
Newsletter and digest of proceedings

**Productivity Commission inquiry into
prices regulation for airports**

April 2001



LateraEconomics

Newsletter

1. Introduction

Welcome to Lateral Economics first newsletter and digest of proceedings for the Productivity Commission's Inquiry into Prices Surveillance for Airports. It seeks to cover important policy issues upon which the inquiry will deliberate. Given the limited size of this document, it cannot be exhaustive, either in covering all the relevant issues or in the way in which it deals with those issues it explores.

*A new service for
busy executives*

Nevertheless, we hope and fervently believe that the newsletter and digest will be useful to those who use it to stay closely in touch with the progress of the inquiry with a minimum investment of their own time. Although both the newsletter and the digest are each over 10 pages long, clients are unlikely to be interested in every issue, much less every submission. No issue or submission is covered in much over a single page.

This first edition of the newsletter reports on submissions to the inquiry which were available on the website up to April 16th 2001. Further editions of the newsletter and digest will be as follows:

1. A newsletter and digest of the first round of hearings;
2. A newsletter on the release of the draft report;
3. A newsletter and digest of the second (or draft report) round of hearings.

We would of course appreciate feedback on what we've got right and what we could do better. We will circulate a questionnaire later in the inquiry to ascertain more fully client's views.



***Incumbent
Airlines
outgunned by
Airports***

Welcome to our editorial. Where we think we have a useful comment to make about the conduct of the inquiry we'll be saying it in our newsletter.

The incumbent airlines – already reeling from the competitive heat from new entrants – have most to lose from the outcome of the inquiry. So far in the inquiry their own preference for something like the current system of prices regulation and slot allocation is coming under credible attack not just from well briefed and resourced airports and airport investors. It is also under attack from highly credible and disinterested participants such as Professor Peter Forsyth – a leading Australian microeconomist.

All the major airports have made substantial, well informed and well argued submissions. The Motor Traders' Association of Australia, which runs MTAA super fund with substantial exposure to Adelaide and Brisbane airports, has also funded a strong submission from Access Economics.

The incumbent airlines' position has been addressed in the IATA submission. Being a series of bald assertions of IATA's policy on various issues, it is unlikely to endear itself to the Commission. The Commission is more likely to be persuaded by argument than assertion. The Board of Airline Representatives Australia (BARA) submission is of a much higher quality, yet still falls well short of the airports' submissions.

The invisible participants in the inquiry are the ultimate users of airports – passengers and those using airfreight – whose long term interests will be at the heart of the Commission's determinations.

Ansett and Qantas submissions are still to be posted on the PC's website. We will report upon them in our next newsletter. The submissions of Virgin Blue and Impulse – the new entrants – will be more influential than their relative brevity would suggest. This is particularly the case with Impulse Airline's submission because its own focus on market access leads it to embrace much of the airports' agenda concerning obtaining prices sufficient to fund investment in new facilities (see below).

**Nicholas Gruen
CEO Lateral Economics.**



2. Monopoly pricing

Introduction

The central issue before the Productivity Commission is how to ensure efficient service delivery at a reasonable cost given that airports are increasingly in private hands and have clear natural monopoly characteristics.

Thus, the potential for abuses of monopoly is at the heart of the policy problem of airports. At best, regulation can only approximate the right outcome. The result is inevitably a compromise – a choice between the risks of market and regulatory failure.

The issues

As Sydney Airport concedes, “[m]ajor airports... generally accept that they have a degree of market power in some of the services and facilities they provide”.¹

Airports typically argue that they are unlikely to abuse this market power for both commercial² and political³ reasons.

If it is abused, monopoly power will impair the allocative efficiency of the economy by restricting the amount of airport services that are sold. But an important question is ‘by how much?’ Several airports point out that if demand is really insensitive to price, then at least at the margin, price rises will have little effect in reducing air travel, and will mostly transfer rent from airlines to the airports.⁴

Professor Forsyth from Monash University is one of Australia’s leading micro-economists and an expert in aviation economics. He has made a comprehensive and very impressive submission to the inquiry that will be particularly influential. Forsyth argues that:

[Airports’] market power is very strong. Airports could, if unregulated, set prices well above costs without fear of losing much traffic. [Nevertheless]...It is possible to achieve minimal use of this market power by imposing price regulation. However, this regulation brings its own costs, and these will be greater than any efficiency gains from lowering price levels.⁵

His submission and many others, particularly those of the airports suggest that the cure of regulatory failure is likely to be worse than the disease of monopoly pricing.

¹ Sydney Airport Submission, p. iii.

² Sydney Airport Submission, p. iii. See most other airport submissions for similar arguments.

³ Melbourne Airport Submission, p. 2.

⁴ See, for example, both Melbourne’s and Sydney’s submissions.

⁵ Forsyth Submission, p. 31.



