Commission in its May 2001 Pricing Decision, updated for investment, depreciation and disposal of assets; and
- for other price monitored airports, the prices negotiated as at 1 July 2006 are at least sufficient to provide a commercial return on existing assets.

Furthermore, for all price monitored airports, the [Australian] Government considers that:

- anticipated increases in passenger demand should provide a source of downward pressure on airport charges for the use of existing assets;
- in the absence of investment and with strong growth in passenger numbers, even constant prices might be indicative of the exercise of market power;
- unless agreed with customers, future asset revaluations should not provide a basis for higher charges for monitored aeronautical services; and
- the benefits of improved productivity should be shared between airport operators and their customers; productivity improvements do not include increased use of existing assets through anticipated growth in traffic levels.'

Source: Sub. DR48, p. 3.

The Commission's assessment

The Commission considers that the addition of more prescriptive pricing principles, such as some of those put forward by BARA, would not be appropriate. Taken together, they could be operationally little different to price caps for existing services, with provisions for new investment to be negotiated with users. In the Commission's view, the role of the overarching principles is to guide the negotiating process, not to direct the outcomes it should deliver.

In addition to providing guidance to the negotiating parties, the overarching principles will provide some reference points for any triggering of the requirement

for an airport to ‘show cause’ as to why its conduct should not be subject to further scrutiny (see above).

In seeking to provide useful guidance, the Commission still sees merit in the overarching principle making it clear that there should be reasonable sharing of productivity gains. Also, the feedback on the Draft Report has convinced the Commission that the principles should allow for passenger growth to be a source of downward pressure on airport charges — though the corollary, of course, is that declines in traffic may be a source of pressure for higher charges.

However, it considers that seeking to precisely specify how productivity gains should be shared (along the lines suggested by some participants), or how passenger movements should relate to charges, would necessarily require a degree of prescription incompatible with a ‘light handed’ regulatory regime.

- A pricing principle which specified the relative shares of productivity gains airports would be ‘allowed’ to retain would be effectively equivalent to setting an ‘X factor’ under the CPI-X regime (a point noted by Virgin Blue, sub. DR62, p. 42).
- And, as Melbourne Airport observed (sub. DR55, p. 17), a pricing principle tightly linking downward pressure on charges to passenger movements would necessarily be subject to a number of caveats, resulting in an extremely cumbersome principle. For example, rising charges in the face of growing passenger numbers might reasonably reflect capacity constraints or a price trajectory that defrayed the initial impact of a necessary price increase (such as in relation to major new investment). Further, airports should derive some benefit from unit cost savings that arise from successful efforts to attract new airline business.

Accordingly, the Commission has sought to encapsulate these matters within the overarching principles in a high level way. The Commission accepts that this will require those assessing behaviour against these principles to exercise judgment. However, given the element of give and take involved in the negotiation of charges, and the goal of the light handed approach to provide for some latitude on outcomes, a role for judgment is not unreasonable. Moreover, assessments of these matters would also have regard to the existing principles, which the Commission is recommending be retained — including the first which specifies that expected revenue should not be significantly above long-run costs.

The Commission further considers that the overarching principles should emphasise the need for ‘good faith’ negotiations. As discussed above, a key objective of the light handed approach is to facilitate the development of commercial relationships between airport operators and airlines. Clearly, ‘good faith’ negotiations are

essential to developing such relationships. A reference to this in the overarching principles could help to reduce the incidence of ‘gaming’ by the parties, especially in relation to the operation of the proposed new process for triggering further investigation of an airport’s conduct where there is prima facie evidence of significant misuse of market power.

Similarly, the Commission considers that the overarching principles should reinforce the notion that, consistent with a commercial approach, the parties are expected to negotiate solutions to the disputes that will inevitably arise and make provision for commercial arbitration/mediation arrangements to facilitate this.

RECOMMENDATION 4.4

Assessments of airport behaviour during the next period of price monitoring should be governed by an overarching set of principles. All of the current ‘Review Principles’ should be retained. In addition, there should be three new principles specifying that:

- *further asset revaluations should not generally provide a basis for higher charges for monitored aeronautical services;*
- *the parties should negotiate in good faith to achieve outcomes consistent with the principles, including through the negotiation of processes for resolving disputes in a commercial manner; and*
- *there should be a reasonable sharing of risks and returns between airports and their customers (including those relating to productivity improvements and changes in passenger traffic).*

4.5 Why airport-specific arbitration is not warranted

As reflected in the current Review Principles, the intent of the light handed regime is that provision of aeronautical services should be primarily dictated by commercial agreements negotiated by airport operators and airlines. As alluded to above, for a commercially-driven approach to be effective arrangements must be in place to deal with the disputes that inevitably arise. Hence the Commission is recommending that the new overarching principles include explicit reference to the need for the parties to negotiate such arrangements.

In this context, a number of participants proposed augmenting price monitoring through the introduction of an airport-specific arbitration mechanism. However, as explained below, this could fundamentally undermine the light handed regime. Moreover, the recommended ‘framework’ changes to the monitoring arrangements (outlined above) should remove some significant impediments to the development

of commercial relationships and further reduce the case for introducing airport-specific arbitration.

Current dispute resolution arrangements

All airports have in place dispute resolution processes for matters arising during the life of a negotiated agreement. Although these vary between airports, they most commonly involve a stepped process, with progressive referral to more senior representatives of the parties, and ultimately to an independent mediator (see for example, Brisbane Airport Corporation, sub. 35, p. 40; Northern Territory Airports, sub. 37, p. 26).

However, mediation is almost always non-binding. (One of the few exceptions is the Terminal 3 Licence Agreement between Westralia Airports Corporation and Virgin Blue.)

Moreover, it is important to distinguish between dispute resolution mechanisms for agreements already in place and mechanisms for resolving disagreements arising during the negotiation of a new agreement (a point also made by a number of participants). While some participants identified problems with mechanisms to address the former (for example, Shell Australia, sub. 18, p. 7), most concerns underlying proposals for airport-specific arbitration related to disputes arising during contract negotiation (see below).

What are airport users main concerns?

During this inquiry, there was a significant divergence of views on how constructive and productive the negotiation and dispute resolution process has been, and on the extent of development of commercial relationships between the parties.

For the most part, airports considered that considerable progress has been made on both fronts. In particular, airports commented favourably on the negotiations that have occurred on new investment and associated charges, compared to the previous price-cap regime. That said, some airports raised concerns about aspects of negotiations to date. For example, Melbourne Airport (sub. 13, p. 67) observed that the dispute between Virgin Blue (and subsequently Qantas) and Sydney Airport — that has led to the Part IIIA declaration of domestic airside services at the airport — has taken ‘absurdly long’ to resolve.

Among the airlines, BARA and Virgin Blue recognised that there have been some positive outcomes from the negotiation process. For example, BARA (sub. 3, p. 2) commented that ‘in most instances following the removal of the CPI-X price cap,

there were meaningful negotiations with airport operators over the provision and pricing of aeronautical services and facilities for the following five years.’ And Virgin Blue (sub. 27, pp. 24-5) said that negotiations over access to terminals vacated by Ansett had been productive.

However, both of the major domestic airlines and their regional counterparts indicated that contract negotiations have often been difficult. Some of their particular concerns included:

- a perceived ‘take-it or leave-it’ approach to negotiations by airports;
- a lack of transparency in regard to the basis for offers;
- the absence of ‘accessible’ and binding dispute resolution procedures when the parties cannot reach agreement — which was viewed as a particularly dysfunctional aspect of the current arrangements; and
- the imposition of onerous conditions in regard to various non-price matters — for example, allocation of gate and aircraft parking positions, and rights to vary terms and conditions (see chapter 2).

Similar concerns were also raised by some third party providers, such as fuel companies, and by providers of freight services.

As noted in chapter 3, airport users acknowledged that the extent of such problems had differed across the monitored airports, with negotiations generally considered to have been most difficult at Sydney Airport. Some also noted that the Part IIIA national access regime may in the future play a greater role in resolving disputes and conditioning negotiations.

However, Part IIIA was still regarded as costly and time consuming to access. This, together with the extent of perceived problems to date and the underlying imbalance in bargaining power, led several participants to call for the introduction of airport-specific dispute resolution mechanisms.

Participants’ proposals for airport-specific dispute resolution mechanisms

At one end of the spectrum, BARA (sub. 3, p. 21) proposed a role for the Minister for Transport and Regional Services to decide whether, in response to complaints from airlines, a public inquiry into the pricing practices of an airport was warranted. This proposal is ‘one step along’ from the Commission’s process for triggering further investigation of airport conduct (discussed in section 4.2). The key difference is that BARA’s proposal would require a response to a specific complaint of airport behaviour, whereas the Commission is recommending that the totality of

information on an airport's conduct (including from monitoring reports) be considered in deciding whether further investigation is warranted.

At the other end of the spectrum, Qantas and Virgin Blue proposed much more 'encompassing' dispute resolution mechanisms which would utilise the declaration provisions of Part IIIA.

- Qantas (sub. 28, pp. 24-33) recommended the introduction of a 'core principle' that negotiations should be based on full and transparent exchange of information and provision for binding independent dispute resolution. This 'core principle' would be introduced through the lodgement by airports of Part IIIA undertakings — either on a self-standing basis, or to conform with an approved airport 'access code'. Airports submitting acceptable undertakings — with provision for binding dispute resolution — would be both exempt from declaration (as at present) and no longer subject to price monitoring. To further encourage the lodgement of such undertakings, Qantas also proposed that, where an acceptable set of access terms and conditions was not submitted, the airport's aeronautical services would be deemed to be declared.
- The Virgin Blue proposal (sub. 27, pp. 70-6; and sub. 45, pp. 3-6) involved automatic declaration of aeronautical services under Part IIIA with negotiations underpinned by ACCC guidelines on pricing and costing.

Notably, one airport, Melbourne (sub. 13, pp. 70-2), also put forward a dispute resolution mechanism which involved a process for triggering a Part VIIA inquiry, similar to that proposed by BARA. Under this mechanism, an airport found to have breached the overarching principles could ultimately be subject to declaration under Part IIIA.

Importantly, however, the airport emphasised that airlines availing themselves of this mechanism should be required to put in a 'reasonable' counter-offer. Also, Melbourne Airport's motivation for proposing such a mechanism was somewhat different from that of the airlines — in part, the mechanism was intended to address its concerns that an airport which complies with the overarching principles could still be declared under Part IIIA (see chapter 3).

Other airports, however, did not see the need for an airport-specific arbitration system — although, following the release of the Draft Report, Brisbane Airport indicated that it was not opposed to a mechanism of the type suggested by BARA, providing genuine negotiations occurred first (trans. p. 90).

The Commission's approach in the Draft Report

In its Draft Report, the Commission recognised that:

- there have been deficiencies in the negotiation process — highlighted by the declaration of the domestic airside service at Sydney Airport under Part IIIA;
- expectations and negotiating stances remained heavily conditioned by perceptions of the outcomes that the previous price cap regime might have produced in similar circumstances; and
- there are a number of points of contention between the parties — foremost among which is the issue of asset valuation — which have acted as stumbling blocks to relationship building and progressing the next round of price contracts.

Nonetheless, the Commission observed that there has been considerably more negotiation between the parties than under the previous price cap regime, an important outcome of which has been the much more timely resolution of arrangements governing new investment.

Moreover, it noted that, as in any commercial negotiating environment, disputes between the parties are to be expected. Indeed, it said that it would be surprising if negotiations had not been intense and sometimes protracted, given the major investments that both airports and airlines have in their businesses.

In examining whether an airport-specific arbitration/dispute resolution mechanism is warranted, the Commission acknowledged participants' concerns about the costly and time consuming nature of seeking to resolve protracted disputes through the Part IIIA national access regime. But it also said that it is not unreasonable to set a high bar for invoking compulsory arbitration of disputes over the terms and conditions of supply for essential infrastructure services — pointing to experience in some other sectors where easy access to a sector-specific arbitration process has undermined genuine negotiations, with parties who perceive they will get a better outcome from the designated arbitrator simply going through the motions as a prelude to arbitration.

It went on to say that this was precisely why it had considerable reservations about the introduction of an airport-specific arbitration regime, arguing that it did not appear possible to devise a mechanism that would retain strong incentives for *all* of the parties to negotiate outcomes, rather than viewing arbitration as the default option.

Further, the Commission noted that the Qantas proposal operating through the Part IIIA undertaking provisions would not circumvent this core problem.

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- The proposal is still underpinned by the principle that either party in a dispute should be able to precipitate independent and binding arbitration.
 - The undertaking approach is simply a means to pre-emptively give effect to arbitration. That is, the ACCC would be arbitrating on the reasonableness of pricing proposals and related matters in the undertakings submitted by the airports.

The Commission did, however, seek to test these judgments by specifically inviting further input on whether a system could be devised which retained strong commercial incentives to negotiate. In this context, it referred to the possibility of final offer arbitration (see discussion below).

But the Commission also questioned whether it would be premature to introduce an airport-specific arbitration regime.

- The effectiveness of price monitoring in constraining misuse of market power and encouraging the development of commercial relationships is only beginning to be fully tested. The key stakeholders should be given reasonable opportunity to show that through constructive negotiation they can deliver effective outcomes — rather than making provision for third parties at arms length from commercial realities to set prices and terms and conditions for them.
- Implementation of the Commission’s proposals to address some of the key sticking points in current negotiations — especially the asset valuation issue — could make it easier for the parties to reach agreement in the future.

Finally, the Commission observed that the need for an airport-specific arbitration regime cannot be properly judged until the consequences of the declaration at Sydney Airport have played out. As discussed in chapter 3, since the release of the Draft Report, there have been significant developments in this regard which cast further doubts on the need for such an arrangement.

Responses to the Draft Report

Most airports strongly agreed with the Commission that access to compulsory arbitration would limit incentives for the parties to engage in genuinely commercial negotiations. Melbourne Airport (sub. DR75, p. 12), the only airport to have previously canvassed an airport-specific dispute resolution process (see above), sought to support negotiations within this process through the introduction of a new overarching principle — namely, that airlines should negotiate in good faith and respond to any airport offer with a genuine counter-offer.

However, the major airlines reiterated their initial view that, given the imbalance in bargaining power between airports and their customers, a compulsory arbitration mechanism should be introduced. In doing so, they suggested that, while the bar for achieving declaration under Part IIIA has almost certainly been lowered by the recent Federal Court decision, it will remain a costly and time consuming mechanism (though, as noted in chapter 3, Qantas indicated a willingness to use it if an airport-specific arbitration mechanism is not introduced).

Further, airlines disputed the argument, advanced in the Draft Report, that airport-specific arbitration would reduce their incentives to negotiate. Both Qantas and Virgin Blue, for example, claimed that such a mechanism would only be used as a last resort and that access to it would itself encourage compromise and fruitful negotiation. They also claimed that such mechanisms in other regulated infrastructure sectors have not fundamentally undermined the negotiation process.

Taking a more circumspect view, Air New Zealand (sub. DR52, p. 8) acknowledged the tensions involved in encouraging commercial negotiations in the presence of a compulsory arbitration mechanism, but also said that reasonable incentives to negotiate could be retained, particularly if key sticking points in current negotiations were addressed.

Beyond asserting that their preference under an airport-specific arbitration regime would be to negotiate, neither Qantas nor Virgin Blue responded specifically to the Commission's invitation to comment on if and how an arbitration mechanism could be configured to retain strong incentives for genuine negotiation. However, several other participants did so:

- Air New Zealand (sub. DR52, p. 8) and Regional Express (sub. DR64, p. 7) saw some potential value in final offer arbitration — under which an arbitrator is constrained only to choose between the final offers made by the parties and not consider alternatives.
- But, a number of airports pointed to the difficulties involved in employing this approach in negotiating terms and conditions for the supply of airport services, which typically involve several negotiating parties and multiple issues.
- Westralia Airports Corporation (sub. DR58, p. 14) also argued that final offer arbitration can be 'gamed', with the parties commencing negotiations with unreasonable starting positions in the expectation that adopting a more conciliatory stance prior to arbitration will increase the chance of their final offer being accepted.

The views of some participants on the Commission's draft proposals on dispute resolution are elaborated on in box 4.5.

Box 4.5 **Responses to the Draft Proposals on dispute resolution**

Is an airport-specific mechanism warranted?

Westralia Airports Corporation (sub. DR58, p. 13)

... introducing compulsory dispute resolution provisions into the regime at this time would most certainly result in a serious undermining of the incentives for both parties to work toward the development of fully functional commercial relationships. In effect, such a move would indeed be a return to a more heavy-handed, interventionist form of regulation.

Qantas (sub. DR60, p. 5)

Currently, Qantas attempts to reach agreement with airports by escalating material issues to senior management (including ultimately its CEO). Access to a binding dispute resolution mechanism will arguably enhance this current process — instead of stalemates being reached after a series of negotiations between increasingly senior executives in each organisation, more issues would be resolved as both parties will need to assess whether their conduct would be considered reasonable in the event the other party invoked its right to refer the issue to independent binding arbitration.

Virgin Blue (sub. DR62, p. 4)

Other Australian industries, such as the telecommunications, gas and electricity industries, that depend on services provided through significant monopoly infrastructure do not rely merely on price monitoring to ensure efficient terms and conditions for access to that infrastructure. Instead, a variety of other mechanisms, such as negotiate-arbitrate models and/or access undertakings are used to ensure that prices charged by access providers do not rise significantly above efficient costs. Virgin Blue does not see any legitimate reason why the aviation industry, with its reliance on monopoly airports, should be an exception to this rule.

Can incentives to negotiate be preserved?

Air New Zealand (sub. DR52, p. 8)

There may be no dispute resolution mechanism that fully accommodates the Commission's desire to maintain strong incentives for all parties to negotiate while also providing a means for resolving irreconcilable disputes. Unfortunately, there is an unavoidable tension between these two objectives. However, we would emphasise that users do have an incentive for airports to invest in appropriate infrastructure and that, as current ambiguities around pricing principles are progressively addressed, neither airports nor airlines will have a great deal of appetite to engage in costly, arbitrated outcomes.

SACL (sub. DR70, p. 10)

[Final offer arbitration] may offer certain advantages in relation to the resolution of disputes which involve a single issue and where the parties will not necessarily have any ongoing relationship ... However, there are substantial difficulties in implementing any form of 'final offer' arbitration where the parties have an ongoing commercial relationship which involves continual negotiations and cooperation on a wide range of interrelated operational, commercial and strategic matters, each of which requires flexibility, trade-offs and an element of 'give and take' that characterises genuinely commercial negotiations.

The Commission's assessment

None of the responses to the Draft Report has changed the Commission's view that a readily accessible airport-specific arbitration system would fundamentally undermine incentives for the parties to negotiate outcomes. Put simply, it seems highly likely that such a system would come to be viewed by airlines in particular as the default option, effectively leading to a return to heavy-handed determination of charges and conditions for airport services, with all of its attendant costs.

