PRODUCTIVITY COMMISSION

Productivity Commission Submission in Response to the NCC's Draft Recommendation on Declaration of Sydney Airport

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Foreword

The Productivity Commission completed a 12-month inquiry into price regulation of airport services in early 2002. As a result of that inquiry, the Commonwealth Government replaced price caps and other price controls at major airports with a prices monitoring regime.

Despite several events which have affected aviation and airport markets significantly since then, the Commission sees no fundamental changes in airport behaviour that would require alteration of its conclusions or recommendations.

This brief submission draws on research and analysis undertaken during the Commission's inquiry, highlighting some issues germane to the current application for access declaration of Sydney Airport.

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Chairman
August 2003

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In its 2002 report on future price regulation of airports, the Productivity Commission's preferred option was for the replacement of price caps and prices notification arrangements with a mandatory system of price monitoring. There were several reasons for this recommendation, including in particular:

- the risk of regulatory failure and its attendant costs, given the severe information problems confronting the regulator; and
- existing commercial constraints on pricing by airports. Though the four largest airports were assessed by the Productivity Commission as having substantial market power, the prospect of them using it in a way that would be anti-competitive or generate significant costs to the economy or community was supported neither by the evidence nor the analysis. For one thing, there are strong commercial incentives pulling in the other direction, including scope for increased profits in non-aeronautical activities from increased passenger volumes. For another, there are incentives for airports to differentiate their pricing in such a way as to minimise any downsides for efficient use of airports.

The Commission's view was that a less intrusive form of prices oversight — price monitoring — would provide a better balance between regulatory constraint and promotion of commercial relationships between airports and airlines. In particular, by providing a credible threat that price controls could be reintroduced, enunciating principles of efficient pricing to guide airport behaviour, and imposing disclosure requirements, it was judged that any tendency for airports to increase their charges beyond efficient levels would be constrained effectively.

This view was subsequently accepted by the Commonwealth Government and a price monitoring regime adopted. After removal of price controls, there were significant price increases at airports previously subject to price caps, but these increases largely reflected a necessary shift from regulated single-till prices to dual-till pricing. In this and other respects, they were consistent with the ACCC-endorsed

aeronautical price increases at Sydney Airport in 2001, which were set having regard to the estimated efficient costs of supplying aeronautical services at that facility. In most cases, airports have negotiated price agreements with airlines. In several instances, medium-term agreements have been negotiated which cover service quality, consultation procedures, and airport investment.

On the basis of evidence so far, the new arrangements appear to be generally working satisfactorily. Among the pay-offs are the removal of day-to-day regulatory involvement in investment decision-making, and at least the beginnings of genuine commercial negotiations between airports and airlines, within the broad parameters set by the regulatory framework.

That framework includes scope for airport customers to seek declaration of airport services under Part IIIA of the *Trade Practices Act 1974* (TP Act). In the Productivity Commission's report *Price Regulation of Airport Services*, it was observed:

> The Commission also draws attention to the continued relevance of third-party access provisions (Part IIIA) and Part IV of the TP Act to airports. The Commission does not consider that airports have strong incentives to deny or frustrate access in order to impede competition in a way that would be likely to lead to declaration of aeronautical facilities (at least under the modified declaration criteria recommended in the *Review of the National Access Regime*). Nonetheless, the potential activation of this mechanism does provide users with regulation of last resort, providing additional encouragement for airports to enter into reasonable agreements regarding prices and conditions of airport use. (PC 2002, p. 356)

The issue at hand is whether declaration of airside services at Sydney Airport is justified. While the Commission stands by its analysis and recommendations, and sees no evidence that the new monitoring arrangements have failed (importantly, the NCC has not found that Sydney Airport has or is exercising market power), it understands that declaration under Part IIIA must be guided by the existing legislative requirements of the TP Act.

The NCC's draft recommendation for declaration of airside services at Sydney Airport rests on several pillars, including that:

- the facility is a natural monopoly;
- the facility is of national significance;
- access to the service would promote competition; and
- declaration would not be contrary to the public interest.

The Commission has no major disagreement with the first two conclusions.[1] However, some observations are made with respect to the latter two issues.

Would access to the service 'promote competition'?

At issue is whether Sydney Airport has an incentive to levy charges in excess of 'efficient' levels (that is, prices that reflect the costs of efficiently providing appropriate aeronautical service levels), which may in turn affect competition in the aviation market. In its draft recommendation, the NCC appears to be in agreement with the Commission's conclusion that there does not seem to be any incentive for Sydney Airport to impede competition in the aviation market, for example, by frustrating a new airline's access to the airport. Indeed, competition in aviation markets would tend to reduce scope for airline countervailing power in negotiations with airports, and generate increased traffic, both of which would benefit airports. However, the NCC has concluded that, notwithstanding the impact of non-aeronautical revenues on aeronautical pricing, and the threat of the reintroduction of price controls, Sydney Airport has an incentive to raise its charges above competitive levels and that the consequent adverse effect would be material.