**Choosing between
the risk of windfall
gains, or poor
airport services**

3. Cost and incentive based price regulation: Productive and allocative efficiency

Two types of price regulation may be contrasted: 'cost based' and 'incentive' regulation. Cost based regulation uses the regulated firm's costs as the benchmark to set the prices it can charge. This is the most efficient means of eliminating monopoly profits, but there are two major problems with it:

- the regulator has imperfect information, and
- the returns to the airport of productivity enhancing investments and other improvements in operations are confiscated so that in the long run, incentives to improve efficiency are undermined.

The alternative is 'incentive based' regulation that enables airports to benefit from – and so encourages – productivity improvements. The regulated price might be arrived at by benchmarking airports against similar airports elsewhere. But the airport gets to keep any cost reductions it can achieve below the regulated price. However, benchmarking is an imperfect science and no two airports are the same. Here there is substantially more risk that the 'wrong' initial price is set, either handing over large profits to the airport, or windfalls to airport customers at the expense of the airport.

A compromise is CPI-X regulation. This has been in favour in Australia in recent years. ⁶ Forsyth argues that whilst CPI-X regulation might be intended to provide substantial incentives for productivity improvements, it can nevertheless be imposed in a way that becomes essentially cost based. Wherever the *actual* cost of production becomes the benchmark for pricing, incentives to lower costs are necessarily undermined to some extent – the extent being determined by the extent to which the CPI-X formula insulates the price surveillance regime from the original cost based benchmark:

CPI-X regulation is essentially a format for regulation; it can be consistent with either incentive regulation or cost-plus regulation. In Australia it is becoming quite cost based. In its recent draft decision on Sydney airport charges, the ACCC proposed regulation of specified non -aeronautical services which is essentially pure cost-plus regulation. ⁷

Conclusion

There exists a trade-off between risk and productive efficiency. The cost based approach has the least risk for the firm and the regulator but is productively inefficient. 'Incentive based' regulation, such as the use of benchmarks, may improve productive efficiency but increases risk to the regulator and the firm. There exists a large middle ground, but the trade-off still applies.

⁶ Industry Commission, *Implementing the National Competition Policy: Access and Price Regulation*, AGPS, 1995.

⁷ Forsyth Submission, p. 5.



**Except for Sydney
there are no easy
answers**

4. Single till versus dual till

Introduction

So called 'single till' price regulation regulates the prices an airport receives over the whole of its activities – from aeronautical services through to retailing. The result is that the most profitable activities – usually retailing – subsidise other services such as aeronautical services.⁸ The 'dual till' approach focuses price regulation on those services in which the airport is considered to have market power. Other airport prices are left unregulated.

Not surprisingly, the airports favour price regulation on as narrow a range of their services as possible.⁹ On the other hand, the airlines claim that "the market power of airports affects the provision of a large range of airport services".¹⁰ In particular, the Board of Airline Representatives Australia (BARA) submission defines the market for airport services as being a 'Cluster Market', meaning that by using the airport, airlines are actually paying for a cluster of services, including the non-aeronautical services. The argument is that once an airline decides to use the aeronautical services of an airport it cannot use the non-aeronautical services of a competitor.¹¹ Thus, effectively the aeronautical service monopoly gives the airport market power in non-aeronautical services and hence BARA does not distinguish between these two markets.

The issues

The microeconomics of the issue are complex and involve trade-offs between different kinds of efficiencies. To expand its retail profits under a single till, an airport will be forced to direct at least some of those profits towards lower charges for aeronautical services to meet a global price cap under a single till. This forces the airport to subsidise aeronautical services.

Other things being equal, where there is spare capacity in aeronautical services, there will be efficiency gains in lowering the price of aeronautical services from average or above average cost closer towards marginal cost. However other things are not equal, as the single till affects the pricing efficiency and or investment incentives associated with other airport services (usually adversely). Accordingly, even where there is spare airport capacity the choice between single and dual till is not straightforward.

Where the airport is congested, subsidies to the price of aeronautical services generate direct inefficiencies by underpricing a service in scarce supply and thus generating excess demand. Accordingly, the case for a 'dual till' approach becomes substantially stronger as airports become busier.

⁸ Melbourne Airport claim that their retailing revenues alone account for 40% of total revenue compared to the entire spectrum of aeronautical services which account for 33% of total revenue, in the 1999/00 financial year.

⁹ Melbourne Airport Submission, p.20.

¹⁰ BARA Submission, p. 1.

¹¹ BARA Submission, p. 5.



***Where there are
easy answers, we
have got them
wrong!***

Melbourne Airport argues that the more focused 'dual till' price regulation is more consistent with the spirit of the national competition policy . This is because it focuses intervention as narrowly as possible upon facilities of national significance with natural monopoly characteristics. Airport retailing does not fit this description.

Conclusion

Except where airports are congested, in which case the weight of opinion favours dual till price regulation, economic theory does not allow us to identify either dual or single till approaches to price regulation as strictly superior to the other. ¹² Ironically, in the one airport where theory provides good guidance we have chosen to ignore it.

¹² CAA Consultation Paper, p. 5.