The Commission draws little comfort from the use of such mechanisms in other regulated infrastructure sectors (see box 4.6):

- Service provision in these sectors is typically subject to price regulation (and/or ACCC specification of indicative prices) so the scope for negotiations has already been curtailed. For example, the ACCC has undertaken no arbitrations for access disputes in the gas sector where prescriptive pricing and access guidelines have been issued.
- In sectors such as gas and electricity distribution negotiations occur over the supply of a relatively homogeneous product which further reduces the range of issues over which disputes may arise.
- While in sectors such as gas there is clearly considerable negotiation between access providers and seekers, this is often in regard to foundation contracts for new infrastructure, rather than about charges for access to existing facilities. As such, these negotiations are akin to those relating to new investment at airports, where there has been much less dispute than over charges and conditions of use for existing infrastructure.
- And where such mechanisms are focussed on disputes over access to existing facilities, arbitration can be heavily used. For example, in 2005-06, the ACCC was notified of 30 access disputes under the sector-specific regime applying to telecommunications (section XIC of the TPA) (ACCC 2006c, p. 107).

The Commission therefore considers that while there would still be negotiations under the umbrella of an airport-specific arbitration mechanism, such negotiations would increasingly be in a narrow band around a default set by the outcome of those disputes that had proceeded to arbitration.

These concerns are the same as those which the Commission has about the possible recent 'lowering of the bar' for declaration under Part IIIA. Indeed, as argued in Chapter 3, introduction of an airport-specific arbitration mechanism, in conjunction with a potentially more accessible Part IIIA regime, raises the prospect of two intrusive mechanisms being available for resolving disputes between airports and their customers.

Box 4.6 Dispute resolution mechanisms in regulated sectors

In a number of regulated infrastructure sectors there is provision for arbitration. In gas and telecommunications, the arbitrator is the ACCC. In electricity, disputes can be referred to a panel of experts chosen by a dispute resolution adviser appointed by the Australian Energy Regulator (AER). In all these sectors, arbitration may result in the imposition of binding conditions on supply, including the setting of access charges.

While the parties are typically encouraged to pursue alternative dispute resolution mechanisms — such as commercial mediation — the incidence of arbitrated outcomes can be high. In 2005-06, the ACCC commenced and progressed 41 arbitrations in the telecommunications sector, some of which had been lodged in the previous year (ACCC 2006c, p. 107). Most of these disputes related to access charges, despite the issuing of ACCC pricing guidelines intended to:

... inform the market of its likely decisions in arbitrations and so provide greater certainty to access seekers and [promote] the timely resolution of access disputes without having to refer them to the ACCC. (ACCC 2006d, p. 60)

The issuing of prescriptive pricing and access guidelines in the gas sector has acted to limit the number of disputes between access seekers and providers. To date, the ACCC has not received an access dispute notification under section 6.1 of the National Gas Code (which applies to pipelines regulated by the Code and for which there is an access arrangement in place). While disputes can arise over 'foundation' contracts for new pipelines, these need to be resolved before the pipeline can be used. Consequently, both parties face strong incentives to resolve any disagreements relating to new investment.

In electricity transmission, where pricing and access guidelines have also been issued, few disputes have been referred to arbitration and these typically related to the legal interpretation of clauses in existing supply contracts or in the National Electricity Rules.

Sources: ACCC 2006c, 2006d; AER website.

As well, the 'framework' changes that the Commission is recommending to the light handed approach reduce further the case for an arbitration mechanism.

- Introduction of an explicit process for triggering further investigation of inappropriate airport behaviour should partly address users' concerns about the consequences of imbalance in bargaining power.
- Resolving the asset valuation issue should considerably narrow the negotiating divide between the parties.
- Augmentation of the overarching principles to make it explicit that the parties are expected to negotiate mechanisms for resolving disputes should encourage the further development of commercial arbitration/mediation processes, tailored to the particular needs of individual airports and their customers.

With these changes in place, the key stakeholders should then be given the opportunity to show that through constructive negotiation they can deliver effective outcomes, with their performance judged accordingly.

Mandatory information disclosure

In its Draft Report, the Commission also invited comment on less intrusive alternatives to airport-specific arbitration for facilitating negotiated outcomes and efficient and timely dispute resolution. Among the possibilities it put forward was mandatory information disclosure requirements.

These requirements are a feature of several industry-specific arbitration access regimes and have also been previously endorsed by the Commission as helpful in certain situations (PC 2001, p. 213; PC 2004, p. 360). Against a backdrop of concerns about a lack of transparency in pricing offers, some airlines identified value in this approach — especially mandated application of the ‘open book’ policy practised by some airports (Regional Express, sub. 29, p. 23; IATA, sub. DR59, p. 6).

However, SACL (sub. DR70, p. 11) contended that it was premature to move in this direction and a ‘...more mature commercial environment’ should be allowed to develop before assessing whether such requirements would be beneficial. And, Air New Zealand (sub. DR52, p. 2) commented that in New Zealand, where such arrangements apply, a lack of clarity in the governing regulations has prevented customers from understanding the price setting processes at airports.

In the light of this input, the Commission is not convinced that mandatory information disclosure provisions are warranted at this time. The New Zealand experience suggests that it may be difficult to draft requirements that actually assist the negotiation process. Moreover, at those airports which follow an ‘open book’ policy, even well crafted provisions would seemingly add little value to negotiations.

This may be an issue which could be reconsidered at the next review of price monitoring (see recommendation 5.5), especially if developing commercial relationships do not ease concerns over the lack of transparency in airports’ pricing offers. However, if such arrangements are introduced at some stage in the future, they should be genuinely two-way. That is, there should be an obligation on airlines to provide relevant information that would help airports formulate their pricing offers. Further, the Commission considers that information disclosure is good commercial practice and airports’ willingness to volunteer necessary information

during negotiations should be taken into account when evaluating behaviour against the overarching principles.

RECOMMENDATION 4.5

Neither an airport-specific arbitration regime, nor mandatory information disclosure requirements for airports, should be introduced at this time.

5 Implementing a modified price monitoring regime

Key points

- The new price monitoring regime, proposed to operate from July 2007, should apply to Adelaide, Brisbane, Melbourne, Perth and Sydney Airports.
- Service coverage of the two regulatory instruments giving effect to price monitoring should be aligned, for the most part in accordance with a proposal by the Department of Transport and Regional Services (DOTARS). In particular, this would mean that:
 - all revenues from the provision of aircraft refuelling, ground and airside freight handling, and common-use check-in counter services would be covered by the price monitoring process.

However, airport office space and telecommunications infrastructure, which are currently included in the proposed DOTARS definition, should not be monitored.

- In streamlining and rationalising quality of service monitoring, the ACCC should give particular attention to:
 - dispensing with commentary and qualitative survey results from the Australian Customs Service;
 - removal of matters from airline satisfaction surveys which are also covered by passenger satisfaction surveys or by quantitative indicators; and
 - greater use of comparative passenger satisfaction results from reputable international benchmarking exercises.
- To further streamline reporting processes, and to help put price changes into context, price and service quality monitoring reports should be combined.
- The new monitoring regime should operate for a period of six years — ending on 30 June 2013 — and be reviewed in 2012. This would enable the Government to consider what arrangements should then be put in place in the light of the findings of the next scheduled review of the national access regime.

The previous chapter set out the key foundations for the proposed post-2007 price monitoring regime. This chapter considers issues associated with how that regime

should operate — specifically, (i) the list of airports and services which should be monitored, (ii) the role of quality of service monitoring and, (iii) duration, reporting and review arrangements.

5.1 Airport coverage

The airport coverage of the current monitoring regime is based on the Commission's assessments of market power in its previous review of airport pricing. Those assessments focused primarily on the ability for airlines, or their passengers, to substitute away from the services provided by the airport (towards another airport, another destination or another mode of transport).

The conditions underlying the Commission's assessment of market power have not changed greatly since the time of the last review. The composition of passengers (business/visiting friends and relatives/tourists) travelling to the monitored airports remains broadly the same (see appendix D), as do the substitution possibilities available to passengers (notwithstanding the development of Avalon Airport and strong traffic growth at Gold Coast Airport). After conducting a detailed examination of market conditions, the Australian Competition and Consumer Commission (sub. 39, pp. 6-9) reached a similar conclusion.

Nonetheless, claims from the smaller monitored airports that they should be removed from monitoring arrangements, together with suggestions from some airlines that additional airports should be scrutinised, led the Commission to reconsider the issue of airport coverage.

The Commission sees no case for removing the four largest airports from price monitoring. Indeed, all of these airports accepted that they should be encompassed by any future monitoring regime. As argued below, the Commission considers that Adelaide Airport should also continue to be monitored. However, recent developments at Canberra and Darwin Airports have led the Commission to conclude that inclusion of these airports in price monitoring arrangements is no longer warranted.

Darwin Airport

In 2002, the Commission argued that, as a result of competition from other holiday destinations, Darwin Airport possessed less market power than mainland state capital airports. While data provided by the ACCC (sub. 39, p. 8) suggests that the proportion of business travellers and those visiting friends and family may be higher

than previously identified by the Commission, holiday passengers still represent a significantly larger share of traffic than at most other monitored airports.

Moreover, since the Commission's previous review, there have been a number of other developments which appear to have further constrained Darwin Airport's market power:

- Virgin Blue has cancelled around one-third of its services into Darwin, reinforcing the dominance of Qantas at the airport. Qantas now provides 85 per cent of domestic flights into Darwin (compared with a national market share of 60 per cent) and over three-quarters of international flights (compared with a national market share of around 30 per cent). Qantas' larger market share is likely to have enhanced its bargaining power at the airport.
- The dominant market share of Qantas also reinforces incentives for the airport to encourage other airlines to initiate services to Darwin (or not to cancel existing services).
- The airport faces greater competition for international traffic from both Broome and Cairns Airports, particularly for passengers from South-East Asia. Neither of these airports is monitored and Cairns Airport has more than twice as many domestic passengers and four times as many international passengers as Darwin Airport.

While charges have risen substantially at Darwin Airport since price controls were lifted, these increases have reflected the continued unwinding of the previous, commercially unsustainable, charges; significant new investment; and the costs of meeting more stringent security requirements. In this latter regard, because of the much lower traffic volume at Darwin Airport, the per passenger cost of paying for compulsory security upgrades is significantly higher than at most of the other price monitored airports.

Taking all these factors into account, the Commission recommended in its Draft Report that the airport should not be subject to price monitoring once current arrangements expire in June 2007.

A number of airlines commented on this recommendation.

- Though Qantas did not dispute that its countervailing power at Darwin Airport has increased somewhat, it argued that any competitive pressure from Cairns and Broome Airports only applies to the relatively small proportion of international passenger traffic at the airport (sub. DR60, p. 14).
- Virgin Blue argued that even if Qantas' bargaining power has improved (which it doubted) there is no guarantee that this will flow through to charges for other airlines (sub. DR62, p. 49).

However, the Commission does not consider that such arguments for continued monitoring of the airport are particularly compelling. While it is true that the relatively low share of international traffic reduces the overall significance for outcomes of competition from other airports, the corollary is that Darwin Airport relies heavily on domestic passenger traffic, largely supplied by Qantas. And, as the airport's charging does not differentiate between carriers, other airlines serving the airport will benefit from Qantas' relatively strong negotiating position.

The Commission has also been mindful of the fact that Darwin Airport has considerably fewer passenger movements than its larger counterparts — accounting for less than 2 per cent of total movements at the price monitored airports (appendix D, table D.1). It is also smaller than (the non-monitored) Cairns, Gold Coast and Hobart Airports and, according to the airport, will be smaller than Townsville and Avalon Airports within the next five years. Over the same period, Newcastle and Maroochydore Airports are likely to increase their domestic passenger base to be on a par with Darwin Airport (trans. p. 39).

Accordingly, the Commission sees no reason to change its position that Darwin Airport be excluded from price monitoring after 2007.

Canberra Airport

In 2002, the Commission assessed Canberra Airport as having 'low to moderate' market power on the grounds that it faced significant competition from other modes of transport.

In its initial submission to this inquiry (sub. 30), the airport argued that it should no longer be subject to monitoring on the basis that:

- its passenger numbers are much lower than at the other monitored airports (except Darwin);
- those numbers are also lower than at some other airports which are currently not monitored (such as Gold Coast and Cairns); and
- its costs of complying with the current arrangements are disproportionately high.

It further contended that its low traffic volumes mean that the major airlines negotiate from a position of some strength — as indicated by the fact that it has typically been relegated to a secondary position in the negotiation sequence. This has apparently led to delays in reaching agreements as a result of airlines waiting for issues at the larger airports to be resolved (sub. 30, p. 12).

However, the Commission also received complaints from airport users about the behaviour of Canberra Airport. In its assessment included as part of the Qantas

submission, NERA (2006, p. 4) claimed there had been ongoing disagreement with airlines over prices and conditions of service and the issue of asset revaluation. Smaller airlines also expressed concerns about a range of outcomes at the airport — with the Regional Aviation Association of Australia (sub. 25, pp. 6-7) arguing that denial of security of tenure for some users and the introduction of new arrangements for charging for fuel (see section 5.2) are indicative of the exercise of market power.

Also, while Canberra Airport pointed to increased potential for modal competition on the Sydney route, the Commission observed in the Draft Report that the proportion of less price-sensitive business passengers — which is higher at Canberra Airport than at any other monitored airport — has increased since 2001. As a result, the Commission suggested that airlines may see less need to exercise countervailing power in their negotiations with the operator.

While acknowledging that the arguments were finely balanced, the Commission proposed, in its Draft Report, that Canberra Airport continue to be monitored after 2007.

In response, Canberra Airport provided additional information on developments at the airport since 2001 (sub. DR67, pp. 5-8).

- Around one-third of flights servicing the airport have been cancelled, the majority of these on the Sydney route, where the degree of modal competition is highest. According to the airport, this demonstrates the capacity of the airlines to exercise countervailing power.
- As a result of these changes, the dominant carrier at the airport, Qantas, now has a market share of 75 per cent.
- The scope to vary charges in coming years will be limited by new 15 year terminal agreements which have been negotiated with airlines and by the airport's agreement to the airlines' request for terms no less favourable in the provision of aeronautical services.

In such an environment, any additional constraining effect on charges of continued price monitoring may only be small. The Commission further notes that:

- aside from the issue of asset valuation, recent negotiations between the airport and major airlines appear to have proceeded well (see, for example, the comments of Qantas, trans. p. 111);
- like Darwin Airport, Canberra Airport has considerably fewer passengers than the major monitored airports and is smaller than some of the non-monitored airports, such as Cairns; and

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- the capacity of the airport to impose excessive charges for its new refuelling facilities are likely to be limited by the ability of airlines to refuel at other airports.

After carefully considering the position of the airport, and in the light of information submitted in response to the Draft Report, the Commission now considers that Canberra Airport need no longer be monitored.

Adelaide Airport

In its 2002 review, the Commission assessed Adelaide Airport as having a ‘moderate’ degree of market power. Specifically, the Commission considered that while there was some potential for substitution towards alternative modes of transport (based on the relatively high proportion of visitors from New South Wales and Victoria who arrive by car), the ability for most passengers to substitute towards alternative airports or destinations was limited. Recent data on the composition of travellers to the airport indicate that these conclusions remain valid (appendix D, table D.2).

That said, users have not raised major concerns about the behaviour of the airport since price controls were removed.

- Adelaide Airport has been flexible in commercial negotiations, offering the choice of ‘passenger-based’ or ‘weight-based’ landing charges — a choice the airport has indicated it intends to continue to offer.
- It also offers discounts to regional airlines. According to the airport, Regional Express enjoys the lowest regional airline charges of any capital city airport (sub. DR61, p. 1).
- Along with Melbourne Airport, it is the only monitored airport to have reached a long term aeronautical services agreement with Qantas (NERA 2006, p. 9).
- BARA also expressed satisfaction with commercial developments at the airport, noting that negotiations with the operator have essentially established an acceptable price path for international carriers for the next 15 years (trans. p. 58).

As well, Adelaide Airport disputed the suggestion of the South Australian Government (sub. 36, p. 2) that recent good commercial relations with its customers may reflect a temporary increase in airline countervailing power while negotiations over the new terminal facility were underway. The airport contended that substantial excess capacity at the new terminal will continue to limit its ability to exercise market power (sub. DR61, p. 1).

Based on this track record, the airport argued that it too should be removed from the group of monitored airports when current arrangements end in 2007.

However, while relations between the airport and its customers appear to have been generally satisfactory, the profile of demand conditions supporting the inclusion of Adelaide Airport in price monitoring has not fundamentally changed since 2001, and, for most passengers, the substitution possibilities remain limited. Hence, though excess capacity in the new terminal facility may have enhanced the bargaining position of the airlines, in the Commission's view, it retains considerably more market power than either Darwin or Canberra Airports.

Given that some caution is warranted in winding back the coverage of a regime that is yet to be fully tested, the Commission considers that it would be inappropriate to remove Adelaide Airport from the group of monitored airports at this time.

Other airports

Those larger airports which were not subject to regulatory oversight when the current price monitoring arrangements were implemented have identified benefits similar to those at price monitored airports. That is, the investment environment has improved and airport management has been required to adopt a more commercial focus (Hobart Airport, sub. 4, pp. 3, 13; Queensland Airport Limited, sub. 22, p. 3; Cairns Port Authority, sub. 40, p. 3). Moreover, the limited comments from users on outcomes at these airports have generally been positive (BARA, sub. 3, p. 9; NERA 2006, p. 9).

Nonetheless, two airlines argued for extended airport coverage under a future price monitoring regime:

- Virgin Blue (sub. 27, p. 72) submitted that modified monitoring arrangements (including a dispute resolution mechanism) should be extended to cover Alice Springs, Cairns, Gold Coast, Hobart, Launceston and Townsville Airports.
- Regional Express (sub. DR64, p. 4) argued that, in response to what it perceived as excessive charges, price monitoring should be extended to major regional airports.

However, in the Commission's view, the case for extending the coverage of the proposed price monitoring regime is not compelling. Indeed, as argued above, the Commission considers that it is no longer necessary to oversight the two smallest currently monitored airports.

The larger non-monitored airports generally face significant competition from other airports, other modes of travel and/or other destinations. In 2002, the Commission

found that a combination of these factors meant that Alice Springs, Gold Coast, Hobart, Launceston and Townsville Airports had little market power (PC 2002, p. XXIV) — a conclusion generally endorsed by the ACCC and accepted by the Government in establishing the coverage of the current price monitoring regime.

The larger non-monitored airports must also deal with airlines that appear to have considerable countervailing power through capacity to reduce or withdraw services. This is particularly the case for airports which are reliant on tourist traffic. In commenting on the impact of low cost carriers (LCCs), Cairns Airport (sub. 40, p. 2) said:

Jetstar and Virgin Blue both adopt a far more aggressive negotiating stance than has traditionally been the case ... During negotiations of agreements with the LCCs they have emphasised that they have a wide range of route options and that, in the context of the lower airfare environment, the relative cost to fly to destinations is an important factor in the airlines' determining which destinations will be serviced.