In the period when the Commission prepared its report on airport price regulation (December 2000 to January 2002), Sydney Airport was slot-constrained for several hours each day (due to the government-imposed hourly movement limit). At a capacity-constrained facility, efficient pricing will need to reflect the opportunity cost of using slots, not the actual costs incurred by the airport. Moreover, it was observed that any rise in airport charges at peak times was unlikely to lead to higher passenger airfares because airlines would have already factored the scarcity value of the slots into fares. Hence, any rise in charges at Sydney Airport, at least at peak times, would merely transfer scarcity rents from airlines to airports without having much effect on passenger fares or demand.

Over the past two years, a number of demand and supply-side shocks have reduced the pressure on Sydney Airport. In the short to medium-term, it would appear that Sydney Airport will not be slot-constrained. That said, given the long lead times for investment, decisions about expanding capacity may have to be taken in the not-too-distant future. Sydney Airport therefore now faces somewhat similar incentives to other major airports in Australia.

[1] However, as the Commission has noted previously (PC 2002), while there are significant barriers to entry in the provision of airside services in a particular location arising from natural monopoly characteristics and regulatory constraints, often there is scope for some competition from airports in other locations and some destinations may face particularly strong competition from other modes of transport on particular routes.

As noted, airports with excess capacity face commercial constraints that temper their incentive to increase prices overall. In addition, airports have both an incentive and ability to differentiate in pricing, particularly to encourage marginal users of the airport. The Commission's arguments are set out in some detail in its report. Some comments are offered here in relation to the NCC's draft recommendation.

- The Commission's analysis indicated that non-aeronautical revenues were likely to be a significant constraint on airport pricing behaviour. The NCC, while accepting that non-aeronautical revenues will tend to constrain airside prices, concludes that this effect will not be significant. Quantitative scenarios submitted to the NCC by Frontier Economics are cited as evidence to support this view. Somewhat similar scenarios were submitted to the Productivity Commission's inquiry into airport price regulation by Network Economics Consulting Group (NECG) (as consultants to the ACCC) and Frontier Economics (as consultants to the Board of Airline Representatives of Australia (BARA)).

  While, in this context, the scenarios generally assume low demand elasticities for air travel, airlines typically argue that price responsiveness of air travellers is quite high. The Commission noted that the elasticities used in calculations presented to it appeared too low, allowing for little if any scope for competition from other airports and destinations or travel modes. For example, regional flights to and from Sydney could use Bankstown Airport, other eastern seaboard airports provide alternative arrival and departure points for international carriers, while some routes to Sydney compete strongly with other transport modes (eg Canberra–Sydney).

- Secondly, the draft recommendation does not appear to explore the incentives for, and feasibility of, airports discriminating among airlines in their pricing. There is broad agreement that Virgin Blue typically carries more price-sensitive domestic passengers than Qantas. Moreover, Virgin Blue suggests that, for them, airport charges as a proportion of ticket prices may be around 10 per cent, compared with industry averages of three or four per cent. In these circumstances, an airport has an incentive to treat Virgin Blue (or any similar low-cost carrier) differently from a mainstream, well-established carrier such as Qantas, in order to increase throughput and airport profits. The only question is whether such discrimination is practicable. There is ample evidence that airports provide incentives to airlines to add new services. Whether they can discriminate *between* airlines hinges on their ability to 'quarantine' special prices or rebates. During the course of its inquiry, the Productivity Commission received evidence of different treatment of different airlines, especially in the wake of the Ansett collapse and the events of 11 September 2001.

- The current application for declaration of Sydney Airport's airside services is in part a response to a proposal to replace 'weight-based' charges for domestic services with 'passenger-based' charges. The NCC considered that it was unable to determine whether the proposed conversion to charging according to passenger numbers amounted to an exercise of market power by the airport. Traditionally, airports have charged according to aircraft maximum take-off weight, but in recent years there has been a trend towards passenger-based charges, generally with the support of airlines. It is difficult to see how, of itself, such a shift — which from the airlines' perspective, converts a fixed cost per sector to a charge per passenger — indicates the exercise of market power. At face value, a shift from a pricing structure that apparently imposes a greater burden on passengers with lower price sensitivity relative to those with more sensitive demands, to one that imposes a flat fee across all passenger types, does not seem consistent with airport profit maximisation.