“[I]t is difficult to determine which approach is preferable on efficiency grounds”

Peter Forsyth on the choice between dual or single till regulation

One issue which seems to attract more attention than most is that of whether a single till approach to regulation is preferable to a dual till. This attention is not warranted by the issue's importance in determining efficiency; it is difficult to determine which approach is preferable on efficiency grounds. Rather the interest is generated by the fact that the choice of approach has implications for the sharing of rents; under the dual till, the airport will gain at the expense of airlines and passengers relative to the single till.

There are several efficiency aspects to the choice, and many have some content, though whether any is particularly strong is not obvious. The final choice is a matter of judgement. A list of some of the main arguments that have been used are as follows:

(a) The Broad Base for Pricing Argument. If cost recovery is spread over a wider set of services, the overall outcome will be more efficient. In particular, profits on non-aeronautical services will lower aeronautical prices, bringing them closer to marginal costs in airports with ample capacity. This favours the single till.

(b) Underpricing Busy Airports. If profits from non-aeronautical services are used to subsidise aeronautical services, this will reduce prices below their efficient levels. This favours the dual till.

(c) Cost Allocation. A dual till requires more detailed cost allocation between aeronautical and non-aeronautical services, if a cost based approach to regulation is adopted. This favours the single till.

(d) Defining the Basket. Dual tills pose problems for the regulator in defining the regulated basket of services because airports will be introducing new charges that elude regulation. This favours the single till.

(e) Interdependent Demands. Additional revenues from passengers may induce the airport to improve capacity allocation at busy airports. This favours the dual till.

(f) Investment Incentives. If non-aeronautical revenues are regulated in a cost-plus manner, there will be an incentive to overinvest in non-aeronautical services. This favours the dual till.

(g) Extending the Regulatory Base. If regulation imposes costs, these will be increased by the single till, which extends the scope of activities regulated. This favours the dual till.

(h) Cost Based Regulation. The dual till is more consistent with incentive regulation, since only one set of benchmarks (for aeronautical services) need to be used. The single till is more consistent with cost-plus regulation because benchmarks for non-aeronautical services are difficult to find or implement.

Other arguments for and against the single till have been advanced. One matter that is clear, however, is that the case for a dual till is stronger with busy, capacity constrained airports such as Sydney, than at airports with spare capacity.

It is thus peculiar that the ACCC regulated the non busy airports in Australia with a dual till approach, but it has recently proposed regulating Sydney with what amounts to a variant of the single till approach. Profits from specified non-aeronautical services will be applied, in their entirety, towards reduction of aeronautical charges. This proposed approach is doubly inefficient in that it amounts to pure cost-plus regulation of the affected non-aeronautical services, since all profits from them will be taken away, and the airport will face no incentive to minimise costs.¹³

¹³ Forsyth Submission, pp. 27–8.



**Expanding capacity
is critical to the
economic success
of airline
deregulation**

5. Incentives to invest

Introduction

Price regulation typically seeks to regulate prices at or around the price they would be if airports competed freely with one another. Good regulation should seek to ensure that airports receive sufficient prices to invest in new infrastructure as and when required.

The issues

Airports argue that substantial price deregulation is necessary to ensure sufficient incentives to invest in expanding capacity and improving quality¹⁴ and that current prices were inadequate to fund investment.¹⁵

An argument previously put by the Network Economics Consulting Group (NECG) is adopted by several airports;

[T]he setting of prices below a competitive market outcome has significantly greater negative effects in the long run than does setting prices above a competitive market outcome.¹⁶

Accordingly the argument goes, because of their imperfect information, regulators should err on the side of pricing a little over rather than a little under the optimal price. NECG argue that the efficiency effects of under-investment are much higher than the efficiency effects of slight overpricing (a reduction in demand which is small because demand is inelastic).

BARA on the other hand argue that airports may not expand capacity even with higher deregulated prices because they may keep capacity constrained to take advantage of higher prices.¹⁷

Most airports expressed concern¹⁸ about incentives to invest relating to recent experience installing additional capacity for new entrants and refurbishing airports.¹⁹ BARA on the other hand, believes that the NNI scheme has encouraged efficient investment.²⁰

¹⁴ See, for example, Melbourne and Sydney Airport submissions.

¹⁵ Again, see Melbourne and Sydney Airport submissions.

¹⁶ Brisbane Submission, p. 22. See also Melbourne Airport Submission, p. 53. This submission extends the argument further by considering regulatory credibility and its effect on the cost of capital and investment. Access Economics argues on behalf of the Motor Traders' Association of Australia (MTAA) that

The critical issue facing Australian airports over the coming decades is the provision of sufficient capacity to cater for growth in air travel in a growing but changing market. Congestion and delay could rapidly become a greater cost to the economy than any modest increase in airport charges necessary to ensure adequate and timely investment in airport capacity. (p. ii.)

¹⁷ BARA Submission, p. 10.

¹⁸ AAA Submission, p. 8. See also Melbourne Airport Submission, p. 43.

¹⁹ AAA Submission, p. 8; Melbourne Airport Submission, p. 36 and Westralia Airports Corporation Submission, p. 17.

²⁰ BARA Submission, p. 1.



The coming of Impulse and Virgin is not just big news in the market. Its big news in airport regulation.