Similarly, a number of factors argue against the extension of price monitoring to regional airports:

- Strong commercial relationships have developed between airlines and some regional airports. Regional airlines have indicated that these relationships have resulted in reductions in landing charges, increases in passenger numbers and improvements in service quality (Creedy 2006).
- As noted by Regional Express (sub. DR64, p. 4), there is considerable scope for competition between those regional airports that rely heavily on tourist traffic — for example, between Ballina and Lismore and between Burnie, Devonport and Launceston.
- This suggests that the countervailing power of airlines is likely to be greater than at major capital city airports — a point noted by NERA in its report for Qantas (NERA 2006, p. 26). Moreover, since flights to regional airports are typically direct services they often can be cancelled without disrupting existing airline networks.
- Such withdrawal of services may, in turn, lead to significant public criticism of an airport if its behaviour is perceived as having been a contributing factor.
- And, though Regional Express raised concerns about charges at some regional airports (see appendix D, figure D.1), such relatively high charges, of themselves, do not necessarily indicate an abuse of market power. The smaller traffic volumes of regional airports suggest that unit costs will often be commensurately higher than at the larger airports.

All this is not to suggest that the degree of market power of regional airports is uniformly low. In this regard, Regional Express (sub. DR64, p. 4) argued that while

airports in communities vulnerable to attracting and maintaining air services are usually willing to adopt a more commercial and co-operative focus:

... where the level of vulnerability whether real or perceived is reduced ... many of the larger regional airports adopt similar approaches to those of the major airports. The only real bargaining power an airline has is the withdrawal of service.

However, though the capacity of carriers to exercise countervailing power will differ between individual regional airports, overall their ability to do so is clearly greater than at the major price monitored airports. This, together with the other general competitive constraints on regional airports, suggests that monitoring of these airports is not warranted.

RECOMMENDATION 5.1

The new price monitoring regime should apply to Adelaide, Brisbane, Melbourne, Perth and Sydney Airports. Darwin and Canberra Airports should not be subject to monitoring once the current arrangements end.

5.2 Service coverage

Service coverage should be based on a market power test

If price monitoring is to be a credible instrument for identifying instances of inappropriate airport behaviour in setting charges, it should encompass all services for which airports are likely to have significant market power. Conversely, inclusion of services for which airports have little or no scope to exercise market power would add little to assessments of the reasonableness of their behaviour.

With a few exceptions (discussed below), the services monitored under a market power test would be the same as those currently monitored under the ‘dual till’ which restricts oversight to aeronautical and related services and excludes non-aeronautical activities, such as retailing.

The two sets of regulations governing coverage should be aligned

As outlined in chapter 1, the ACCC is required both to monitor prices at certain airports (under direction 27 pursuant to Part VIIA of the Trade Practices Act) and to report on their financial accounts (under the Airports Act).

However, the definitions and service coverage in these two regulatory instruments differ, with the most substantive differences being that:

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- *landside vehicle services* (including car parking and taxi holding and feeder rank services) are classified as aeronautical-related under direction 27 and therefore subject to price monitoring, but are classified as non-aeronautical under the relevant provisions of the Airports Act and thus not subject to financial monitoring; and
 - *aircraft refuelling services* are similarly encompassed by price monitoring but not by financial monitoring. However, in this case, the situation is further complicated by the fact that some airports have relied on an ‘exemption’ clause (see below) to exclude revenue related to these services from their aeronautical accounts submitted for price monitoring purposes.

In November 2005, the Department of Transport and Regional Services (DOTARS) recommended that, in order to streamline data collection and simplify the presentation and interpretation of monitoring reports, there should be a consistent definition of services to be monitored. In essence, the aligned definition proposed by DOTARS, which is detailed in appendix D (table D.3):

- includes all those services currently monitored under *either* direction 27 or the Airports Act, apart from landside vehicle services (which, as noted above, are currently monitored under direction 27); and
- incorporates some services which are not currently monitored (such as ground handling, airside freight handling, telecommunications infrastructure and office space for airline employees).

Like participants in this inquiry, the Commission considers that if two regulatory instruments remain necessary to implement price monitoring, then their service coverage should be the same. The current differences serve no useful purpose, add to the costs for airports of preparing accounts for the ACCC, and make interpretation of the results of the monitoring process more difficult. Moreover, the current distinction between ‘aeronautical’ and ‘aeronautical-related’ services is an artificial and unhelpful legacy from previous regulatory arrangements.

Which services should be monitored?

As well as there being general agreement on the need for definitional alignment, there is little debate about the inclusion of most of the specific services encompassed by the DOTARS’ proposal. The proposed coverage also generally accords with the Commission’s service-by-service assessment of market power in its 2002 review. Consequently, the Commission has not sought to replicate that assessment — especially as, for the most part, the opportunities for airport users to

use alternative services, or source services from alternative suppliers, have changed little since 2002.

However, some particular aspects of DOTARS' proposed service coverage have been addressed at some length in submissions to this inquiry. The Commission has therefore examined these specific matters in more detail, having regard to its previous assessments of market power, the arguments raised by participants, and the implications of the shift from price regulation to price monitoring.

Aircraft refuelling facilities

Aircraft refuelling facilities are generally built and operated by oil companies as a joint user hydrant installation (JUHI), on land leased from the airport operator. Hence the issue of market power arises in relation to the setting of terms and conditions in these leases.

The imposition of fuel throughput levies — a charge set as a fixed percentage of the total volume of fuel pumped — has been a particularly contentious issue. Brisbane and Perth Airports have introduced such levies and some other airports have indicated that they intend to do so in the future¹.

The concerns about fuel throughput levies arise from the reporting treatment for aircraft refuelling services under current price monitoring arrangements. Though these services are defined as aeronautical under direction 27, some airports have not separately reported revenues from their provision because of an exemption for charges covered by contractual arrangements pre-dating privatisation. In this regard, 15 year standard licences for JUHIs, negotiated between the oil companies and the FAC in 1997, contained provision for fuel throughput levies. In addition, as noted above, refuelling services are not explicitly identified as aeronautical services for the purposes of financial monitoring under the Airports Act.

In 2004-05, Brisbane, Perth and Sydney Airports included revenues and costs associated with aircraft refuelling in their non-aeronautical accounts — though in previous years Brisbane and Sydney reported this item as aeronautical (ACCC 2006a, p. 15). In the case of Brisbane and Perth Airports, these revenues include a contribution from fuel throughput levies and, especially given the possible wider use of such levies in the future, this has raised concerns that the price monitoring

¹ While a number of participants have argued that Canberra Airport has also introduced a fuel throughput levy, the airport has distinguished its charge on the basis that it is not a fee for accessing infrastructure installed by refuelling companies, but a fee designed to recover the cost to the airport of replacing outdated refuelling infrastructure (sub. DR67, p. 10).

process is being ‘circumvented’. Synthesising these concerns, the Department of Transport and Regional Services (sub. 24, p. 8) argued that fuel throughput levies:

... are effectively an economic rent on the land the airport makes available for aircraft refuelling services and facilities. Aircraft refuelling is clearly an aeronautical service which should fall within the scope of the Government’s pricing principles. DOTARS’ view is that there is no logical reason why aircraft refuelling services should be excluded from the regulatory pricing regime, including aeronautical pricing negotiations, and they have therefore been included in the proposed new definition of aeronautical services and facilities.

In the Commission’s view, it seems clear that the major airports do have considerable scope to exercise market power in negotiating terms and conditions for the provision of refuelling services by the oil companies. As the Commission observed in its previous report (PC 2002, p. 166), at larger airports, the scope for airlines to use alternative suppliers or refuel off-site will be limited. While ultimately the fuel service providers could threaten the withdrawal of services, the potential loss of significant refuelling assets, or costs associated with their removal from the airport site, undermines this as an effective constraint.

Indeed, the airports themselves did not dispute the proposition that they have some market power in negotiating leases with the oil companies. Rather, opposition to inclusion of refuelling-related revenues within the monitoring regime was based on the argument that bids for the privatised airports had assumed that these revenue streams would not be subject to prices oversight, at least until the contracts negotiated with the FAC had expired. As well as referring to the exemption provisions for pre-existing contractual arrangements, airports also pointed to the lack of clarity on the regulatory treatment of refuelling services at the outset of the privatisation process. For example, they noted that not until after the sale of the Phase 1 airports did the Government (Costello 1997) explicitly indicate that refuelling services would be subject to price monitoring.

Under the previous price cap regime, these arguments would have had considerable force. In effect, bringing a previously exempt revenue stream within the price cap would have potentially reduced an airport’s total revenue earning capacity. To the extent that this possibility had not been indicated at the time of sale, the airport would have suffered a regulatory-related windfall loss.

However, the arguments are of less relevance under price monitoring. As a mechanism intended to provide airports with some pricing latitude, inclusion of revenue from fuel throughput levies and other charges for the provision of refuelling services, would not automatically require offsetting reductions in charges for other services. In this regard, information available to the Commission indicates that the increase in previously reported rates of return on aeronautical assets at

Brisbane and Perth Airports, had revenues from their fuel throughput levies been included, would have been less than one percentage point.

Inclusion of these revenues would better inform any overall assessment of airport behaviour and, as argued earlier, if price monitoring is to be a credible instrument for identifying instances of inappropriate airport behaviour in setting charges, it should encompass all services for which airports are likely to have significant market power. Accordingly, and consistent with the DOTARS proposal, the Commission considers that all refuelling-related revenues should be encompassed within the proposed new price monitoring regime to operate from 2007. While there were some continuing concerns about overriding the contractual exemption provided under direction 27, most airport responses to the Draft Report indicated that this would not be an unreasonable approach (see, for example, Brisbane Airport Corporation, sub. DR69, p. 2; Westralia Airports Corporation, sub. DR58, p. 23).

Check-in counter facilities

Check-in counter facilities — which comprise common-use counters and terminal space — are subject to both price monitoring under direction 27 and the financial reporting provisions of the Airports Act. But some airports are not currently reporting revenues and costs related to these facilities on the basis of the exemption for contractual agreements pre-dating privatisation. As in the case of fuel throughput levies, some users expressed concerns that these airports might thereby escape scrutiny of excess returns on their investments in such facilities (see, for example, BARA, sub. 3, p. 4).

In its previous review (PC 2002, p. 152), the Commission assessed airports as having moderate market power in relation to the provision of these facilities. While airlines have taken some steps since then to introduce off-site check-in, passengers with luggage must continue to check-in at the terminal. Moreover, even if there is some discretion as to the number of counters used, airports will also have market power in the provision of space for alternatives such as self check-in facilities.

Thus, in the Commission's view, on market power grounds, the revenue streams from the provision of common-use check-in counter facilities should be subject to monitoring. And, as in the case of aircraft refuelling services, it does not consider that the existence of pre-privatisation contractual arrangements covering these facilities provides a cogent separate reason for exclusion. Accordingly, and consistent with the DOTARS proposal, the new price monitoring regime to operate from 2007 should encompass check-in counter services and facilities.

In response to the Draft Report, airports generally accepted that this should be the case. However, a number expressed concern that coverage could potentially extend to dedicated terminal space under long-term lease to airlines (for example, Westralia Airports Corporation, sub. DR58, pp. 23; Melbourne Airport, sub. DR55, p. 10). Qantas has dedicated terminal space at Brisbane, Melbourne, Perth and Sydney Airports, while Virgin Blue has its own terminal (the former Ansett terminal) at Brisbane Airport.

The Commission concurs that it would not be appropriate for monitoring to extend to terminal space under dedicated, long-term lease to airlines. Such leases, entered into when the airports were in public ownership, place the terminal space under the direct control of the airlines. Under the terms of these leases — which typically have at least another decade to run — airports are unable to alter lease payments or conditions of use.

Ground handling and airside freight handling

Ground handling services include cleaning and catering, provision of power and fuel, and loading and unloading of baggage and freight. They are either provided by airlines themselves, or are contracted to specialist providers. Currently the airports do not derive revenue from the provision of these services. However, some airports have indicated that they intend to charge an access fee for ground handling services in the future.

Ground handling services are not covered by either direction 27 or the financial reporting provisions in the Airports Act. Some other services of this nature — namely airside freight handling and long/short term staging areas essential for aircraft loading and unloading — also fall outside the coverage of both of the current regulatory instruments. As part of its proposal to align the coverage of the these regulatory instruments, DOTARS has advocated that the two sets of services in future be encompassed by the monitoring regime. Such inclusion is consistent with the Commission's assessment in its previous inquiry (PC 2002, pp. 146-152) that for all services requiring access to aircraft parking areas, the market power of airports is likely to be high. Provision of ground handling and airside freight handling services requires such access.

Coverage should also extend to storage for ground service and freight handling equipment — storage that is essential to airlines. The Commission previously found (PC 2002, p. 174) that while off-airport storage of freight handling equipment is technically possible, it is commercially infeasible given the additional costs it would impose on users. Off-airport storage would also reduce operator efficiency and flexibility.

However, the Commission does not consider that coverage should be extended to sites and buildings used for general freight storage. The Commission concluded in its last review of airport pricing (PC 2002, p. 175) that the existence of off-site alternatives that could be used by airlines for general freight storage effectively constrains airport market power. In its submission to that inquiry, the ACCC (2001, p. 84) also noted that off-airport duplication of storage sites ‘freely occurs’.

Office space and telecommunications infrastructure

The aligned DOTARS definition includes the previously unmonitored categories of airline office space and telecommunications infrastructure. In its Draft Report, while generally endorsing the DOTARS alignment proposal, the Commission did not specifically comment on these additional categories. In their responses to the Draft Report, several airports requested that the Commission clarify its position on whether such services should be monitored in the future.

Office space at airports is used by airlines to perform administrative functions and provide facilities, such as lockers and change rooms, for their staff. This space may compete with alternative operational or commercial uses (such as retail).

In its previous review (PC 2002, p. 176), the Commission found that, while airlines require office space at airports, there is a high degree of discretion in how much space is procured, and that therefore airport market power in this area is modest at best. This view was shared by the ACCC (2001, p. 84) which, in its submission to that review, noted that developments in telecommunications and information technology had enabled airlines to move many administrative functions off-airport (and, in some cases, overseas).

The Commission has received no information that would warrant altering that conclusion. Indeed, none of the airline submissions to this inquiry indicated dissatisfaction with terms under which office space at airports has been provided. The Commission therefore considers that office space for airline staff should not be encompassed within the post-2007 price monitoring arrangements.

On further examining the DOTARS proposal, it is also unclear what would be monitored under the category of ‘telecommunications infrastructure’. Access for telecommunications service providers to ensure appropriate infrastructure is installed and maintained at airports is guaranteed by Schedule 3 of the *Telecommunications Act 1997*. There is also provision for ‘reasonable’ compensation to be paid by the telecommunications provider in the event that financial loss is incurred as a result of that access. And, in regard to other services

potentially encompassed by the DOTARS definition, Canberra Airport (sub. DR67, p. 13) observed:

... the broad definition of telecommunications services would also cover revenue derived by airports for wireless internet services, internet kiosks and public payphones for which airports possess negligible market power due to available substitutes, and the fact that the consumption of these services by airlines and/or passengers is discretionary. Further, the definition would also cover mobile phone towers for which airports do not possess any market power given that they can be located off-airport without any detriment to the service provided.

Moreover, the Commission notes that if DOTARS' intention in including this item is to extend coverage to the communications cabling installed inside the terminal to enable airlines to undertake administrative functions related to the movement of passengers and aircraft, this could be achieved in other ways. For example, charges for cabling required for the operation of self-service check-in counters could be monitored as part of common-use terminal facilities.

Accordingly, the Commission does not consider that a separate category of 'telecommunications infrastructure' should be introduced in future monitoring arrangements.

Car parking and other landside vehicle charges

Fees for public and staff car parking are typically levied at an hourly rate for short-term parking and at a daily rate for long-term parking. Charges for taxi holding and feeder services are levied on either a charge per trip or per pick up basis.

In its 2002 report (PC 2002, pp. 162-4), the Commission found that airports are likely to have some market power in the setting of these charges. However, it argued that the extent of that market power was limited by:

- the availability of off-airport alternatives for those needing long term parking in particular;
- the fact that taxi drivers have some discretion in regard to their use of airport-provided taxi parking facilities; and
- the availability of alternative transport options for travelling to and from airports — for example, buses and in some cases trains.

As noted earlier, car parking and other landside vehicle charges are subject to price monitoring under direction 27, but not to financial reporting under the Airports Act. Under the DOTARS alignment proposal, they would be excluded from both. Such exclusion would be consistent with the views of the airports that their car parking

charges are not excessive — especially when judged against rates for short term parking in the CBD.

However, some other participants argued that airports do have considerable market power in relation to landside vehicle services. The Australian Automobile Association (sub. 43, p. 2) contended that further investigation of the behaviour of airports in relation to parking charges is warranted. And Virgin Blue (sub. 27, p. 104) submitted that, in contrast to the DOTARS proposal, landside vehicle services should continue to be monitored.

In the Commission's view, the appropriate future treatment of these services as far as price monitoring is concerned is finely balanced.

In principle, were airport operators to have significant market power in relation to landside vehicle services, then they should be encompassed within the monitoring regime. In terms of the impact on air travellers, it matters little if market power is exercised through increasing the cost of travelling to and from the airport or raising the cost of landing aircraft.

However, the Commission considers that off-airport provision of car parking remains a meaningful constraint on the scope for airports to raise charges for landside vehicle services within the airport precinct. Indeed, Virgin Blue is now offering passengers the option of booking off-airport parking over the internet.

Also, most people will be prepared to pay more for the convenience of parking close to the terminal. As the ACCC (sub. 39, p. 11) noted, separating the impacts of such locational advantages from any application of market power by an airport operator is extremely difficult. To the extent that ready access to the airport provides a convenience benefit, it is also not necessarily unreasonable for airport operators to appropriate some of that benefit through taxi drop-off or pick-up fees.

Equally, the ability of airports to control 'front door' access to transport providers will potentially have ramifications for the charges imposed on these providers and also for car parking. From this perspective, the so-called 'locational rents' attaching to the provision of these services are not independently determined. That is, charges within the airport precinct will to some extent influence the cost of off-airport alternatives.

To further inform its assessment of this issue, the Commission compared car parking charges at monitored airports, and their movement over time, with those in more central city locations where a premium is also paid for parking convenience (appendix E). The data indicate that while car parking charges have increased at all airports since 2001, in some cases significantly, the increases have generally been

no larger than at central city locations, and overall charges remain lower. Though not by itself definitive, this comparative analysis suggests that constraints on the ability of airports to increase these charges have been influential.

Accordingly, and given the growth in off-airport parking alternatives since the commencement of the current price monitoring regime, the Commission considers that the proposal by DOTARS to remove car parking and other landside vehicle services from the coverage of further monitoring is appropriate.