  There are several considerations that may underlie the shift to passenger-based charging. While weight-based charges can approximate efficient price discrimination under certain conditions, weight-based charges will tend to discourage use of larger planes on any given route, which may have negative efficiency consequences, particularly if airports are approaching capacity constraints. It also has been suggested that passenger-based charges give greater incentives for airports to work with airlines in stimulating passenger demand and shift some of the risks of low load factors from airlines to airports (Tretheway 1996). Moreover, as noted above, passenger-based charges do not preclude airports from offering incentives to low-cost carriers and/or marginal passengers or off-peak users.

Would declaration be 'contrary to the public interest'?

In the Commission's view, declaration of airside services at Sydney Airport at this time *would* be contrary to the public interest, because in its judgment the costs would outweigh any benefits.

As noted above, the Commission considers that commercial pressures and incentives, combined with the threat of re-regulation will act to constrain airport pricing to a level which broadly falls within the pricing guidelines set out in the Commission's reports on airports and the national access regime (PC 2002 and PC 2001a respectively).

The major advantage of this approach is the encouragement for airports and airlines to negotiate terms and conditions and for future airport investment decisions to be

made outside the reach of day-to-day regulatory involvement. The 'necessary new investment' provisions in the previous regime were a particular problem.

While the NCC acknowledges the potential for regulatory error in the setting of price caps, it suggests that the potential regulatory costs associated with the declaration process (with scope for compulsory arbitration of terms and conditions) are likely to be lower. The Commission does not agree with this conclusion.

- While it is acknowledged that parties are able to negotiate settlements under the access provisions, the fact remains that such negotiations take place in an environment where non-agreement results in compulsory arbitration. As the Commission has previously observed, there can be incentives for the access seeker to choose this route, depending on perceptions about the regulator's likely decision. This process is not dissimilar to the necessary new investment process under the previous regulatory arrangements for airports. Although the ACCC was required to approve any price increases (outside price caps) for new investment at airports, the necessary new investment provisions had been designed to allow and promote commercial negotiations between airports and airlines. However, 'the relatively easy recourse to the ACCC combined with the incentives facing airlines appear to have forestalled the negotiation process' (PC 2002, pp. 242–3).
- Presumably any arbitrated decisions on terms and conditions would adopt methodologies similar to those used to set price caps — with similar risks of regulatory error and costs. In its *Review of the National Access Regime* (PC 2001a), the Commission concluded that the major cost of access regulation was its potential 'chilling' effect on investment in essential infrastructure arising from a tendency for 'regulatory truncation' of potential returns and heightened regulatory risk. In its report *Telecommunications Competition Regulation* (PC 2001b), the Commission cautioned that 'access pricing is a balancing act … errors are inevitable …. Given the long-run consequences, the ACCC should try particularly to avoid large errors on the low side' (p. XXXIII). The ongoing need for substantial investments at major Australian airports weighed heavily in the Commission's decision to recommend the removal of price controls.
- Declaration for access purposes opens up potential for each and every proposed change in prices and/or conditions of airport use to become subject to compulsory arbitration. Even if price-cap regulation had continued, the Commission recommended that the caps should be set explicitly to allow for planned investment over the price cap period, in order to remove the need for project-by-project regulatory involvement. If declared, Sydney Airport could, of course, propose long-term agreements with airlines which incorporated proposed investments for the life of the agreement, but then all aspects of such agreements

could become the subject of arbitration. Even within price caps, airports had some ability to alter price structures within overall revenue constraints and there were pass-through provisions for increases in the costs of mandated services such as security.

Conclusion

In the Commission's view, the risks and costs of increased regulatory intervention in the setting of prices and conditions at Sydney Airport would outweigh any benefits. There appears to be no evidence that Sydney Airport is currently exercising market power to the detriment of competition or efficiency, and the commercial and regulatory pressures which are currently constraining its behaviour can be expected to operate in the foreseeable future. Taken together with Sydney Airport's incentives, under prevailing excess capacity, to differentiate prices and conditions according to the responsiveness of demand, it is difficult to envisage any significant benefit from declaration under Part IIIA relative to the current light-handed regulatory framework. Against this, the costs of declaration in terms of compliance costs and particularly the scope for regulatory error and consequent impacts on investment and re-investment are potentially more substantial.

More broadly, there is a question as to whether the public interest can be served by cutting short a new and innovative approach to airport regulation, developed following an independent public inquiry — at least, without good reason. In the Commission's judgment, no sufficient reason has been or can be demonstrated at this time.

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