The NNI scheme is relatively new and given time for regulatory learning, may improve. While it may be necessary to review the scheme to eliminate certain structural problems, it must be noted that the absence of regulation won't guarantee superior outcomes.

IATA believe that airlines should be included in investment decisions,²¹ since airlines have to pay higher prices to fund new investment. However, airlines may well use their consent as a bargaining chip in unrelated negotiations with airports. Furthermore, if capacity constraints raise barriers to entry then incumbent airlines themselves may well try to restrict capacity expansion.

6. The new entrants

Introduction

The new entrant's views on regulation are highly significant. Their benign influence on the competitiveness of the aviation market is certainly appreciated at the political level. They also provide a unique new set of interests. Their concerns differ from those of established airlines. They help to provide a new 'growth oriented' focus for the debate.

The issues

For as long as there is spare capacity in existing infrastructure, there is a political temptation to keep prices low with regulation. This is because the costs of this – the suppression of the incentive to invest – is only felt many years later, when spare capacity is finally exhausted and existing politicians and officials have moved on.

The newcomers have dramatically expanded aviation consumption in Australia. This has not only highlighted the gains to be had across the whole of aviation and beyond – for instance in tourism – from improving access to airports. It has generated immediate requirements for spare capacity. The inadequacies of the price regulation regime are thus being exposed immediately.

And they are generating some interesting and potentially very powerful alignments of interest.

Virgin Blue's concerns are perhaps closer to the incumbent airlines than Impulse. It argues that

[A]irports retain significant market power and are able to charge prices which are significantly above the cost of providing an appropriate level of service to Virgin Blue...However, the current framework for price regulation is poorly defined, uncertain and costly (for all participants), particularly with respect to the necessary new investment provisions. The current regime leaves substantial scope for airports to be opportunistic.²²

²¹ IATA Submission, p. 4.

²² Virgin Submission, p. 3.



Impulse's contribution is a more dramatic event in that its position is not very far from that of some of the major airports. It is clearly much more pre-occupied by the effect of existing regulation in obstructing further investment, particularly the development of apron and terminal space for its own operations.

The current...price cap meant that infrastructure quality had to be compromised in both the cases of Melbourne and Sydney's domestic express terminals...We believe that airports should be able to make returns on capital invested. We are also happy to pay to have infrastructure provided, for it is only with sufficient infrastructure that we can expand our business...If an airport and an airline agree on a price for a new service, this should be able to occur beyond the price cap.²³

Conclusion

In the light of the growth unleashed by the new entrants, Impulse's submission underlines and gives immediate relevance to the claim made by airports that underpricing leads to greater economic losses than overpricing of airport services.

7. Countervailing market power of airlines

Introduction

Whilst most airports exhibit natural monopoly characteristics, as virtually all the airports have pointed out,²⁴ their immediate customers are also highly concentrated.

The issues

Certainly, it seems that the airports consider themselves vulnerable to the economic power of the airlines. For instance, Perth Airport provides the following figures:

Approximately 46% of aeronautical revenues and 64% of property revenues come from two customers – Qantas and Ansett. When airline alliances are taken into account, 84% of aeronautical revenues and 68% of property revenues are earned from the two alliances. By contrast, aeronautical charges represent approximately 4% of airline costs.²⁵

Forsyth dismisses this argument as "facile and insubstantial", stating:

If Qantas did switch out of Sydney, it would harm itself more than it would harm its protagonist, since most of its customers on Sydney flights wish to come to or leave from Sydney. Its competitors would immediately take the slack and provide Sydney flights, paying the airport the charges it demands. The countervailing power argument fails because it can only work if the airline has a good substitute airport to use; and it does not. There are no airports anywhere near Sydney that Qantas could use.²⁶

²³ Impulse Submission, pp. 2–3.

²⁴ See Melbourne Airport Submission, p. 15; Westralia Airport Corporation Submission, p. 33; Adelaide Airport Submission, p. 10; Brisbane Airport Submission, p. 28, Sydney Airport Submission, p. 3.

²⁵ Perth Airport Submission, p. 33.

²⁶ Forsyth Submission, p. 12. BARA likewise argues that airlines possess no countervailing market power on account of their lack of 'outside options' if they decide opt out of a deal with the airport. There are no useful substitutes to using the airport in most cases. BARA Submission, p. 10.



**We think airlines
may have some
countervailing
power at the margin**

If Forsyth is right, then the airports are either misguided or deliberately exaggerating their own fears for the sake of the inquiry. We believe that there may be more to the countervailing power argument than Forsyth argues. This is because all meaningful negotiation occurs *at the margin*. When an Australian airport negotiates with a major customer both parties are capable of doing each other so much harm (at least in the short term) by wholly boycotting the other, that this is never in serious contemplation.²⁷ Both parties also know that it would bring into play unpredictable political forces. *At the margin*, the parties are more equal, as (with the possible exception of Sydney Airport) large airport customers would be able to substantially switch a substantial part of their business to another airport.