Moreover, it no longer intends to recommend that the Government consider separately monitoring car parking charges, as proposed in the Draft Report. Its further assessment of the car parking issue and in particular its comparative assessment of charges at airports with those in central business districts, have led it to conclude that a ‘second tier’ monitoring instrument is not warranted.

RECOMMENDATION 5.2

Price monitoring should apply to all of those services for which airports have significant market power. Consistent with this, the service coverage of the new monitoring regime should be that specified in the current proposal from the Department of Transport and Regional Services to align the relevant parts of the Airports Act and the directions pursuant to the Trade Practices Act giving effect to airport price monitoring, subject to the exclusion of:

- *office space used by airline staff; and*
- *telecommunications infrastructure.*

Also, the definition of terminal space and related facilities in the Departmental proposal should be clarified to explicitly exclude dedicated terminal space, under long-term lease to airlines.

5.3 Quality of service monitoring

Quality of service monitoring is intended to complement price monitoring by identifying misuse of market power by airports through either degrading service standards or ‘gold plating’ services. In addition, assessment of service quality helps to put price movements in context — especially where quality improvements sought by customers have necessitated new investment.

Participants questioned the usefulness of quality monitoring

Various concerns were raised in submissions about the reliability and inherent usefulness of the current quality monitoring process (see, for example, Australian Airports Association, sub. 38, p. 20; Northern Territory Airports, sub. 37, p. 22; Sydney Airport Corporation, sub. 26, p. 36).

A particular concern for airports was the nature of the process which they claimed is mechanistic and does not account for the practicalities and complexities of service delivery. Allied to this was a concern that the monitoring process effectively treats airports as responsible for some quality of service problems beyond their direct control (such as in relation to Customs desks). Several also objected to the inclusion in the ACCC's quality monitoring reports of 'unsubstantiated' commentary from airlines and from the Australian Customs Service (for example, Melbourne Airport, sub. DR55, p. 12).

Among the airlines, BARA (sub. 3, pp. 17-19) considered that the current arrangements could be enhanced by adding to the range of quality indicators. However, Regional Express (sub. 29, p. 19) was more sceptical about the current approach, commenting that it:

... does not believe the activity of the ACCC in undertaking service quality monitoring has served to provide much benefit in specifically making the [major privatised airports] address quality issues.

And Qantas (sub. 28, p. 23) argued that, with an appropriate dispute resolution mechanism, price and service quality monitoring could be dispensed with altogether.

Based on its experience as the monitoring body, the ACCC also questioned whether the current arrangements provide an adequate guide as to whether service quality is appropriate for individual users. It went on to suggest that modifications to the existing regime may be required to '... shed more light on whether airports are degrading service standards or 'gold plating' services' (sub. DR54, pp. 8-9).

On the basis of the evidence put to it, the Commission considers that the value added by some aspects of the current quality monitoring process is questionable. High level indicators that aggregate a range of views are clearly unsuited to capturing the diversity in the quality needs of particular service users. There is also some duplication in the information collected from the various stakeholders.

The Commission further considers that the risk of significant misuse of market power by airports to degrade service quality is low. Indeed, quality of service at the

major Australian airports appears to be quite reasonable by international standards (see chapter 2).

That said, the Commission reiterates that some idea of what is happening to service quality is important to put price changes in context. Hence, in its view, dispensing with quality monitoring would be problematic.

The approach proposed in the Draft Report

In its Draft Report, the Commission recommended reconfiguring current quality of service monitoring to rely solely on commentary and supporting information from stakeholders — airports, airlines, airfreight operators and third party service providers. The Commission argued that such a reconfiguration could have a number of advantages:

- It would help to ensure that reporting on service quality outcomes was properly informed by the price and other considerations impinging on those outcomes.
- It would obviate the need for detailed reporting on quality matters that are of little concern to any of the parties.
- While it would still allow for the provision to the ACCC of the sort of supporting information that is supplied under the current arrangements, airports and their customers would have the discretion to decide how much of this information was genuinely relevant.

In response to the Draft Report, there was recognition of the need to make quality of service monitoring more relevant and some support for the Commission's specific approach (see for example Brisbane Airport Corporation, sub. DR69, p. 3; and Regional Express, sub. DR64, p. 8).

But, there was also scepticism from several airports and their customers that a commentary-driven approach would be workable. In particular, there were concerns that:

- the system would be 'gamed' and used by airport customers to provide unsubstantiated commentary (Westralia Airports Corporation, sub. DR58, p. 18);
- airports would not disclose relevant information, reducing the ability of monitoring to detect abuse of market power (ACCC, sub. DR54, p.8; BARA, sub. DR48, p. 21); and
- there would be a loss in capacity to identify trends in service quality at airports over time (ACCC, sub. DR54, p. 8; Westralia Airports Corporation, sub. DR58, p. 19) and subjective commentary would not be amenable to international benchmarking (Sydney Airport Corporation, sub. DR70, p. 15).

However, despite these views and the general consensus that the effectiveness of aspects of the current quality of service monitoring is questionable, few participants offered an alternative. One of the few to do so, Sydney Airport Corporation (sub. DR70, p. 15), suggested dispensing with quality of service monitoring by the ACCC and replacing it with a requirement that monitored airports publish the outcomes of passenger satisfaction surveys.

Current quality of service monitoring should be retained, but streamlined

In light of the responses to the proposal contained in the Draft Report, and the absence of widespread support among stakeholders for an alternative arrangement, the Commission believes that the best option is to continue with a streamlined version of the current approach.

A proposed amendment to the Airports Act, currently before the Parliament, will enable the ACCC — following consultation with the Department of Transport and Regional Services and the Australian Government Treasury — to decide which quality of service indicators should be reported by airports for monitoring purposes. (Currently, the indicators against which airport performance is assessed are set out in regulations issued under the Airports Act.)

In considering improvements to the performance indicators currently collected, the Commission considers that the ACCC should give particular attention to:

- the possibility of dispensing with commentary and qualitative survey results from the Australian Customs Service. A number of airports have expressed concerns over what they regard as ‘unsubstantiated’ comments provided by employees of the Customs Service (see above) and, as Melbourne Airport (sub. DR55, p. 12) argued, it appears incongruous to include explicit commentary from the Australian Customs Service and not from other public sector service providers. Continued inclusion of this commentary may be a source of unnecessary tension since airport performance in enabling provision of these services could continue to be monitored by passenger satisfaction surveys — which are a broader measure of service quality, potentially encompassing more than the relationship between the service provider and the airport — and by quantitative indicators (such as the number of inspection desks available); and
- the scope to rationalise airline satisfaction surveys. For example, the quality of terminal facilities, such as check-in counters and baggage retrieval, is also covered in passenger satisfaction surveys. Moreover, there are quantitative indicators which relate to the provision of these services (such as statistics on the average number of baggage movements).

The Commission also considers that the ACCC should continue to allow the use of passenger satisfaction results from international benchmarking exercises — such as Airport Service Quality survey undertaken by the Airports Council International. Approximately 80 international airports, including Adelaide, Gold Coast, Melbourne and Sydney participate in this survey. In allowing Sydney Airport to submit results from the survey for its most recent Quality of Service Monitoring Report, the ACCC noted the broad similarity with the passenger surveys usually employed in the Report and also observed that the survey is ‘... an authoritative independent survey’ which benchmarks performance ‘against the world’s best airports’ (ACCC 2006b, p. 17). Placing greater emphasis on such comparative benchmarking studies would ensure consistency between generally-accepted performance indicators used by airports to benchmark and improve their own service delivery and those collected for monitoring purposes.

RECOMMENDATION 5.3

In examining opportunities to improve and streamline quality monitoring, the Australian Competition and Consumer Commission should give particular attention to:

- *whether it remains necessary to report survey responses from the Australian Customs Service;*
- *how best to eliminate overlap between the airline and passenger satisfaction surveys, and between these surveys and other quantitative indicators; and*
- *whether greater emphasis should be placed on comparative passenger satisfaction results contained in authoritative international benchmarking exercises.*

5.4 Reporting and review arrangements

Price and service quality reporting

In its Draft Report, the Commission put forward two related proposals:

- integration of price and quality of service monitoring reports into a single publication; and
- publication of this integrated publication every two years, instead of annually as at present.

In doing so, it argued that integrated price and service quality reports would serve to place reported price movements in better context and that biennial reporting would reduce compliance costs.

The first proposal was generally supported by participants.

However, the second received less support. Airlines argued that less frequent publication of monitoring data might enable misuse of market power to go undetected for a longer period of time (see for example, BARA, sub. DR48, p. 20). Some airports were also concerned that biennial reporting could undermine the credibility of the monitoring regime (Westralia Airports Corporation, sub. DR58, p. 20). Moreover, several airports said that the cost savings in moving to biennial reporting would not be significant (since the financial data required for price monitoring purposes is produced on an annual basis anyway).

In the light of this commentary, the Commission will now recommend that price and service quality reports be combined into a single annual publication.

RECOMMENDATION 5.4

Under the new price monitoring regime, price and service quality outcomes should be presented in a single report, published annually.

Duration and review arrangements

In its Draft Report, the Commission recommended that the new price monitoring regime should run for five years, with a review towards the end of that period to assess outcomes and what arrangements should apply thereafter. Most participants did not comment on the length of the next period of price monitoring, and those that did typically thought a five year review period would be appropriate.

However, Westralia Airports Corporation questioned whether a five year review period would provide sufficient time to assess the behaviour of the airports and airlines in a commercial environment:

The prospect of periodic 5 yearly reviews of the kind currently being undertaken by the Commission prolongs uncertainty and may tend to cast a shadow over commercial negotiations. For instance, an impending review may present airlines with less incentive to settle commercial negotiations amicably, as the existence of an on-going dispute may influence the outcome of such a review. WAC acknowledges that all parties with a stake in the outcome of such reviews face incentives that may well elicit strategic behaviour in the lead up to, and during, periodic reviews. (sub. DR58, p. 7)

It went on to suggest that a review period of seven or eight years would enable the review body to observe behaviour during two further price negotiation rounds.

The Commission sees considerable merit in these arguments. Uncertainty over the extent to which a price monitoring regime can constrain the exercise of market power by airports would of course be a factor militating against such a longer

review period. However, its proposal to introduce an explicit process for triggering further investigation of airport behaviour where there is prima facie evidence of significant misuse of market power (see chapter 4), should provide a stronger discipline on airport behaviour.

A further important consideration in setting a review period is how the Part IIIA national access regime evolves and what changes emerge from the scheduled 2011 review of that regime. As discussed in chapter 3, it is possible that the recent Federal Court decision upholding the declaration of the domestic airside service at Sydney Airport could see Part IIIA supplant price monitoring as the operative regulatory instrument in the airport sector.

But, even if this does not occur, changes emerging from the review of Part IIIA could have implications for the future oversight of the behaviour of the major airports. Thus, it would seemingly be premature to conduct the next review of price monitoring before this broader review exercise has been completed. Accordingly, the Commission considers that the next period of price monitoring should be for six years ending on 30 June 2013. That would allow for an end-of-period review, commencing in 2012, to take account of the outcomes of the Part IIIA review.

RECOMMENDATION 5.5

Unless ‘supplanted’ at an earlier date by Part IIIA (see recommendation 3.2), the new price monitoring regime should operate for six years ending on 30 June 2013. The new regime should be reviewed in 2012, with that review having regard to the outcomes of the scheduled 2011 review of the national access regime.

6 Other matters

Key points

- The impact of both the price notification of charges for regional airlines, if extended beyond 2007, and the reservation of peak-time slots for regional airlines should be kept under review.
 - The costs of both arrangements are likely to increase over time.
 - There is scope to reduce the adverse impact of the regional ring fence without compromising underlying objectives.
- Some key airport services are delivered by monopoly government providers. This lack of competition may sustain inefficiencies in service delivery — and thereby lead to unnecessarily high charges — and/or cross subsidies between airport users.
 - Opportunities to introduce contestability to this service provision should be pursued. Where this is not possible, benchmarking against service providers in other countries may be a means of introducing greater competitive disciplines.

A number of other aspects of the regulatory framework affect charging arrangements and the efficiency of airport operations more generally. While not explicitly within the remit of the Commission's inquiry, this chapter examines some issues of particular significance for airport charges: the regulatory arrangements relating to regional airlines' access to Sydney Airport; government provision of certain airport services; and international Air Service Agreements.

6.1 Regional airlines' access to Sydney Airport

Special access and charging arrangements apply at Sydney Airport for regional airlines, which carry about 6 per cent of all passengers moving through the airport (BTRE 2006b). The Government regulates access by regional airlines in two ways: the maintenance of a regional 'ring fence'; and the regulation of prices charged by Sydney Airport for providing aeronautical services to regional airlines.

Regional ring fence

Government policy guarantees continuing access to Sydney Airport in peak times for regional airlines (Anderson 2000). To give effect to this policy, the slot management scheme (box 6.1) was amended in 2001 to prevent the peak-time slots held by regional services being reallocated to non-regional airlines — the regional ‘ring fence’. For the purposes of the ring fence, ‘peak-time’ is defined as between the hours of 6:00-11:00 am and 3:00-8:00 pm on weekdays. To limit the impact on passenger throughput at periods of high demand, the Government also precluded the allocation of additional slots to regional services during those peak times, and introduced a requirement that new services to Sydney Airport use aircraft with a minimum of 18 seats. Sydney Airport (sub. 26, p. 8) stated that slots subject to the ring fence comprise approximately 25 per cent of total peak-time slots.

The effects of the regional ring fence

The reservation of slots for regional airlines potentially limits passenger throughput in two ways. For safety reasons, a greater length of time between flights is generally required when a small regional aircraft follows a large jet. As a result, interspersing regional flights with flights by larger jets potentially reduces the number of air traffic movements in a given period of time. Also, regional airlines carry far fewer passengers per plane than do the major domestic and international carriers.

As it happens, the first of these restrictions is not currently binding — Sydney Airport has indicated (trans. p. 167) that its runway and airfield capacity is somewhat greater than the legislated 80 movements per hour cap (see box 6.1), even with the interspersing of regional aircraft.

However, the second constraint has a considerable impact on passenger throughput. During the airport’s busiest periods — between 7:00 am and 9:30 am on weekdays — the number of slots sought by airlines approaches or exceeds the number available. If it is assumed that all regional flights during these times could be replaced with domestic and international flights, up to 4000 additional passengers could be flown into or out of Sydney each day. This suggests that there is potentially a significant efficiency loss from the ring fence. Moreover, as traffic increases at Sydney Airport, the costs of maintaining the ring fence will grow.

Box 6.1 **Slot management at Sydney Airport**

A 'slot' is defined as a specified aircraft movement at a specified time on a specified day. All commercial and private aircraft require a slot to land or take-off at Sydney Airport (DOTARS 2006a).

A number of controls limit aircraft movements at Sydney Airport. These controls are established by Government regulations, and attempt to balance the requirements of airport users with limiting the impact of aircraft noise on the densely populated residential areas adjacent to Sydney Airport. The main controls are:

- a movement cap: The *Sydney Airport Demand Management Act 1997* stipulates an 80 per hour limit on aircraft movements;
- a curfew: jet aircraft are unable to take-off from or land at Sydney Airport between 11:00 pm and 6:00 am. However, propeller aircraft of the sort used to provide the bulk of regional services to and from the airport are not subject to this restriction; and
- the Long Term Operating Plan: the plan imposes operating restrictions on runway use, with the aim of sharing noise around Sydney by using all three runways.

To match demand to the supply of slots, the Government has established an administrative slot allocation regime at the airport. Under this regime, take-off and landing slots are allocated and administered by the Slot Manager, currently Airport Coordination Australia.

In the main, access to slots is based on historical precedent subject to a 'use it or lose it' test — if an operator does not operate at least 80 per cent of the aircraft movements permitted by its allocated slots, then it loses precedence to those slots.

Any 'vacant' slots not filled on the basis of historical precedent are allocated by the Slot Manager according to a series of priorities set out in the *Slot Management Scheme 1998*. These rules give preference, for example, for international services over interstate services, interstate services over regional services, larger aircraft over smaller aircraft, and regular services over one-off flights. A vacant slot that is part of the regional ring fence can only be allocated to a regional airline.

Once allocated, operators may swap slots with other operators, either on a temporary or permanent basis, if approved by the Slot Manager. Slots may not be traded for cash.

Reducing the impact of the regional ring fence

Finding the right balance between protecting the interests of regional airline passengers and encouraging the efficient use of Sydney Airport is not straightforward. Peak period access to Sydney Airport is clearly important for regional travellers. As Dubbo City Council (sub. DR49, p. 1) submitted:

... the continued access by regional airlines to Sydney Airport is essential to ensure the efficient and economical transport links between Regional NSW country centres and

Sydney. Rural residents require access to the Sydney Central Business District for a range of services including medical, business, education, recreation, trade and welfare.

Likewise, Albury City (sub. DR50, p. 2) stated:

Quick, reliable and easy access into capital city airports enabling accessibility to major clients and markets both within Australia and internationally has a significant positive impact on the development of regional economies and as such it is imperative that these arrangements be retained.

And the NSW Farmers' Association (sub. DR57, p. 2) submitted that:

Without the current regulatory restrictions [a] monopolistic position would allow Sydney Airport to structure its pricing to gain maximum profits from the market and in turn have significant social and economic implications for those travellers on regional airlines. The Association believes that the current arrangements should be maintained to ensure that regional airline travellers are afforded the same opportunities offered to those on other domestic flights.

However, some pointed to the efficiency costs of the ring fence, and argued that it is therefore appropriate to investigate ways to ameliorate these costs so as to achieve a better overall balance in outcomes. For example, Sydney Airport (sub. 26, p. 11) commented:

It is in the interests of Australia that the most efficient use is made of the nation's most important international gateway. SACL recommends that the structural rigidities in place at Sydney Airport be reviewed to ensure that the Government's overall objectives are being met, including balancing the interests of regional users and other stakeholders.

While recognising the importance of continued regional access to Sydney Airport, the Commission believes there is merit in keeping under review options to reduce the adverse impacts of the regional ring fence — which can only increase over time. To this end, it has set out a number of possible measures that could lessen those impacts, while still providing regional communities with reasonable access to Sydney Airport.

In its Draft Report, the Commission suggested that increasing somewhat the minimum aircraft size able to use Sydney Airport could be one way to achieve a better balance between efficiency and regional objectives. However, its further analysis indicates that this approach would not be practical, as most regional flights use aircraft with at least 34 seats, well above the current mandated minimum size of 18 seats.

But there are a number of other approaches.

Exempting smaller aircraft from the movement limit

Regional Express' submission in response to the Draft Report (sub. DR64, p. 8) highlighted the possibility of exempting propeller aircraft from the 80 aircraft movements per hour limit at Sydney Airport. As outlined in box 6.1, the airport is subject to this legislated hourly movement limit, a curfew for jet aircraft, and noise-sharing arrangements, all aimed at reducing the impact of aircraft noise on nearby residents. However, in recognition of their low noise levels, propeller aircraft of the sort used to provide regional services are exempted from the curfew.