Perth Airport tells the following story in defence of the 'countervailing power' argument

In January 2001...Qantas and South African airlines decided to...over-fly Perth to Sydney and Melbourne. As noted previously, this decision...resulted in the loss of 13 x B747 aircraft landings per week, a revenue loss to WAC of \$1m pa, or 5% of WAC's aeronautical revenues.²⁸

Some airports, such as Melbourne and Perth, also argue that airlines' countervailing economic power derives from political circumstances and also from the scope they may have for legal harassment.²⁹ Forsyth appears to concede this as a possibility.³⁰ Elsewhere, Forsyth suggests that airport regulation invariably assumes the "de facto objective of keep[ing] profits at moderate levels"³¹ This comes close to conceding the point that the airlines are at least part of a political coalition which appears to have considerable power over the economic fortunes of airports.

The de facto objective of regulation, in the airport context, is to redistribute income, and more specifically, to keep profits at moderate levels. In this paper, it will be assumed that a decision has been taken to subject airports to price regulation, in spite of its costs.³²

²⁷ See also Sydney Airport's argument:

The simplistic 'black and white' view of countervailing power considers the potential for an individual customer to completely cease operations without incurring any costs, while causing significant commercial harm to the supplier. Clearly, very few firms would be considered to have countervailing power using this measure. However, this belies the sophistication and complexity of relationships between airports and airlines which result in many shades of grey in terms of countervailing power (p. iii).

²⁸ Perth Airport Submission, p. 34.

²⁹ Melbourne Airport Submission, p. 19; Perth Airport Submission, p. 34.

³⁰ Forsyth Submission, p. 12.

³¹ Forsyth Submission, p. 9.

³² Forsyth Submission, p. 9.



The case for prices deregulation is probably strongest for regional airports

8. Price regulation for smaller airports

Introduction

Forsyth emphasises that congested airports should be regulated differently from uncongested airports.³³ Currently we only have one seriously congested airport: Sydney. Then there are the major mainland capital city airports. Smaller regional airports make up a third tier. Should they be regulated differently?

The Issues

Hobart and Gold Coast airports claim that their traffic is predominantly generated by the tourism industry.³⁴ The elasticity of demand for tourism is high, as tourism destinations compete with each other in a way that is not the case for much other transport. If these airports raise prices, the tourists will go elsewhere and thus the airports will lose income rather than gain it. On the other hand, even here, the cost of aeronautical services for the airline are such that a small rise in their cost would produce an extremely small rise in total costs.

Small airports also complain that they face relatively much higher costs in complying with regulation than larger airports.

Conclusion

We expect that the Commission will recommend that industry specific price regulation cease for regional airports.

9. Capacity constraints at airports

Introduction

Once an airport becomes congested, the critical regulatory problems change substantially. Higher prices become more justifiable both to fund new capacity and to ration access to existing capacity. These issues loom large for one airport only at present – Sydney. However, they remain of significance for most major airports because

- some more minor expansion of capacity has become necessary because of new entrants and market growth. In addition;
- new parallel runways will probably be required before the end of this decade in several major airports such as Melbourne and Perth.

³³ Forsyth Submission, pp. 9, 34.

³⁴ Hobart Airport Submission, p. 4; Gold Coast Airport Submission, p. 3.



**The commission
will recommend
changes to current
engagements**

The issues

Incumbent airlines have a considerable interest in maintaining a status quo that gives them privileged access to those slots which are available. Not surprisingly, they are keen to hold onto these privileges. The IATA submission claims that

[S]hortage in airport capacity is handled world-wide by 'slot-allocation' procedures. A charges system would not add any value to this procedure; slot co-ordination takes a global view in addressing capacity shortages at airports...Although the sale of slots may improve capacity utilisation, the price per peak slot may become prohibitive for the operations of smaller aircraft.³⁵

This is a fairly weak argument. Since slots are rationed, the loss of slots by smaller aircraft would seem consistent with economic efficiency. The Commission is likely to be unmoved by the IATA defence of slots and will be influenced by the considerations raised by airports. For example, Sydney Airport argues as follows:

The grandfathering system, whereby slots are held indefinitely by any party on the basis only of continued use, creates significant potential for inefficient allocation. This includes "slot banking" by incumbents with an anti-competitive intent to restrict the access by or growth of competitors.³⁶

The Commission will be much more moved by these considerations than those raised by IATA. Its report will explore the efficiency with which a price mechanism can solve airport rationing problems in the interest of economic efficiency and the travelling public.

Conclusion

In its 1998 inquiry into International Air Services the Commission has already criticised "the inability of the committee based slot allocation process to provide adequate provision for new entrants is a fundamental weakness of the system".³⁷ Chapter 8 of its 1998 report was consistently sympathetic to solving the problem of congestion with market pricing rather than the administrative means favoured by the incumbent airlines.

³⁵ IATA Submission, p. 2.

³⁶ Sydney Airport Submission, p. v.

³⁷ Productivity Commission, (1998), pp. 194–5.



10. The New Zealand case

Introduction

In New Zealand, Auckland and Wellington airports have been privatised and are not directly regulated. Rather, the Commerce Commission maintains a vigil to ensure monopoly power is not abused. The threat of regulation seems to be effectively ensuring that prices are not prohibitively high. While higher than airport charges in Australia, airport charges at Auckland are not high relative to similar airports worldwide.

The issues

Professor Forsyth argues that the New Zealand case does not provide much insight into how unregulated airports behave. He claims that the threat of regulation is effectively a form of regulation.³⁸

Yet there do seem to be some attractions. If, as seems plausible, the existence of some regulation to prevent excessive profits is politically inevitable, then this form of quasi-regulation is lighter handed and has lower compliance costs than formal regulation.

Secondly, airports are given a great deal more latitude, allowing them to adapt to changing market conditions. They have the flexibility to raise prices to fund necessary new investment and/or to help relieve capacity constraints should these arise.

Conclusion

Nevertheless, we agree with Forsyth that it is too early to tell with any certainty how this New Zealand experiment should be viewed.

11. References

Industry Commission, 1995. *Implementing the National Competition Policy: Access and Price Regulation*, AGPS.

Productivity Commission, 1998. *International Air Services*, Inquiry Report, Report No. 2, 11 September.

³⁸ Forsyth Submission, 2001, Page 17.



Digest of Submissions



LateraEconomics

Digest of Submissions

1) Peter Lewis

This submission claims that parking charges at airports are very high and ever increasing. This is seen as being indicative of airports' market power in regard to their car park business. The submission concludes that price controls should be brought to bear on car park charges.

2) W.H. Scott-Bloxam

This submission addresses the landing charges at Lizard Island National Park. The argument is that charges are kept high to ensure the 'exclusive' nature of the resort. The author accepts that charges may be high due to the 'sealed' nature of the airfield. No suggestions are presented.

3) Aero-Tropics Air Services

Aero-Tropics provides the most comprehensive service to the Torres Strait Islands. It is claimed that Horn Island Airport raised fees by an amount comparable to other airports in Australia, in November 1999. The complaint is that the airport provides a low quality of service coupled with poor facilities when compared to other airports. Author seeks a price versus service regulation to deal with this issue and a higher authority to resolve disputes between the airline and airport.

4) Australian Taxi Industry Association

This submission argues that airports are a chief source of revenues for the taxi industry. In addition the submission proposes that airports have market power while the fragmented and competitive taxi industry has no counter-veiling power. The taxi industry is concerned over the time delay between the time that the airport raises charges to taxis and the time it takes for the taxi industry regulator to allow the taxi industry to pass these increased charges on to customers. It is proposed:

- that airports should have to submit proposals for increasing charges to taxis to the taxi industry regulator and only increase charges from a date to be determined by the regulator;
- that these fees should be advertised as being 'airport charges'.

5) Prof. Peter Forsyth – Monash University

The countervailing power of users is a mirage...A little reflection should indicate how facile and insubstantial this argument is (pp. 31, 12).

This submission argues that price regulation of airports is driven by a political imperative to confiscate excess profits of airports. The objective of regulation is thus essentially 'distributional' rather than being motivated principally by the pursuit of economic efficiency.

1. A newsletter and digest of the first round of hearings;
2. A newsletter on the release of the draft report;
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We would of course appreciate feedback on what we've got right and what we could do better. We will circulate a questionnaire later in the inquiry to ascertain more fully client's views.



Professor Forsyth argues that:

- airports do possess substantial market power and that unregulated airports would use that power to increase prices sometimes to very high levels;
- the counter-veiling power of airlines is not significant since they have no substitute source of airport services if they wish to service given markets;
- airports can service the competitors of any airlines who refuse to pay higher landing charges – including those competitors who fill the vacuum of the airline who has refused to pay the higher price.

Nevertheless, the submission argues that an unregulated environment would be economically more efficient than a regulated one. This is because prices regulation suppresses incentives for productivity growth within airports and because the economic loss **to the economy** from higher airport prices is very low. (The measure of ‘allocative’ inefficiencies is the extent to which any price rises would distort economic behaviour. Higher airport prices would simply be paid by airlines and passed on to consumers and, given the very low proportion of airfares which landing charges represent, consumers would change their behaviour very little.)

Forsyth further suggests that:

- the importance of maintaining adequate incentives for investment where price regulation can suppress them;
- given the choice to regulate, Australia’s current regulation of airports is appropriate for airports that are not capacity constrained, but inappropriate in the case of Sydney;
- the controversy between single and dual till prices regulation gains more attention than it deserves – neither approach is clearly superior in principle, though dual till is likely to be superior in the case of congested airports.

To support this argument, Forsyth provides a useful list of the many issues to be considered in choosing between single and dual till approaches.

Professor Forsyth’s submission is one of the few submissions to explore the New Zealand experience however he argues that the active threat of regulation in New Zealand has a similar effect to active regulation.

6) Department of Tourism, Racing and Fair Trading

This submission expresses concern that the turn from a political to an economic focus in airline decision-making means airlines will focus on large population centres, making survival difficult for regional airports. These regional airports have significantly reduced market power, especially since Sydney serves as the major gateway to Australia for international flights. The conclusion is that airport authorities need to be actively encouraged to price their services and products competitively and to form strategic and marketing partnerships to include local airports.