As noted above, Sydney Airport indicated (trans. p. 167) that its runway and airfield capacity is somewhat greater than the 80 movements per hour limit. If exemptions from the curfew for propeller aircraft were extended to the movement limit — so that the limit only applied to jet aircraft — additional slots during busy periods could be allocated to large domestic and international carriers without reducing access for regional airlines.

Rationalising regional route networks

Several regional centres that currently have services to and from Sydney during busy periods are in relatively close proximity. Examples include Lismore and Ballina (30 km apart by road), Orange and Bathurst (55 km) and Gunnedah and Tamworth (77 km) — there are over 100 busy period services a week to and from Sydney airport from these centres alone. Whilst the current arrangements are convenient for residents of these regional centres, and evidently profitable for the airlines involved, such dual services may not be necessary to meet the objective of guaranteed peak-time access to Sydney Airport. Indeed, travelling times between these centres are probably less than many travellers in Sydney face in getting to and from Sydney Airport.

Administratively moving regional flights out of busy periods

An option mentioned in the Draft Report was to shift regional flights into the less busy 'shoulder' periods, but still within the legislatively-defined peak times. In response to this suggestion, the Regional Aviation Association of Australia (sub. DR53, p. 2) said that any such changes to the current ring fence arrangements would necessarily impact on airline schedules, pointing out that:

...because large numbers of regional passengers need to transit to or from domestic or international aircraft, and therefore need to travel via Sydney Airport at specific times to connect with those flights, the removal of the ring fence arrangements ... would have what RAAA believes to be unacceptable results for regional communities and the airlines that service them.

Nevertheless, modest rescheduling could free up additional slots during busy periods, at least in the short term. By way of illustration, if half the number of regional flights arriving at or departing Sydney Airport between 7:00 am and 8:00 am could be brought forward by 45 minutes, and half of those between 8:00 am and 9:30 am were moved back 45 minutes, then the number of regional flights in the 7:00-9:30 am busy period would be reduced by about 25 per cent. Of course, such an approach would not be a long term solution — as traffic increases and the shoulders become more congested, the problem would re-emerge.

Further analysis is warranted

The Commission emphasises that it is not endorsing any of these particular measures. They are merely illustrative, and would (along with other possible options) require further analysis. However, investigation of such measures is likely to be important if regional objectives are to continue to be met at the least cost to the overall efficiency of operations at Sydney Airport.

Price notification for services to regional airlines

The provision of aeronautical services to regional airlines at Sydney Airport is also subject to price notification. This means that the airport must notify the Australian Competition and Consumer Commission (ACCC) of any proposed changes in the charges for regional airlines for aircraft movement facilities and activities, and for passenger processing facilities and activities. Further, under a related regulatory direction, the average revenue-weighted percentage increase in prices for these services is not allowed to exceed the increase in the CPI. These instruments are intended to give effect to the Government's policy that 'the current pricing regime for regional airlines will be maintained, even after the airport is privatised, so that they cannot be forced out by an underhand policy of the landlord upping the rent' (Anderson 2000). The price notification arrangements are to expire on 1 July 2007.

Since these arrangements have been in place, Sydney Airport has formally notified the ACCC of price changes for aeronautical services for regional airlines only once, and these were of a structural nature relating to the use by regional airlines of the former Ansett terminal purchased by the airport in September 2002. Accordingly, overall charges for aeronautical services provided to regional airlines have not increased since the price notification arrangements commenced.

The effects of price notification

In commenting on the effect of the price notification arrangements at Sydney Airport, Regional Express (sub. 29, p. 18) stated that there is ‘no doubt’ that, together with the regional ring fence, they have:

... resulted in not only access to that airport by regional airlines and the communities they serve, but [have] also prevented the airport from peak period pricing or loading up the price structure for regional airlines.

Similarly, the Local Government Association of NSW and the Shires Association of NSW (sub. DR56, p. 3) expressed support for the current arrangements:

Many regional services operate on an extremely tight economic basis and the prospect of fare increases arising from the loss of this price notification instrument has the potential to directly affect the viability of many regional services and therefore the accessibility of those affected communities.

However, as these Associations went on to acknowledge, such benefits for regional airlines and air travellers do not come without costs. In particular, to the extent that price notification and the related price cap result in more favourable charging outcomes for regional airlines than for other carriers, they will involve an element of cross-subsidy (or a shortfall in revenue for Sydney Airport).

To date neither the benefits nor the costs of price notification have been large. While charges for regional carriers have not increased between July 2002 and June 2005, general charges at the airport increased by only 13 per cent (see chapter 2).

But, depending on the outcome of the current price negotiations between Sydney Airport and the airlines, and the extent of future investment at the airport, a continuation of price notification after 2007 could potentially drive a larger wedge between charges for regional and other carriers.

Moreover, while it is almost certainly the case that without price notification charges for regional airlines using Sydney Airport would be higher, it is not clear that, after an initial adjustment, any subsequent increases would be any more significant than for other airlines, especially given that:

- public criticism of Sydney Airport would be likely were regional airlines to be treated less favourably; and
- increases in Sydney Airport’s total revenue arising from even large, and therefore contentious, rises in charges for regional airlines would still be modest.

For regional travellers, any increase in charges resulting from the removal of price notification would be unwelcome. But those increases would most likely represent only a small proportion of the ticket price for regional flights into and out of Sydney

Airport, especially at busy times. Also, charges levied at the Sydney end of the flight would still often be significantly less than those at the regional end (see for example appendix D, figure D.1).

In summary, the need for additional price protection for regional airlines at Sydney Airport is not clear, especially if, as the Commission is recommending, a strengthened process for investigating any significant misuse of market power by the major airports (see chapter 4) is adopted. Though allowing price notification to lapse in 2007 would almost certainly see some rise in prices for regional airlines at Sydney Airport, the preceding discussion indicates that these airlines are unlikely to be treated less favourably than their larger counterparts. Additionally, allowing the price notification arrangements to lapse would prevent a further widening of the gap between charges for regional and other carriers in the event that congestion charging is introduced at the airport at some stage in the future.

But if price notification is extended beyond 2007 then, like the regional ring fence, its impact should be kept under review. As the discussion above indicates, the costs of these requirements are likely to increase over time.

6.2 Government-provided airport services

A number of government organisations provide services at airports. These organisations include:

- Airservices Australia (ASA), which is to all intents and purposes the sole provider of en-route navigation, terminal navigation and aviation rescue and fire fighting (ARFF) services in Australia;
- the Australian Customs Service and the Australian Quarantine and Inspection Service, which are responsible for detecting and deterring the unlawful cross-border movement of goods;
- the Department of Immigration and Multicultural Affairs, which issues short-term visas; and
- Australian Federal Police, which provides aviation security services.

Total charges for providing these services are greater than those for airport-provided aeronautical services. In 2005-06, over \$1 billion was collected by government providers from airport users, mainly at the price monitored airports — \$643 million for the services of Airservices Australia, and \$375 million for customs, immigration and quarantine services (in the form of the Passenger Movement Charge). This total is around 50 per cent more than the combined aeronautical revenue of the price-

monitored airports, and represents an average of \$16 per ticket for all passenger movements (ASA 2006; ACCC 2006; ACS 2006; BTRE 2006a).

Of itself, this impost and its relativity to charges collected by airports is of no particular policy concern. That is, these services are an essential part of the provision of air travel. However, the lack of contestability raises questions about the efficiency and quality of service provision. An example of the latter is the delays that can be caused by understaffed customs facilities. A lack of contestability can also sustain cross subsidies in pricing structures that would not be possible in a more competitive environment.

Several participants raised the cross subsidy issue in relation to the provision of ARFF services. In particular, both Melbourne Airport (sub. DR55, p. 20) and BARA (sub. 3, p. 13) expressed concern about ASA's recent move to 'network-based' pricing for these services, with BARA commenting that:

Airservices and the ACCC have decided that prices charged at regional locations for ARFF services need only to recover the short-run marginal cost (SRMC) of the service. Because most costs are fixed and do not vary by the landing of individual aircraft, the SRMC is close to zero. Based on this logic, virtually all the costs of providing ARFF services at regional locations are allocated to major airports on a 'capacity to pay' basis, crudely approximated by the landed tonnage of aircraft at each airport.

BARA subsequently submitted that the new pricing structure for ARFF services probably results in international airlines being overcharged by more than \$30 million per year (sub. DR48, p. 24).

BARA and Melbourne Airport went on to emphasise that their concerns about the lack of service contestability relate solely to its role in sustaining cross subsidies, and not about its potential impact on the efficiency of provision or service quality. Indeed, Melbourne Airport (sub. DR55, p. 20) argued that:

... contestability is unlikely to lead to a reduction in total ARFF services costs – Airservices is a relatively efficient provider. Further, Airservices may possess some scale economies in training, staff relief and insurance relative to a model where the ARFF service was provided by location specific providers.

More broadly, Melbourne Airport suggested that any regional policy objectives should be funded by government, not by a tax on users of major airports.

The ACCC (sub. 46, p. 6) downplayed concerns about the new price structure for ARFF services. It suggested that it is based on Ramsey pricing principles and is more efficient than the one it replaced. However, in the Commission's view, Ramsay pricing principles do not seem particularly relevant in the case of ARFF services, given that common costs across different airports are unlikely to be significant.

More generally, the Commission notes that the Government has signalled that it will introduce contestability for ARFF services, with a recent discussion paper released by DOTARS (2006b) canvassing options for giving effect to this commitment. If provision for contestability is implemented in a way that avoids inefficient cross subsidies, it should allay concerns of the sort raised by BARA and Melbourne Airport.

There may also be opportunities to extend the planned approach for ARFF services to other government-provided services at airports. Where this is not feasible, there may be scope to introduce greater competitive disciplines on providers through benchmarking their prices, costs and quality against service providers in other countries.

6.3 International air services

Charges for aeronautical services are heavily dependent on the costs of infrastructure. Hence, growth in traffic that allows these costs to be spread over a larger passenger base can be a significant source of downward pressure on charges.

As set out in chapter 1, recent growth in passenger traffic at Australia's major airports is expected to continue in the future. However, a number of airports have previously argued that the way in which Australia is applying its 'open skies' aviation policy is nonetheless constraining traffic growth. In this inquiry, Melbourne Airport (sub. 13, p. 8) stated that:

There are airlines prepared to operate services to Melbourne who cannot get rights, at the same time other carriers that have access to rights (such as Qantas and British Airways) choose not to use them.

Consistent with its report on International Air Services (PC 1998), the Commission notes that a bilateral, 'open skies' policy which, among other things, removes restrictions on capacity and frequency to, from, between and beyond Australia and bilateral aviation partners could provide a strong stimulus to traffic levels at Australia's international airports. In doing so, it would add to the aforementioned downward pressure on aeronautical charges. While the Government's policy is to aspire to 'open skies' agreements, as comments from the airports illustrate, the extent of progress in this area continues to be a matter of debate.

APPENDIXES

A Inquiry Information

A.1 Conduct of the inquiry

The Commission received the Terms of Reference for this inquiry on 6 April 2006. As required by the terms of reference, and in line with its normal inquiry procedures, the Commission has encouraged maximum public participation.

- Soon after receipt of the terms of reference, it placed advertisements in the national press and sent a circular to a range of individuals and organisations thought likely to have an interest in the inquiry.
- As detailed in section A.2 below, it held informal discussions with all seven price monitored airports, the two major domestic airlines (Qantas and Virgin Blue), the Regional Aviation Association of Australia (representing regional airlines), the Board of Airline Representatives of Australia (representing international airlines operating to and from Australia), the Australian Taxi Industry Association and a number of government entities, including the Australian Competition and Consumer Commission.
- In early May 2006, it released an issues paper to assist participants in preparing their submissions. Some 46 submissions were received in response to this paper (see table A.1) from a wide range of interested parties. The public parts of those submissions are available on the Commission's website (www.pc.gov.au), at the Commission's Canberra and Melbourne libraries, State libraries and from Photobition Digital Imaging Centre.
- It also sought advice on some key inquiry issues from Professor Peter Forsyth (Monash University) and met with Dr Harry Bush (Group Director, Civil Aviation Authority, UK).
- In early September 2006, it released a Draft Report (PC 2006) on which it sought further comment via written submissions and/or participation at public hearings held in late October (see table A.2). An additional 34 submissions were received in response to the Draft Report (see table A.1).

Commissioners Gary Potts and Neil Byron thank participants for their contributions during the course of the inquiry.

A.2 Informal discussions

Canberra

Canberra Airport
Corporate Air
Darwin Airport (via video conference)
Department of Industry, Tourism and Resources
Department of The Treasury
Department of Transport and Regional Services
Dr Harry Bush (UK, Civil Aviation Authority)
Perth Airport
Professor Peter Forsyth (Monash University)
Regional Aviation Association of Australia
Sydney Airport Corporation Limited

Adelaide

Adelaide Airport
South Australian Government (3 Departments and SA Tourism Commission)

Melbourne

Australian Competition and Consumer Commission
Melbourne Airport
Shell Australia

Sydney

Board of Airline Representatives of Australia
Qantas Limited
Sydney Airport Corporation Limited

Brisbane

Australian Taxi Industry Association
Brisbane Airport Corporation
Virgin Blue Airlines

A.3 Submissions

Table A.1 List of submissions^a

<i>Participant</i>	<i>Submission no.</i>
Adelaide Airport Limited	23, DR61
Alliance Airlines	21
Air New Zealand Limited	DR52, DR76
Airnorth	9, DR47
Albury City	DR50
Australian Airports Association	38, DR51
Australian Automobile Association	43
Australian Competition and Consumer Commission	39, 46, DR54
Australian Council for Infrastructure Development	15
Bankstown Airport Limited	7
Board of Airline Representatives of Australia Inc	3, 41, DR48, DR73
BP Australia Pty Ltd – Air BP	32, DR74
Brindabella Airlines	19
Brisbane Airport Corporation Pty Ltd	35, DR69
Broome International Airport	44
Cairns Port Authority	40
Canberra Airport	30, DR67
City of Belmont	8, 33
Corporate Air	34*, DR63*
Department of Industry, Tourism and Resources	10
Department of Transport and Regional Services	24
Dubbo City Council	DR49
Government of South Australia	36, DR79
Hobart International Airport	4
International Air Transport Association	17, DR59
Local Government Association of NSW and Shires Association of NSW	DR56
Maroomba Airlines	12
Melbourne Airport	13, DR55, DR75
Ministry of Transport	DR77

continued

Table A.1 **continued**

<i>Participant</i>	<i>Submission no.</i>
Moorabbin Airport	16
Motor Trades Association of Australia Superannuation Fund	11
National Competition Council	5, DR66
Northern Territory Airports Pty Ltd	37
NSW Deputy Premier and Minister for Transport	42
NSW Farmers Association	DR57
Overnight Airfreight Operators Association	6
Qantas Airlines Limited	28, DR60, DR65
Queensland Airports Limited	22
Regional Aviation Association of Australia	25, DR53
Regional Express Holdings Limited	29, DR64
Reilly, Chris	1, 2
Shell Company of Australia Limited	18
Shire of Walgett	DR68
Skywest Airlines Pty Ltd	14
Stott, D.K	31
Sydney Airport Corporation Limited	26, DR70
The Allen Consulting Group	DR78
Virgin Blue Airlines	27, 45, DR62, DR71
Wellington International Airport Limited (NZ)	DR72
Westralia Airports Corporation Pty Ltd	20, DR58, DR80

^a Written submissions received in response to the Draft Report are indicated by the prefix "DR". Submissions containing material supplied in confidence are indicated with an asterisk (*).

A.4 Public hearings

Table A.2 Public hearings and participants

<i>Participants</i>	<i>Transcript page no.</i>
Melbourne – 24 October 2006	
Melbourne Airport	1 – 22
Regional Express	23 – 38
Northern Territory Airports Pty Ltd	39 – 52
Sydney – 30 October 2006	
Board of Airline Representatives of Australia	54 – 68
Westralia Airports Corporation	69 – 86
Brisbane Airport Corporation	87 – 102
Qantas Airlines	103 – 124
Virgin Blue Airlines	125 – 148
Sydney Airport Corporation	149 – 167
Canberra Airport	168 – 169
Brisbane Airport Corporation	169 – 170

B Regulatory arrangements for airport services

B.1 Price regulation — 1997 to 2001

In 1997 and 1998, the Australian Government privatised, through long term leases, 17 airports formerly owned by the Federal Airports Corporation. The remaining five airports, which included Essendon Airport and the four Sydney-basin airports, were privatised in 2002 and 2003. The objectives of this privatisation were to:

... improve the efficiency of airport investment and operations in the interests of users and the general community, and to facilitate innovative management. (Harris 1997, p. 2)

In privatising these airports, the Government recognised that some had significant market power. Hence, it also introduced price regulation — though the number of airports covered and the nature of the regulation has changed over time.

Details of the regulatory regimes that prevailed prior to July 2002 are discussed in chapter 3 of the Commission's 2002 report (PC 2002). In essence, price regulation of Phase 1 and some of the Phase 2 airports in the period from the sale of leases until October 2001, comprised:

- prices notification for aeronautical services;
- a CPI-X price cap on aeronautical services for a sub-group of privatised airports;
- price monitoring of aeronautical-related services; and
- provisions governing necessary new investment at airports, which required regulatory approval.

However, in October 2001, with some airports facing financial pressures in the light of the suspension of Ansett's operations and reduced global demand for aviation services following the September 11 terrorist attacks, these regulatory arrangements were eased.

- Melbourne, Brisbane and Perth Airports were allowed a once-only price increase, as a pass-through in the price cap for aeronautical services, of up to 6.2, 6.7 and 7.2 per cent of starting point prices at privatisation, respectively;

-
- price caps on aeronautical services at Adelaide, Canberra and Darwin Airports were replaced by price monitoring of those services under the Prices Surveillance Act; and
 - all forms of price control were abolished at Coolangatta¹, Alice Springs, Hobart, Launceston and Townsville airports.

Over this period, Sydney Airport still operated as a corporatised government entity, but was also subject to price notification.

B.2 Current price-related regulation

In July 2002, the Australian Government announced the introduction of a light handed regulatory approach to airport services — involving price monitoring with the explicit threat of stronger measures if increases in charges proved ‘excessive’, complemented by quality of service monitoring and the generic national access regime (see below). This approach was in line with recommendations made by the Commission in its 2002 Report on Airport Price Regulation (PC 2002).

Price monitoring

Under the Government’s new policy, price notification and price caps were discontinued for all airports (with the exception of price notification for services provided to regional airlines at Sydney Airport), and replaced by price monitoring for Adelaide, Brisbane, Canberra, Darwin, Melbourne, Perth, and Sydney airports. The new regime was introduced for a period of five years, with a review of the arrangements to be conducted towards the end of this period. However, the Government reserved the right to bring forward this review if there was evidence of unjustifiable price increases.