7) Melbourne Airport

Airlines argue that other businesses only use the airport because of the airlines flying to the airport...For the sake of responding to this perspective, but not because it will or should influence the Commission in its deliberations, we suggest the obvious alternative perspective: Airlines only have passengers because they are delivered to and from them by airports, or indeed taxis! (p. 27)

Melbourne airport seeks to differentiate amongst the wide variety of services they provide and make the claim that these services are subject to varying degrees of competition. Accordingly, different services should be subjected to different degrees of regulation. Melbourne Airport therefore strongly opposes single till price regulation.

In addition, this submission argues that:

- non-aeronautical airport services such as retailing are not of 'national significance' and therefore according to the spirit of the National Competition Policy should not be regulated;
- given spare runway capacity, it is in its commercial interests to drive costs down and thereby grow its customer base through facilitating increased competition in the airline industry;
- the Necessary New Investment (NNI) arrangements pose a concern as well as the impediments to rapid expansion that they may involve;
- airlines possess significant counter-veiling market power that is economic, political and legal in nature, and stems from the much larger revenues of airlines in comparison to airports and the way in which regulation is administered;
- price reduction imposed by the regulator is initiated from a very low starting value, thus generates inadequate investment incentives;
- a distinction can be made between 'natural' and 'monopoly' rent (p. 3).

The submission does concede that airports do possess the power to raise prices. However, this price rise would serve to transfer economic rents from airlines to airports and will not affect consumers. Raising prices is not in the airport's long term interests and regulators, who have imperfect information, would do more harm than good to the industry's efficiency.

8) Brisbane Airport Corporation

[T]here is little scope for airports to abuse their theoretical market power, and there is no evidence during the years since privatisation to indicate that they have done so (p. 1).

The Brisbane Airport Corporation submission suggests competition exists between airports within Australia in essentially four forms: (1) to attract new airline services; (2) to act as a hub or transfer between hubs; (3) for general aviation users with airports in urban areas and (4) for the provision of services at airports.

Airlines have significant counter-veiling market power; however, airports lack ability to withhold service without incurring substantial damage to themselves and so do not have the ability to abuse market power.



This submission argues that the current regulatory environment:

- favours incumbent airlines;
- deters or delays new investment;
- does not ensure gains from decreased prices will be passed on to consumers.

An appropriate framework would incorporate:

- ability of investor to achieve a fair return on existing and new investment;
- acknowledgement of the need for early decisions in relation to long term projects;
- commercial rewards for efficiency and innovation;

9) International Air Transport Association

This submission simply asserts the IATA position on various issues and lacks any economic analysis of the underlying issues.

Some of the major assertions in the IATA submission are as follows:

- quality of service monitoring is essential to stop airports making excess profits by lowering quality;
- competition between airports is virtually non-existent and airlines have little bargaining power;
- shortage in airport capacity should be handled by 'slot-allocation' procedures and not by the pricing mechanism;
- airports should earn a rate of return sufficient to attract private capital but lower than what it can borrow at, from financial markets. Privatised airports are under-investing; airports should negotiate investment decisions with airlines;
- an increase in airport services prices would not draw public outcry and thus requires regulation;
- all aeronautical and related services should be subject to regulation;
- Melbourne, Brisbane and Perth have better efficiency and cost effectiveness than Sydney, although these would decline if regulation discontinued.

IATA believes price regulation should provide incentives to improve efficiency, reduce costs with traffic growth, ensure acceptable quality of service and timely cost effective infrastructure development. However, IATA does not support price comparison between airports, as costs, structure, quality and so on may vary. For this reason, IATA doesn't approve of any benchmarking to compare airport performance.

10) AMP Henderson

AMP Henderson, a major equity holder in Melbourne Airport supports its submission but seeks to draw special attention to the following issues:

- certainty and transparency are pre-requisites to promote investor confidence;
- at time of investment, AMP was led to believe that post June 2002, regulatory environment would be lifted completely, or at most, light-handed;
- AMP is opposed to any form of single till to apply at any Australian airport.



11) Hobart International Airport

This submission focuses on the Tasmanian environment and its effect on market pricing rather than regulatory price control.

Specifically, the airport argues that Tasmanian airport operators have no capacity to exercise market power, especially with tourism as their primary source of demand and close competition due to the geographical proximity of competing airports. In particular, there are substitutes within the tourism sector and so Tasmanian airports have every incentive to keep charges low to attract tourist revenues. Accordingly, there is no need in this instance for regulation.

The submission expresses concern over:

- single till pricing and the inclusion of car park revenues in the price cap;
- compliance costs as percentage of total revenues for small airports.

12) Perth Airports Municipalities Group

This submission calls for regulation to be extended to cover 'negative externalities' such as "noise, pollution and inadequate provision of facilities" that result from airport operations. It calls for prices regulation to take into account such negative externalities. The submission raises a legitimate issue, though it does so in a way that appears to confuse the purpose of specific economic instruments. The group calls for an acceleration of the building of the parallel runway at Perth airport on the grounds that it would improve environmental amenity, but the submission is unclear about how this should be funded, or how it is proposed to use price regulation to help.