Details of the operational requirements for price monitoring are given in box 1.1 in chapter 1 of this report.

Price notification

The provision of aeronautical services to regional airlines at Sydney Airport remains subject to price notification. This means that Sydney Airport Corporation must notify the Australian Competition and Consumer Commission (ACCC) if it intends to increase charges for such services (which exclude the aeronautical-related

¹ Now officially known as the Gold Coast Airport.

services encompassed by the price monitoring regime). While determinations made by the ACCC in regard to proposed increases are not enforceable, failure to comply with them could be the trigger for a public inquiry and the freezing of charges. The related regulatory ‘Direction 28’ in the *Trade Practices Act 1974* (TPA) specifies that average (revenue-weighted) charges for these notifiable services should not increase by more than the Consumer Price Index.

Quality of service monitoring

The Australian Government also retained quality of service monitoring by the ACCC for all price monitored airports. This monitoring, which along with requirements for the monitored airports to submit financial accounts to the ACCC is provided for in the Airports Act, was originally introduced to complement price cap regulation, and has been retained under the price monitoring arrangements to:

- reinforce commercial incentives for airports to maintain appropriate service standards; and
- enhance transparency and comparability between airports, and in so doing, assist airport users negotiating with airports and governments to address regulatory matters pertaining to airport activities (ACCC 2006b, p. 1).

The ACCC is limited to monitoring the quality of the services and facilities provided by, or which could be influenced by, airport operators. It does not directly monitor service quality of other organisations providing services at airports — including airlines, Airservices Australia, the Australian Customs Service, the Australian Quarantine and Inspection Service, the Department of Immigration and Multicultural and Indigenous Affairs, and the Australian Federal Police. Moreover, the quality of some key aspects of an airport’s operations, such as domestic terminals leased to airlines, is not subject to monitoring.

Airports Regulations 1997 specify the performance indicators to be used by the ACCC in monitoring and evaluating the quality of airport services. At present, the ACCC uses approximately 50 indicators that cover:

- airside services (eg, taxiways and aerobridges);
- terminal services (eg, gate lounges and baggage handling); and
- ground access services (eg, car parking).

There are usually several indicators for each service. For example, the indicators specified for gates and aircraft parking services are:

- any change over time in the number of aircraft parking bays;

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- any change over time in the total designated bay area; and
 - the change over time in satisfaction with the system, according to a questionnaire of airlines.

As this example illustrates, some indicators are ‘static’ and objective and others are subjective. In compiling the indicators, information is sought from a variety of sources, including airport operators (information for static indicators), passengers (survey), airlines (survey), AirServices Australia and the Australian Customs Service (survey).

Access regulation

All price monitored airports are corporations and thus, are subject to the general provisions of the TPA. Of particular relevance to this inquiry is Part IIIA, the national access regime. In fact, airport access disputes are now subject only to Part IIIA — an airports-specific instrument which previously regulated access (s 192 of the Airports Act) was repealed in 2003 following the move to a light-handed price monitoring regime.

Part IIIA of the Trade Practices Act

Part IIIA establishes a legislative regime to facilitate third party access to the services of nationally significant essential facilities², in prescribed circumstances. Part IIIA is intended to apply when commercial negotiations fail to deliver access to these services, or when parties cannot reach agreement concerning the terms and conditions (including prices) of access. Part IIIA applies, in principle, to all airports deemed to be nationally significant.

While Part IIIA provides several access routes, for airports it is the declaration route that is primarily relevant at the current time. Under this route, airlines or other parties seeking access under Part IIIA to airport services must apply to the National Competition Council (NCC) to recommend that the relevant Minister declare the service(s).

For a service/facility to be declared, the NCC and the Minister have to be satisfied that all of the following criteria are met:

² Facilities that are the source of intermediate services essential to upstream or downstream service provision.

-
- (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;
 - (b) that it would be uneconomical for anyone to develop another facility to provide the service;
 - (c) that the facility is of national significance, having regard to:
 - (i) the size of the facility; or
 - (ii) the importance of the facility to constitutional trade or commerce; or
 - (iii) the importance of the facility to the national economy;
 - (d) that access to the service can be provided without undue risk to human health or safety;
 - (e) that access to the service is not already the subject of an effective access regime;
 - (f) that access (or increased access) to the service would not be contrary to the public interest. (TPA, ss 44G(2) and 44H(4))

The current construction of criterion (a) reflects a recent amendment that took effect on 1 October 2006. Previously, the requirement was simply ‘that access (or increased access) to the service would promote competition ...’. (A number of other changes were also introduced at this time, including to: shorten decision making timeframes; and introduce an overarching objectives clause and pricing principles to guide decision making under the regime.)

If a service is declared, the service provider must attempt to negotiate mutually acceptable terms of access with an access seeker. If negotiations fail, the parties can appoint a private arbitrator to determine those terms and conditions. If the parties cannot agree on an arbitrator, the dispute can be referred to the ACCC for determination.

Declaration decisions are appealable to the Australian Competition Tribunal (ACT). The review by the Tribunal is a re-examination of the facts relevant to the declaration, and the Tribunal may affirm, vary or set aside the Minister’s decision. There is also provision for subsequent appeal to the Federal Court.

Part IIIA has already been invoked on three occasions in an airports context:

- the provision of landside roads and associated vehicle facilities for dropping off and picking up passengers at Melbourne Airport was declared in May 1999;
- freight handling services at Sydney and Melbourne airports were declared from March 2000 until March 2005; and
- domestic airside services at Sydney Airport were declared from December 2005 until December 2010, on appeal by Virgin Blue to the ACT. The application had

earlier been rejected by the NCC, and the Minister. The ACT's decision was subsequently appealed by Sydney Airport to the Federal Court, which upheld the ACT decision and, in doing so, gave a new interpretation to criterion (a). (See chapter 3 and appendix C for further information on, and discussion of, the Federal Court's decision.)

Other access provisions

Access provisions are also contained in the individual airport leases. These leases generally require the lessee at all times to provide for the use of the airport site as an airport, and to provide for access to the airport by intrastate, interstate and international (where applicable) air transport. However, there are 'force majeure' clauses, and access is also subject to provisions under the Airports Act which require the lessee to comply with any demand management scheme and the payment of airport charges by airline operators.

Other relevant arrangements include provisions in:

- long-term domestic terminal lease agreements, which require the incumbent airline, on application, to make gates at some of its terminals available to new entrants;
- Australia's bilateral air services arrangements (see below), which require ground handling services to be available on an equal basis to all international airlines; and
- general 'conditions of use' documents for most larger airports, which set out physical arrangements, and security and other requirements, together with commercial conditions such as facilities provided, and fees, services and indemnities that apply.

B. 3 Other relevant (non-price) regulation

The regulation and related measures outlined above are only one part of a broad ranging regulatory regime governing the operation of Australian airports. This extended regime includes Australian, State and Territory government regulation, as well as provisions in lease, sale and international agreements. While this regulation lies outside the immediate remit of this inquiry, some of it helps to facilitate the price monitoring regime, or may influence the price of airport services.

Australian Government regulation

Much of the relevant Australian Government legislation is specific to the airport sector, with the key regulatory instrument being the Airports Act and associated Airports Regulations.

Airports Act 1996

As noted above, price (and quality) monitoring sits within a broader framework, based on the requirements of the Airports Act and its associated regulations. This Act has a number of stated objectives, including to:

- promote the sound development of civil aviation in Australia;
- establish a system for the regulation of airports that has due regard to the interests of airport users and the general community;
- promote the efficient and economic development and operation of airports; and
- ensure diversity of ownership and control of certain major airports.

Some of the key features of the Airports Act relate to ownership controls, environmental management, building and construction controls, and demand management (box B.2).

Most of the provisions of the Airports Act apply equally to all airports. However, in some instances, they regulate Sydney Airport to a greater extent — for example, in relation to cross-ownership, demand management and access/charges for regional airlines. Melbourne, Brisbane and Perth Airports are also subject to cross-ownership provisions.

The Act was the subject of a recent review. In November 2005, the Minister for Transport and Regional Services announced that a number of changes would be made to the Act to address the identified need to:

- refine the planning and development approval regime for airports;
- integrate the overall legislative framework by addressing and resolving cross-overs between Parts 7 and 8 of the Airports Act and the TPA (including more closely aligning the definitions of ‘aeronautical services’ and streamlining quality of service monitoring);
- clarify and refine processes associated with noise management arrangements; and
- implement an outcomes-based regulatory framework for environmental matters.

While a number of minor technical amendments are being progressed in a Bill currently before Parliament, the key integration reforms to be implemented via amendments to the *Airports Regulations 1997* are being held over, pending consideration of the Commission's views on these issues.

Box B.2 Some key features of the Airports Act

Significant 'non-monitoring' provisions in the Airports Act include the following:

- There is a 49 per cent limit on foreign ownership of Australian airports, a 5 per cent limit on airline ownership of airports and a 15 per cent limit on cross-ownership for Sydney/Melbourne, Sydney/Brisbane and Sydney/Perth airports.
- Each airport must have an airport master plan approved by the Minister for Transport and Regional Services. This 20-year strategic plan must identify, among other things, development objectives, assess the future needs of aviation users, forecast noise exposure levels and include proposals for land use and related development.
- A major development plan (approved by the Minister) is required for each major airport development — such as for constructing a new runway or terminal building, or extending a taxiway or road, and for major non-aeronautical developments (as defined in the Act). The Airports (Building Control) Regulations 1996 establish a system for approval of building and construction activity on airports.
- An airport environment strategy, also subject to approval by the Minister, provides, among other things, all airport users with a clear understanding of the expectations on the airport operator for protection of the environment at the airport. The strategy does this via advocating continuous environmental improvement, in part through specifying environmental management objectives and sources of environmental effects associated with airport operations.
- The Minister may formulate a demand management scheme for an airport, being a category exclusion scheme, a slot allocation scheme, or a movement limitation scheme. The Minister may also declare the capacity of an airport, in terms of the maximum number of aircraft movements permitted in a specified time period. Such arrangements currently apply at Sydney Airport (see later).
- The airport operators are not to provide air traffic services and rescue and firefighting services without approval from the Minister.

Source: Airports Act 1996.

Trade Practices Act

All price monitored airports are corporations and therefore are subject to the general provisions of the TPA. In addition to Part IIIA (discussed above) and Part VIIA governing prices surveillance by the ACCC, provisions which may be of relevance

to an airport's operations include those relating to anti-competitive practices (Part IV).

- Part IV prohibits a range of anti-competitive practices, including arrangements or contracts that contain exclusionary provisions or have the purpose, or effect, of substantially lessening competition — for example, price fixing, secondary boycotts and restricting supply.
- Misuse of market power is also proscribed. A corporation that has substantial market power is prohibited from taking advantage of that power for the purpose of eliminating or damaging a competitor, preventing entry into any market and deterring or preventing a person from engaging in competition.
- Exclusive dealing and resale price maintenance are prohibited, as are mergers and acquisitions that would result in substantial lessening of competition in a substantial market.

Other Australian Government (non-price) regulation

Various other Australian Government regulations affect price monitored airports' operations, costs and pricing.

- The *Air Services Act 1995* and Air Services Regulations set out the structure, functions and powers of Airservices Australia (ASA). ASA's functions include the provision of facilities to permit safe navigation of aircraft within Australian airspace and the provision of services such as air traffic services, aeronautical information and radio navigation services, and aviation rescue and firefighting services.
- The *Civil Aviation Act 1988* established the Civil Aviation Safety Authority (CASA) in 1995. Among other things, CASA is responsible for developing and enforcing aviation safety standards, and issuing aerodrome licences.
- The *Environment Protection and Biodiversity Conservation Act 1999* aims to ensure that matters significantly affecting the environment are fully considered through the assessment of draft airport major development plans and, from time to time, through environmental impact statements. Airport activities that have the potential to generate pollution or excessive noise are regulated by the Airports (Environment Protection) Regulations 1997, made under the Airports Act.
- Under the *Customs Act 1901* and regulations, all passengers, crew and freight (plants, animals and other goods) entering and departing Australia via airports are subject to customs control procedures. Passengers, freight and the aircraft may also be subject to quarantine procedures under the *Quarantine Act 1908*, *Imported Food Control Act 1992* and *Export Control Act 1982* (and regulations).

As well, passengers are subject to immigration controls under the *Migration Act 1958*. Various Commonwealth agencies are involved in implementing these controls, including the Australian Customs Service, the Australian Quarantine and Inspection Service, the Department of Immigration and Multicultural and Indigenous Affairs, and the Australian Federal Police. These services generally require substantial floor space at international airports, which is currently provided by airport operators at below commercial rent — though these arrangements are currently under review by the Passenger Facilitation Taskforce.

- The *Air Navigation Act 1920* and Air Navigation Regulations 1947 regulate air navigation, such as international aircraft, international airlines, non-scheduled flights, aircraft on international flights, investigation of accidents, and aviation and airport security (including passenger and freight). In particular, the Act implements Australia's ratification of the Convention on International Civil Aviation (Chicago Convention) (see below). Pursuant to this Act, to address aircraft noise impacts, the Air Navigation (Gold Coast Airport Curfew) Regulations 1999 restrict certain aircraft movements at Gold Coast Airport between 11pm and 6am.
- The *Adelaide Airport Curfew Act 2000* and associated regulations impose curfew restrictions, similar to those at Gold Coast Airport, on aircraft movements at Adelaide Airport.
- The *Sydney Airport Curfew Act 1995* and associated regulations prescribe curfew arrangements at Sydney Airport. As at Adelaide and Gold Coast Airports, a curfew applies between 11pm and 6am. However, there are also several related restrictions on the use of runways during shoulder times and on international passenger aircraft movements.
- Slot management for aircraft arrivals and departures at Sydney Airport is regulated under the *Sydney Airport Demand Management Act 1997*. The Act prescribes a maximum of 80 aircraft movements in any hour (excluding emergency and state aircraft) and establishes a framework for a slot management scheme (including a 'regional ring fence', which effectively creates a separate pool for regional slots). A slot allocated under the scheme permits a specified aircraft movement at a specified time on a specified day (see chapter 6 for further details and discussion).
- Under the *Aircraft Noise Levy Act 1995* and the *Aircraft Noise Levy Collection Act 1995*, a 'noise' levy may be imposed on the operators of jet aircraft landing at leviable airports. An airport is deemed to be leviable if it meets certain criteria regarding residential exposure to particular noise levels. Currently, a levy is imposed at Adelaide Airport, and a levy was also applied at Sydney Airport until

July 2006. The levy is not imposed on aircraft with noise assessed to be below a specified level.

Airport lease and sale agreements

The lessee of each former Federal Airports Corporation-owned airport has signed both lease and sale agreements with the Australian Government.

The lease and sale agreements set out various obligations for lessees and the Commonwealth as lessor. Specifically, the airports' leases, in addition to requiring that they comply with specific access conditions (as discussed earlier), essentially contain terms to protect the Commonwealth's interests as lessor — principally, to ensure that it receives the airport site back at the end of the lease in good repair. The other key requirements are that lessees:

- use the proceeds of insurance to rebuild in the case of damage or destruction; and
- develop the airports at their own cost, having regard to the actual and anticipated future growth in traffic demand, 'reasonably expected' quality standards and good business practice.

With respect to the sales agreements for the ten major airports (excluding Sydney), commitments were made by the new airport operators to invest specific amounts during the first ten years of the leases. In total, the ten airports committed to spending \$730 million.

In addition to the more general requirements applied above to the major airports, there are limited variations in leases to account for the specific characteristics of certain airports, particularly the joint civil/defence user airports of Darwin and Townsville. In addition, the Canberra Airport lease includes reference to the Fairbairn defence base sub-lease (Commonwealth of Australia 1998).

State and Territory regulation

Price monitored airports and their business activities are also subject to a range of State and Territory regulation covering various matters not explicitly legislated for by the Australian Government, such as waste management, and occupational health and safety, as well as fair trading legislation covering commercial trading, gambling, liquor licensing and vehicle parking at airports.

International agreements

International agreements affect, both directly and indirectly, the operation of those price monitored airports that are ‘designated’ international airports under the Air Navigation Act.

Convention on International Civil Aviation

Of most significance is the Convention on International Civil Aviation (Chicago Convention) — a multilateral agreement signed by Australia and other countries in 1944 (implemented in Australia by the *Air Navigation Act 1920*).

The Chicago Convention is the legal foundation for the regulation of international civil aviation. The Convention includes several Articles that bear directly on economic regulation of aviation and thus affect airport operations and pricing (box B.4). The Chicago Convention (Article 44) also established the International Civil Aviation Organization (ICAO), which seeks to promote the safe and orderly development of international civil aviation through the setting of international standards and regulations. As part of this role, the ICAO develops and releases various policies and guidelines on the regulation of air transport, including on airport charges, capacity and tariffs.

Box B.4 Convention on International Civil Aviation

Key economic regulatory features of the ‘Chicago Convention’ include:

- State sovereignty over airspace;
- rules governing permission for international non-scheduled and scheduled air services in contracting States;
- cabotage, whereby a contracting State may refuse permission for aircraft from other contracting States to take on its passengers, mail and so on;
- the requirement that regulations of the contracting State regarding entry, customs, quarantine and so on must be complied with by other contracting States;
- the requirement that airports in contracting States, that are open for public use by national aircraft, must be open under uniform conditions to aircraft from other contracting States. Airport charges for aircraft from other contracting States should be no higher than those for national aircraft;
- the requirement that air navigation be expedited and that unnecessary (particularly administrative) delays to aircraft, passengers, crews and cargo be prevented; and
- the requirement that contracting States agree to provide airports and navigation facilities which facilitate international air navigation and are in accordance with the Convention.

International Air Services Transit Agreement

Another major agreement signed at the Chicago Conference was the International Air Services Transit Agreement (sometimes known as the Two Freedoms Agreement), which provides for the multilateral exchange of rights of overflight and non-traffic landing for scheduled international air services among contracting States. This Agreement is implemented in Australia by the *Air Navigation Act 1920*.

Bilateral agreements

Bilateral air service agreements are a key feature of the regulation of international air services. Australia has over 50 bilateral agreements. Essentially, they define the terms and conditions under which each party's airlines will have access to the airspace of the other party. Provisions typically include the specification of capacity, frequency, routes, cities, ownership provisions and tariff approval processes. By placing limits on international traffic, such agreements may affect the amount of business airports can attract.

Australia continues to negotiate liberalised bilateral air services arrangements with many countries, most recently with the United Kingdom and Taiwan. However, as discussed in chapter 6, some airports have expressed concern about the extent of liberalisation in these arrangements that has occurred to date.

International Air Transport Association

Apart from ICAO, the other major international body to influence the regulation of international air services is the International Air Transport Association (IATA). IATA (sub. 17) is a trade association currently representing over 230 airlines. Its stated goals include:

- providing safe, reliable and secure air services;
- developing cost-effective, environmentally friendly standards and procedures to facilitate the operation of international air services; and
- identifying and articulating common industry positions and supporting the resolution of key industry issues.

IATA coordinates and standardises technical, operational and commercial aspects of airline operations, and acts as a clearing house for inter-airline accounts. For example, voluntary scheduling conferences provide a forum for reaching consensus on schedule adjustments necessary to meet airport capacity constraints, and tariff coordination conferences can facilitate agreement on 'reference fares' for passenger and cargo to promote interlining — and the division of revenue between interlining

airlines. Many of these IATA activities are subjected to authorisation and regular review by the ACCC.

B.4 Price regulation of airports in some other countries

To date, only New Zealand and to some extent the United Kingdom have pursued the sort of light handed approach to prices oversight at major airports adopted by Australia (see table B.1).

Table B.1 **Comparison of price regulation regimes for Australian and some major overseas airports^a**

<i>Country</i>	<i>Ownership structure</i>	<i>No. of major airports involved</i>	<i>Nature of current regulatory regime</i>
Australia	Fully privatised	7	Price and quality monitoring (plus subject to general access and conduct provisions of the <i>Trade Practices Act 1974</i>); dual till.
Austria	Partially privatised	1	Price-cap regulation.
Germany	Partially privatised	3	Price-cap regulation at Hamburg Airport; rate-of-return regulation at Dusseldorf and Frankfurt Airports; dual till.
Ireland	Corporatised	1	Price-cap regulation; single till.
Netherlands	Partially privatised	1	Rate-of-return regulation; dual till.
New Zealand	Fully privatised	3	No regulation ; but provision for a review of pricing behaviour with the threat of more explicit regulation if behaviour is deemed unacceptable ^b .
United Kingdom	Fully privatised	4	Price cap (RPI-X) regulation; single till. However, within this regime, the UK has recently moved to allow commercially negotiated charges for new investment. Also, through its policy of 'constructive engagement', it is seeking to put more onus on airports and airlines to reach agreement on charges and quality outcomes in relation to existing infrastructure. Other airports in the UK, often of significant size, are not price regulated.

^a In the United States, most airports are owned by governments or local communities (though recently, Chicago has decided to privatise its Midway Airport). While not subject to price regulation, these publicly owned airports are generally subject to controls on investment and financing. Also, while choosing not to privatise airports, Canada has shifted control of its major airports to local authorities. ^b A recent review by the NZ Competition and Commerce Commission recommended that Auckland Airport be re-regulated, but this advice was rejected by the New Zealand Government.

Sources: Submissions; Forsyth et.al (2004); TRL (2006b).

C Declaration of domestic airside services at Sydney Airport

In October 2006, the full Federal Court of Australia dismissed an appeal by Sydney Airport against the Australian Competition Tribunal's decision to declare domestic airside services at the airport under the Part IIIA national access regime. The Federal Court's decision, and more importantly its interpretation of a key criterion for declaration under Part IIIA — namely the 'promotion of competition' test — may make it easier in the future to secure a declaration of nationally significant infrastructure, including major airports. As such, it is likely to affect commercial negotiations between airlines and airport operators, and consequently is an important consideration in whether price monitoring should continue after 2007 (see chapter 3).

This appendix summarises the events and arguments leading up to the Federal Court's decision. Sydney Airport Corporation Limited (SACL) is currently seeking leave to appeal the decision in the High Court — a decision on whether leave is granted is likely to be made in early 2007.

C.1 The decision to declare the airside service

National Competition Council's decision

In July 2002, Virgin Blue applied to the National Competition Council (NCC) to declare the domestic airside service and the domestic terminal service at Sydney Airport under Part IIIA of the Trade Practices Act. The basis for Virgin Blue's application was its difficulty in obtaining access to Terminal 2, and its concern about SACL's ability to charge monopoly prices for the airside service in the absence of price notification — in particular, through the possible introduction of passenger-based charges. After coming to agreement with SACL on terms for terminal access, Virgin Blue withdrew its application to declare the terminal services in December 2002.

In June 2003, the NCC issued a draft decision to declare the domestic airside service (NCC 2003a).

-
- The NCC's decision focussed on its assessment of whether access or increased access to Sydney Airport would promote competition in the domestic passenger market.
 - It assessed that SACL had both the *ability* to exercise market power and the *incentive* to use it. While the impacts on non-aeronautical revenue and the threat of re-regulation were acknowledged to limit this incentive, the NCC argued that there was still an unconstrained range above efficient prices in which it was in SACL's interest to exercise market power.
 - The NCC concluded that, on the presumption that low cost carriers (LCCs) had a reduced capacity to absorb/pass on any monopoly prices, the ability to price in this unconstrained range could have a material impact on competition in the domestic passenger market.

In November 2003, the NCC issued its final recommendation *not* to declare the airside service (NCC 2003b). Critical to its change in position was its further consideration of the likely impacts of SACL setting prices in the 'unconstrained range'. It argued that, while the effects of such pricing would fall more heavily on LCCs, it was not clear that they had less capacity than full service airlines to absorb such increases, or price discriminate so as to minimise the effects on demand. As a result, the NCC concluded that it was unclear whether declaration would promote competition in the domestic passenger market.

In January 2004, the Parliamentary Secretary to the Treasurer published his decision not to declare the airside service at Sydney Airport.

Australian Competition Tribunal's decision

Soon after, Virgin Blue applied to the Australian Competition Tribunal for a review of this decision. As with the NCC, the Tribunal's deliberations focussed on the existing 'promotion of competition' test in Part IIIA (s 44H(4)(a) of the Trade Practices Act), namely whether:

...access (or increased access) to the service would promote competition in at least one market (whether or not in Australia), other than the market for the service...

In its application, Virgin Blue submitted that the factual and counterfactual scenarios germane to the Tribunal's decision were:

... the future state of competition in the dependent market with a right or ability to use the service, and the future state of competition in the dependent market without *any* right or ability to use the service. (ACT 2005, para. 149)

The Tribunal rejected this interpretation of the criterion, stating that:

...the counterfactual should be understood by reference to the current conditions of access projected into the future. Virgin Blue currently has use of Sydney Airport, and to undertake a counterfactual analysis which discounts this fact would be wholly unrealistic. (ACT 2005, para. 149)

As such, the Tribunal's task was much the same as the NCC's, which was essentially to compare (ACT 2005 para. 153):

- the opportunities and environment for competition in the dependent market if the Airside Service is declared; with
- the opportunities and environment for competition in the dependent market if the Airside Service is not declared.

However, contrary to the position adopted by the NCC, the Tribunal put forward a range of arguments to support the notion that declaration of the airside service would improve competition in the dependent market. Amongst other things, it contended that there was no credible threat of re-regulation in the event of SACL misusing its market power; that airlines had little or no countervailing power at Sydney Airport; and that even large increases in aeronautical charges would have little or no impact on passenger throughput and hence non-aeronautical revenue. It further concluded that:

- the change from weight-based to passenger-based charges was inefficient and discriminated against Virgin Blue, and that because such a pricing structure would not have been sustainable in a competitive environment, it represented a misuse of market power; and
- this discrimination would reduce the profitability of Virgin Blue, and LCCs more generally, and as such reduce competition in the domestic passenger market.

In December 2005, the Tribunal set aside the Parliamentary Secretary's decision, and declared the domestic airside service for a period of five years.

C.2 SACL's appeal to the Federal Court

SACL applied for a judicial review of the Tribunal's decision by the full court of the Federal Court. SACL submitted that the Tribunal should have identified:

... whether the supply of the Airside Service had, in fact, been denied or restricted. Only then could a question of access or increased access arise, and only then could one undertake a counterfactual analysis for s 44H(4)(a), that counterfactual analysis being between the future state of affairs with the denial or restriction as found and the future state of affairs without such (found) denial or restrictions on access. (FCAFC 2006, para. 69)

The Federal Court dismissed SACL's appeal, and upheld the decision of the Tribunal to declare the airside service at Sydney Airport. But in doing so, it found that the Tribunal had 'misconstrued s 44H(4)(a) by infusing an overly elaborate body of considerations into that criterion' (FCAFC 2006, para 94). Instead, it agreed with Virgin Blue's submission that:

...all s 44H(4)(a) requires is a comparison of the future state of competition in the dependent market with a right or ability to use the service and the future state of competition in the dependent market without any right or ability or with a restricted right or ability to use the service. (FCAFC 2006 para. 83)

In elaborating on this point, the Federal Court stated that 'the terms of s 44H(4)(a) do not incorporate the requirement for comparison with what is factually the current position in any given circumstances' (FCAFC 2006 para. 84). In reaching this view, the Court had regard to background material, including the Report of the National Competition Policy Review (Hilmer Committee 1993) and the COAG Competition Principles Agreement.

The Court did note that the conduct of the infrastructure owner might still be relevant to the decision to declare (FCAFC 2006 para. 85):

That is not to say that what has happened in relation to the service, how the provider has behaved and the degree to which it can be said that monopolistic behaviour has or has not impeded the efficient operation of the market in question may not be relevant considerations attending the making of the decision. For instance, if it can be demonstrated that the service has been provided in a manner that can be described as fair, even-handed and in a way most likely to maximise vigorous competition in the downstream market, that may be a powerful and relevant consideration as to why no declaration should be made. Thus, it may be that a with and without declaration counterfactual (or some aspect of it) can be seen as relevant to the decision at hand.

And it further commented that (FCAFC 2006 para. 89):

In any given enquiry, there may be room in deciding whether or not to declare the service, to analyse the question whether the engagement of the regime under Part IIIA by the declaration will have an effect on the competitive process in the dependent market.

However, it went on to reiterate that such investigation was not mandated.

Implications of the Federal Court's decision

As discussed in the body of the report, most participants commenting on the decision considered that the Federal Court's interpretation will make it easier to satisfy the first criterion for declaration. However, whether it will be easier for users to secure the declaration of airports under Part IIIA is less clear. Recent legislative

changes to Part IIIA, outlined in chapter 3, are intended to raise the ‘bar’ for declaration. Also, while indicating that an examination of conduct is not necessary in looking at criterion (a), the Court’s interpretation still gives scope to consider conduct with and without declaration via residual discretion available to Part IIIA decision makers. Further adding to this uncertainty, SACL has sought leave to appeal the Federal Court’s decision in the High Court (see below).

As discussed in chapter 3, any significant lowering of the Part IIIA entry bar would raise questions about the sustainability of the light handed approach for airports, and more broadly could deter investment in a range of infrastructure services, including airports. Moreover, even if it transpires that the entry bar has not been significantly lowered by the Federal Court’s decision, the uncertainty created may in itself deter investment.

High Court appeal

SACL has applied for leave to appeal the Federal Court’s decision in the High Court. SACL’s appeal seeks to have the Federal Court’s decision set aside, on the grounds that (*SACL v ACT & Ors* 2006):

- The Federal Court needed to determine ‘whether the supply of the relevant service had in fact been denied or restricted in some way’; and
- ‘the court erred in holding that section 44H(4)(a) of the Act does not involve as the base for analysis the current state of affairs’.

Decision on whether leave is granted is likely to be made in early 2007; if leave is granted an appeal is likely to be heard later in 2007.

D Airports and related information

D.1 Statistical information

Table D.1 **Growth in passenger^a and aircraft movements at major airports, 1998-99 to 2004-05**

								Total growth over period	Average annual growth since 2001-02
Airport	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05		
Passengers	'000	'000	'000	'000	'000	'000	'000	%	%
Adelaide	4 093	4 285	4 535	4 182	4 434	4 966	5 413	32.3	9.0
Brisbane	10 713	11 201	13 284	12 320	12 340	14 373	15 884	48.3	8.8
Canberra ^b	1 930	1 980	2 114	1 826	1 921	2 307	2 484	28.7	10.8
Darwin ^b	1 219	1 250	1 290	1 087	1 086	1 182	1 386	13.7	8.4
Melbourne	14 583	15 571	17 245	16 485	16 918	19 159	20 776	42.5	8.0
Perth	4 969	5 155	5 265	4 837	5 377	6 063	6 655	33.9	11.2
Sydney	22 454	24 318	26 924	24 325	24 453	26 983	28 848	28.5	5.8
Total	59 961	63 760	70 657	65 062	66 529	75 033	81 446	35.8	7.8
Aircraft movements									
Adelaide									
- RPT	74.2	76.4	76.5	67.4	69.0	65.1	70.9	(0.7)	1.7
- GA	36.8	25.8	24.8	28.8	27.9	28.6	28.2	(23.4)	(0.7)
Brisbane									
- RPT	131.3	130.7	143.5	128.8	127.0	133.4	148.2	12.9	4.8
- GA	27.4	30.1	34.9	22.0	10.7	11.3	11.7	(57.3)	(19.0)
Canberra									
- RPT ^c	38.1	41.0	51.9	39.7	36.0	38.4	36.8	(3.4)	(2.5)
- GA	na	na	na	na	na	na	na	na	na
Darwin									
- RPT	22.5	26.9	25.8	18.7	18.0	18.2	18.3	(18.7)	(0.7)
- GA	58.8	57.8	59.7	49.0	40.6	44.3	48.7	(17.2)	(0.2)
Melbourne									
- RPT	154.3	163.1	185.0	155.7	156.3	164.0	179.2	16.1	4.8
- GA	2.5	1.6	2.3	1.9	1.6	1.3	1.3	(48.0)	(11.9)
Perth									
- RPT	61.1	60.9	57.7	49.5	49.5	51.2	56.1	(8.2)	4.3
- GA	37.4	34.0	27.7	24.9	26.5	27.5	30.5	(18.5)	7.0
Sydney									
- RPT	254.3	262.2	290.5	232.7	230.1	243.4	254.1	0.1	3.0
- GA	27.0	30.9	26.8	22.0	22.4	23.3	32.4	20.0	13.8
Totals									
- RPT	735.8	761.2	830.9	692.5	685.9	713.7	763.6	3.8	3.3
- GA ^d	189.9	180.2	176.2	148.6	129.7	136.3	152.8	(19.5)	0.9

^a Includes both regular passenger traffic (RPT) and general aviation (GA) passengers. While the share by airport varies, RPT passengers account for around 97 per cent of all passengers at price monitored airports.

^b Passenger numbers for Canberra Airport in 1998-99 and for Darwin Airport in 1999-00 and 2000-01 are estimates. ^c BTRE data. ^d Excludes Canberra Airport's GA traffic.

Sources: ACCC (2006a); BTRE (2006b).

D.2 Price monitored airports' characteristics

Adelaide Airport

OWNERSHIP

Structure/parent/operating company	: Fully privatised. Adelaide Airport Limited
Major shareholders	: Unisuper (37.4%); MTAA Superannuation Fund (27.5%); Local Government Superannuation Board (16.1%); other (19.1%)

DEMAND CHARACTERISTICS

Aircraft (RPT+GA) movements (2004-05)	: 99 105 (72% RPT)
Passengers (RPT+GA) (2004-05)	: 5 412 945
Share of total aircraft movements (at PMAs)	: 10.8%
Share of total passenger movements (at PMAs)	: 6.6%
Proportion of the airport's passenger movements that is international	: 6.5%
Main market segments (percentage of overnight visitors in 2005)	<u>Domestic</u> : Business 49% and VFR 29%. <u>International</u> : Holiday 41% and VFR 34%.

COMPETITION CHARACTERISTICS

Destination substitution possibilities	Relatively low, given the dominance of business and VFR travellers.
Modal substitution possibilities	Low for business travellers. For VFR and holiday travellers, some modal substitutes appear viable, particularly for visitors from Victoria and parts of New South Wales. More than half of all interstate overnight arrivals to South Australia arrive by private vehicle. Train services also are available.
Airport substitution possibilities	Low. There are no proximate RPT airports.

BUSINESS CHARACTERISTICS (as reported by the operating company to the ACCC) **2004-05**

Proportion of revenue that is non-aeronautical	: 42%
Total tangible non-current assets	: \$413m
Operating profit/(loss) (EBITA)	: \$29.7m
Profitability (EBITA on tangible non-current assets)	: 7.2%
Profits/(Loss) after interest and tax	: (\$5.6m)

EBITA – Earnings before interest, tax and amortisation. **GA** – General aviation. **PMAs** – Price-monitored airports. **RPT** – Regular public transport. **VFR** – Visiting friends and relatives.

Sources: AAL (2005); ACCC (2006a); Submissions.

Brisbane Airport

OWNERSHIP

Structure/parent/operating company	: Fully privatised. BAC Holdings Limited. Brisbane Airport Corporation Pty Ltd.
Major shareholders	: Commonwealth Financial Services; other Australian financial institutions; Port of Brisbane Corporation; Brisbane City Council; Amsterdam Airport Schiphol.

DEMAND CHARACTERISTICS

Aircraft (RPT+GA) movements (2004-05)	: 159 932 (93% RPT)
Passengers (RPT+GA) (2004-05)	: 15 884 417
Share of total aircraft movements (at PMAs)	: 17.4%
Share of total passenger movements (at PMAs)	: 19.5%
Proportion of the airport's passenger movements that is international	: 24.2%
Main market segments (percentage of overnight visitors in 2005)	<u>Domestic</u> : Business 33% and VFR 27%. <u>International</u> : Holiday 61% and VFR 21%.

COMPETITION CHARACTERISTICS

Destination substitution possibilities	Relatively low, given the dominance of business and VFR travellers.
Modal substitution possibilities	Low for business traffic. However, for VFR and holiday travellers, modal substitutes (particularly private vehicle) may be viable (nearly half of interstate visitors to Queensland arrive by modes other than air).
Airport substitution possibilities	Low, but increasing. There are relatively proximate growth airports in the Gold Coast and Maroochydore that are taking some business away from Brisbane (especially the former, since the rail link was finished). But such competition is limited by the scale of Brisbane Airport, the extent of its business traffic and its ability to service international traffic.

BUSINESS CHARACTERISTICS (as reported by the operating company to the ACCC) **2004-05**

Proportion of revenue that is non-aeronautical	: 45%
Total tangible non-current assets	: \$949m
Operating profit (EBITA)	: \$127.2m
Profitability (EBITA on tangible non-current assets)	: 13.4%
Profits/(Loss) after interest and tax	: \$21.5m

EBITA – Earnings before interest, tax and amortisation. **GA** – General aviation. **PMAs** – Price-monitored airports. **RPT** – Regular public transport. **VFR** – Visiting friends and relatives.

Sources: ACCC (2006a); BAC (2005); Submissions.

Canberra Airport

OWNERSHIP

Structure/parent/operating company	: Fully privatised. Capital Airport Group Pty Ltd Canberra International Airport Pty Ltd
Major shareholders	: George Snow and family interests.

DEMAND CHARACTERISTICS

Aircraft movements (RPT only) (2004-05)	: 36 846
Passenger movements (RPT only) (2004-05)	: 2 476 709
Share of total RPT aircraft movements at PMAs	: 4.8%
Share of total RPT passengers at PMAs	: 3.1%
Proportion of the airport's passenger movements that is international	: 0%
Main market segments (percentage of overnight visitors in 2005)	<u>Domestic</u> : Business (64%) and VFR (25%).

COMPETITION CHARACTERISTICS

Destination substitution possibilities	Relatively low, given the dominance of business and VFR travellers.
Modal substitution possibilities	High. Despite the high proportion of business and VFR visitors, nearly three-quarters of visitors arrive in Canberra by car. This may reflect the fact that total travel times by air and car are similar on the Sydney–Canberra route. Also, many of those flying overseas, or to other domestic destinations for holiday purposes, first travel by car or coach to Sydney.
Airport substitution possibilities	Low. There are no proximate RPT airports.

BUSINESS CHARACTERISTICS (as reported by the operating company to the ACCC) **2004-05**

Proportion of revenue that is non-aeronautical	: 61%
Total tangible non-current assets	: \$695m
Operating profit (EBITA)	: \$28.6m
Profitability (EBITA on tangible non-current assets)	: 4.1%
Profits/(Loss) after interest and tax	: \$7.2m

EBITA – Earnings before interest, tax and amortisation. **PMAs** – Price-monitored airports. **RPT** – Regular public transport. **VFR** – Visiting friends and relatives.

Sources: ACCC (2006a); Submissions.

Darwin Airport

OWNERSHIP

Structure/parent/operating company	: Fully privatised. Airport Development Group Pty Ltd. Northern Territory Airports Pty Ltd. Darwin International Airport Pty Ltd.
Major shareholders	: Industry Funds Management (Nominees) Ltd (35.5%); Hastings Funds Management Ltd (Australian Infrastructure Fund) (25.4%); National Asset Management Ltd (14.55%); RBC Global Services Australia Nominees Pty Ltd (14.55%); BAA Australia Pty Ltd (10%) ^a .

DEMAND CHARACTERISTICS

Aircraft (RPT+GA) movements (2004-05)	: 67 004 (27% RPT)
Passengers (RPT+GA) (2004-05)	: 1 385 500
Share of total aircraft movements (at PMAs)	: 7.3%
Share of total passenger movements (at PMAs)	: 1.7%
Proportion of the airport's passenger movements that is international	: 20.3%
Main market segments (percentage of overnight visitors in 2005)	<u>Domestic</u> : Holiday 40%; Business 37%. <u>International</u> : Holiday 59%.

COMPETITION CHARACTERISTICS

Destination substitution possibilities	High. Although the proportion of business travellers to Darwin is higher than for the rest of the Territory, most travellers go for a holiday. Therefore, Darwin and surrounding areas compete with other tourist destinations, including other areas in NT.
Modal substitution possibilities	Low for business travellers and other travellers visiting Darwin only, given the relative isolation of Darwin. For holiday travellers who visit several regions in the Territory, the potential for modal substitution appears to be more significant (more than 40% of interstate visitors to the Territory arrive by modes other than air).
Airport substitution possibilities	Vary by market segment. Low for those visiting only the 'Top End', but higher for those visiting several areas within the Territory.

BUSINESS CHARACTERISTICS (as reported by the operating company to the ACCC) **2004-05**

Proportion of revenue that is non-aeronautical	: 11%
Total tangible non-current assets	: \$87m
Operating profit (EBITA)	: \$7.6m
Profitability (EBITA on tangible non-current assets)	: 8.8%
Profits/(Loss) after interest and tax	: (\$5.2m)

^a BAA has indicated that it intends to sell its share of the Airport Development Group.

EBITA – Earnings before interest, tax and amortisation. **GA** – General aviation. **PMAs** – Price-monitored airports. **RPT** – Regular public transport. **VFR** – Visiting friends and relatives.

Sources: ACCC (2006a); ADG (2005).

Melbourne Airport

OWNERSHIP

Structure/parent/operating company	: Fully privatised. Australia Pacific Airports Corporation Limited.
Major shareholders	: AMP Ltd (40.99%); Deutsche Asset Management Pty Ltd (26.06%); BAA Australia Pty Ltd (19.82%) ^a ; Hastings Funds Management Ltd (13.13%).

DEMAND CHARACTERISTICS

Aircraft (RPT+GA) movements (2004-05)	: 180 514 (99% RPT)
Passengers (RPT+GA) (2004-05)	: 20 776 258
Share of total aircraft movements (at PMAs)	: 19.7%
Share of total passenger movements (at PMAs)	: 25.5%
Proportion of the airport's passenger movements that is international	: 21.6%
Main market segments (percentage of overnight visitors in 2005)	<u>Domestic</u> : Business 48% and VFR 27%. <u>International</u> : Holiday 42% and VFR 26%.

COMPETITION CHARACTERISTICS

Destination substitution possibilities	Relatively low, given the dominance of business and VFR travellers.
Modal substitution possibilities	Low for business traffic. However, for VFR and holiday travellers, modal substitutes (particularly private vehicle) appear to be viable for visitors from some areas, including South Australia and New South Wales. Only about half of interstate overnight travellers arrive in Victoria by air.
Airport substitution possibilities	Generally low — though Avalon Airport in Geelong is being used by the low cost carrier, Jetstar, as an RPT substitute for Melbourne Airport for some of its flights.

BUSINESS CHARACTERISTICS (as reported by the operating company to the ACCC) **2004-05**

Proportion of revenue that is non-aeronautical	: 38%
Total tangible non-current assets	: \$819m
Operating profit (EBITA)	: \$184.9m
Profitability (EBITA on tangible non-current assets)	: 22.6%
Profits/(Loss) after interest and tax	: \$71.1m

^a BAA has indicated that it intends to sell its share of APAC Limited.

EBITA – Earnings before interest, tax and amortisation. **GA** – General aviation. **PMAs** – Price-monitored airports. **RPT** – Regular public transport. **VFR** – Visiting friends and relatives.

Sources: ACCC (2006a); APAC (2005); Submissions.

Perth Airport

OWNERSHIP

Structure/parent/operating company	: Fully privatised. Airstralia Development Group. Westralia Airports Corporation Pty Ltd
Major shareholders	: Utilities of Australia Pty Ltd (46.51%); Hastings Funds Management Ltd (28.45%); BAA Australia Pty Ltd (15%) ^a ; Westscheme Pty Ltd (5%); National Nominees Ltd (3.17%); Colonial First State Private Capital Ltd (1.87%).

DEMAND CHARACTERISTICS

Aircraft (RPT+GA) movements (2004-05)	: 86 664 (65% RPT)
Passengers (RPT+GA) (2004-05)	: 6 655 269
Share of total aircraft movements (at PMAs)	: 9.5%
Share of total passenger movements (at PMAs)	: 8.2%
Proportion of the airport's passenger movements that is international	: 29.7%
Main market segments (percentage of overnight visitors in 2005)	<u>Domestic</u> : Business 42% and VFR 31%. <u>International</u> : Holiday 51% and VFR 27%.

COMPETITION CHARACTERISTICS

Destination substitution possibilities	Relatively low, given the dominance of business and VFR travellers.
Modal substitution possibilities	Low, given the isolation of Perth. In excess of 80% of interstate overnight arrivals in Western Australia arrive by plane.
Airport substitution possibilities	Low. There are no proximate RPT airports. But there are some substitution possibilities for GA traffic, which represents 35% of aircraft movements.

BUSINESS CHARACTERISTICS (as reported by the operating company to the ACCC) **2004-05**

Proportion of revenue that is non-aeronautical	: 53%
Total tangible non-current assets	: \$445m
Operating profit (EBITA)	: \$60.4m
Profitability (EBITA on tangible non-current assets)	: 13.6%
Profits/(Loss) after interest and tax	: \$0.3m

^a BAA has indicated that it intends to sell its share of Westralia Airports Corporation.

EBITA – Earnings before interest, tax and amortisation. **GA** – General aviation. **PMAs** – Price-monitored airports. **RPT** – Regular public transport. **VFR** – Visiting friends and relatives.

Sources: ACCC (2006a); Submissions; WAC (2005).

Sydney Airport

OWNERSHIP

Structure/parent/operating company	: Fully privatised. Southern Cross Airports Corporation Holdings Limited. Sydney Airports Corporation Limited.
Major shareholders	: Various Macquarie Infrastructure Funds (63.64%); Ferrovial Aeropuertos Australian Management Limited (20.9%) ^a ; Hochtief Airport (10.5%); Ontario Teachers Australia Trust (4.96%).

DEMAND CHARACTERISTICS

Aircraft (RPT+GA) movements (2004-05)	: 286 484 (89% RPT)
Passengers (RPT+GA) (2004-05)	: 28 848 432
Share of total aircraft movements (at PMAs)	: 31.3%
Share of total passenger movements (at PMAs)	: 35.4%
Proportion of the airport's passenger movements that is international	: 34%
Main market segments (percentage of overnight visitors in 2005)	<u>Domestic</u> : Business 52% and VFR 24%. <u>International</u> : Holiday 51% and VFR 21%

COMPETITION CHARACTERISTICS

Destination substitution possibilities	Relatively low, given the dominance of business and VFR travellers.
Modal substitution possibilities	Relatively low for business traffic (except for the Sydney–Canberra route). However, for VFR and holiday travellers, modal substitutes (particularly private vehicle) appear to be viable for visitors from some areas, including the ACT, Queensland and Victoria.
Airport substitution possibilities	Low. There are no significant adjacent RPT airports.

BUSINESS CHARACTERISTICS (as reported by the operating company to the ACCC) **2004-05**

Proportion of revenue that is non-aeronautical	: 39%
Total tangible non-current assets	: \$4 594m
Operating profit (EBITA)	: \$40.6m
Profitability (EBITA on tangible non-current assets)	: 8.8%
Profits/(Loss) after interest and tax	: (\$257.4m)

^a Ferrovial has indicated that it intends to sell its share in Sydney Airport.

GA – General aviation. **EBITA** – Earnings before interest, tax and amortisation. **PMAs** – Price-monitored airports. **RPT** – Regular public transport. **VFR** – Visiting friends and relatives.

Sources: ACCC (2006a); SCACHL (2005); Submissions.

D.3 Services coverage of price monitoring

Table D.2 Current services coverage and that proposed by DOTARS

<i>Service categories</i>	<i>Direction 27</i>	<i>Airports Act</i>	<i>DOTARS proposed definition</i>
<u>Aircraft-related services and facilities, including the provision, maintenance and repair of:</u>			
• Runways, taxiways, aprons, airside roads/grounds.	Yes	Yes	Yes
• Airfield and airside lighting.	Yes	Yes	Yes
• Aircraft parking sites and facilities.	Yes	Yes	Yes
• Ground handling services and facilities (including equipment storage and refuelling).	No	No	Yes
• Aircraft refuelling services and facilities (including pipelines to and from the JUHI).	Yes ^a	No	Yes
• Airside freight handling and long/short term staging areas essential for aircraft loading and unloading.	No	No	Yes
• Airfield navigation services and facilities (including visual navigation aids).	Yes	Yes	Yes
• Airside safety and security services (including rescue and fire-fighting services and perimeter fencing).	Yes	Yes	Yes
• Environmental hazard control services and facilities.	No	Yes	Yes
• Services and facilities to ensure compliance with environmental laws.	No	Yes	Yes
• Aircraft lighting and emergency maintenance sites and buildings.	Yes	No	Yes
<u>Passenger-related services and facilities, including the provision, maintenance and repair of:</u>			
• Public areas in terminals, public amenities, lifts, escalators and moving walkways.	Yes	Yes	Yes
• Departure and holding lounges, and related facilities (excluding club/business lounges).	Yes	Yes ^b	Yes
• Aerobridges (including nose-in guidance systems) and airside buses.	Yes	Yes ^c	Yes
• Flight information and public address systems.	Yes	Yes	Yes
• Facilities to enable the processing of passengers through customs, immigration and quarantine.	Yes	Yes	Yes
• Check-in counters and related facilities (including associated queuing areas).	Yes ^a	Yes	Yes
• Landside terminal access roads and facilities (including lighting and covered walkways).	Yes	Yes	Yes
• Security systems and services (including closed circuit surveillance systems).	Yes	Yes	Yes
• Baggage make-up, handling and reclaim facilities.	Yes	Yes ^d	Yes
• Telecommunications infrastructure.	No	No	Yes
• Office space and facilities in terminals or airside for airline staff	No	No	Yes
• Landside vehicle services (including, public and staff car parking (but not valet parking); and taxi holding and feeder services.	Yes	No	No

^a Some airports have not reported all revenues because of the clause 3 exemption for existing FAC leases.

^b Does not include club/business lounges. ^c Does not include airside buses. ^d Does not include baggage make-up and reclaim facilities.

Source: Derived from DOTARS (sub. 34, Attachment 3).

D.4 Miscellaneous data on prices and airport comparisons

Table D.3 **Changes in charges^a at price monitored airports; 2001-02 to 2004-05**

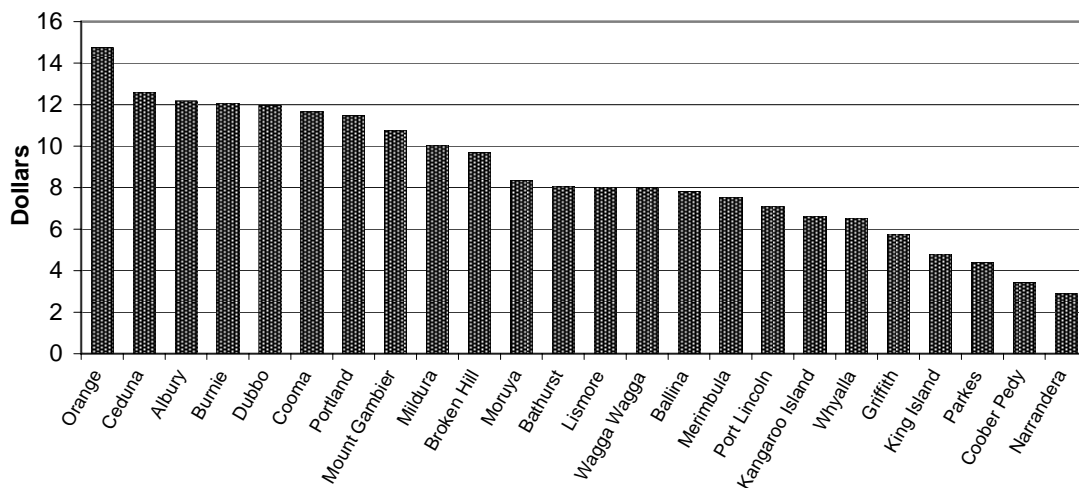
Per cent

	<i>Adelaide</i>	<i>Brisbane</i>	<i>Canberra</i>	<i>Darwin</i>	<i>Melbourne</i>	<i>Perth</i>	<i>Sydney</i>
2001-02	19	11	108	105	9	8	69
2002-03	52	38	22	26	29	58	9
2003-04	13	-2	-7	16	4	0	1
2004-05	3	9	11	9	3	4	3

^a Aeronautical revenue per passenger.

Sources: ACCC (2004; 2006a).

Figure D.1 **Charges^a at Australian regional airports, 2006**



^a Aeronautical revenue per passenger (inclusive of GST and any special 'head tax' agreements).

Data source: Regional Express (sub. 39, p. 6).

E Car parking charges

In the Draft Report, the Commission recommended that car parking charges should not be included in the ‘monitored till’, but that the Government should consider monitoring them separately. As discussed in chapter 5, several airports argued against the necessity for separate monitoring, contending that car parking charges at monitored airports are not excessive — particularly when judged against rates in central city locations.

To help its further consideration of this issue, the Commission looked at movements in car parking charges at the price monitored airports, and at how these charges compare with those at ‘high locational rent’ central business district (CBD) locations. While comparisons of airport car parking charges with those at non-CBD locations — especially those co-located to major facilities — would also potentially be of interest, information on non-CBD parking charges is not readily available.

E.1 What does the evidence show?

At most airports there were substantial increases in car parking charges in the period immediately following privatisation (table E.1). However, with the exception of Canberra and Perth Airports, where increases were delayed until after 2001, subsequent rises have been more modest and, in some cases, below the general rate of increase in the consumer price index.

Moreover, in recent years, increases in car parking charges at a number of airports have been lower than those at other locations encompassed by indicative data, obtained from the Australian Bureau of Statistics. These data suggest that average car parking charges in Australia’s capital cities rose by 35 per cent (or over 6 per cent on an average annual basis) in the five years to 2005-06.

As shown in table E.2, charges at the price monitored airports are typically lower (in some cases considerably so) than those at high ‘locational rent’ CBD car parks where a premium is also paid for parking convenience. The divergence is greatest at Melbourne Airport where the two day rate is less than half of the city rate. Even at Sydney Airport, where charges are the highest, both short and long-stay charges are around one-third less than in the CBD.

Table E.1 Average annual changes in parking charges at price monitored airports^a

<i>Airport</i>	<i>1 hour</i>		<i>2 days</i>	
	<i>1999 to 2001</i>	<i>2001 to 2006</i>	<i>1999 to 2001</i>	<i>2001 to 2006</i>
	Average annual %	Average annual %	Average annual %	Average annual %
Adelaide	15	0	5	0
Brisbane	12	9	21	2
Canberra	0	13	14	3
Darwin	10	10	58	-9
Melbourne	12	11	20	8
Perth	0	5	0	7
Sydney	17	3	17	0

^a Average annual percentage change from June 1999 to June 2001 and from June 2001 to December 2006.

Sources: ACCC (2000; 2002) and airport websites.

Table E.2 Comparative car parking charges

<i>City/Airport</i>	<i>1 hour^b</i>		<i>2 day</i>	
	<i>Airport</i>	<i>CBD</i>	<i>Airport</i>	<i>CBD</i>
	\$	\$	\$	\$
Adelaide	4	5	30	38
Brisbane	8	10	39	56
Canberra	2	1.5	30	14
Darwin	4 ^c	1	12	14
Melbourne	9	13	30	78
Perth	5.2	8	34	65
Sydney	13	18	69	104

^a CBD charges are for indicative Wilson Parking Stations, with the exception of Darwin, which is for the Darwin City Council-owned West Lane Car Park, and Canberra, which is the average for ACT Government car parks in the Civic CBD. Charges typically vary between parking stations. ^b Charge for the first hour. Average hourly rates typically decline for longer stays. ^c The minimum charge at Darwin airport is \$4 (valid for 24 hours).

Sources: Airport websites; Wilson Parking website; Darwin City Council website; communication with ACT Government.

Overall, the data suggest that the constraints on airport market power in setting car parking charges — namely, the availability of off-airport parking and other options for travelling to and from airports — have been influential. These constraints are the reason why the Commission has recommended that car parking charges not be encompassed under the new price monitoring regime (see chapter 5).

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