13) Tourism Tasmania

This submission claims that market power has not brought with it any obvious abuses in terms of pricing and/or inefficient behaviours. It concludes therefore, that continuation of the regulatory regime in the Tasmanian environment does not appear warranted.

14) Australian Airports (Townsville) Pty Ltd

This submission seeks broad CPI-based price cap set for some airport services. Provision should be made for pricing flexibility such that airports may pursue necessary new investment. Beyond this, there should be no other price monitoring.

Australian Airports also suggest:

- the price cap should be restricted to selected aeronautical services where obvious market power exists;
- ambiguities exist between intent of legislation and its application by the ACCC;
- disparity between services and the demand for these services at different airports supports the idea that each airport's 'normal rate of return' is different, and regulation should take account of this;
- airlines have counter-veiling market power especially when dealing with regional airports and thus regulation is not required to help negotiate prices for aeronautical services;
- competition between airports exists in the form of competition between destinations; thus regional airports have less market power.



15) Australian Airports Association

This submission argues that:

- airports do not meet the criteria for natural monopoly because they provide intermediate service totaling 4-5% of user charges and there exists significant counter-veiling market power from airlines;
- the current regulatory environment delays and deters new investment and favours incumbent airlines;
- regulation should only be imposed where market failure takes place and monopoly power is abused, not where it is a mere possibility.

16) Gold Coast Airport Ltd

Gold Coast Airport claims to be neither a monopoly, nor in a position to abuse market power for four reasons: (1) they hold a tiny share of the national market; (2) airlines possess significant counter-veiling market power; (3) they have competitors nearby, especially Brisbane and (4) they depend on tourism, which has a high price elasticity of demand.

The Gold Coast submission argues:

- the costs of complying with regulation are significant for a small airport;
- Necessary New Investment (NNI) is not taking place, and current procedures designed to deal with this have led to increased uncertainty and under-investment.

17) Western Australian Government

This submission argues:

- airlines possess counter-veiling market power;
- airports are not able to properly invest in infrastructure. The submission calls for stakeholder agreement on infrastructure requirements;
- a dual till regime should be adopted;
- different airports should be subjected to different levels of regulation, depending on size.

18) Impulse Airlines

This submission presents essentially two arguments:

- new entrants have opened trunk routes to substantial growth. As a result airports will take advantage of the increased passenger volume by growing their business rather than rent-seeking, i.e. Airports will pursue long term interests over possible short term gains from rent-seeking;
- the Necessary New Investment (NNI) regime is not ensuring sufficient or timely investment in capacity expansion.

The key issue is peak services. Impulse claims incumbents have long term contracts for use of existing facilities and that unless airports expand capacity, entrants will not be able to compete. The submission proposes free negotiation between airline and airports for capacity expansion outside the price cap.



19) Hastings Funds Management

Hastings Funds Management is an infrastructure fund manager with large shareholdings in a number of Australian airports. They are particularly concerned with regulatory risk. Their submission argues that the ACCC has regulated airports in a manner that is neither consistent nor transparent, resulting in perverse outcomes.

While it is conceded that airports do possess market power, they also have the potential to grow their business by offering lower prices and highly professional and efficient service. Related to this, is the need for long range planning of new investment. Uncertainty regarding the actions of the regulator may jeopardise this investment by increasing the associated risks. The ACCC's Necessary New Investment scheme is not achieving its objectives.

Hastings argues:

- airlines possess significant counter-veiling market power and this is demonstrated by their collective behaviour in bargaining, through BARA, and in taking collective legal action against Sydney Airport;
- single till price regulation will worsen congestion problem at capacity constrained airports.

20) Adelaide Airport Limited

The submission makes the following claims:

- Adelaide Airport has limited market power over international traffic due to competition with other capital city airports;
- airlines possess counter-veiling market power;
- Trade Practices Act covers abuses of market power so regulation is not necessary;
- Necessary New Investment (NNI) scheme has failed;
- the current regime results in prohibitive compliance costs;
- the benefits of regulation to consumers is insignificant in comparison to the benefits from increased airline competition.

21) Westralia Airports Corporation Pty Ltd

Westralia Airports Corporation Believes that airports, airlines and government should work collaboratively to ensure that airports are provided with incentives to carry out necessary new investment while keeping quality of service high and prices low.

Further, the submission suggests:

- current regulation has not met government objectives;
- starting prices set under the CPI-X regime were too low;
- airlines possess significant counter-veiling market power;
- the TPA provides sufficient protection from the abuse of market power by airports;
- all services should be treated as contestable unless proven to be otherwise, and only those that are non-contestable should be regulated.



22) MTAA Superannuation Fund Pty Ltd

“The government will always have the ultimate ‘ace up its sleeve’ – the ability to re-introduce more restrictive regulation in the future, should airports abuse their greater freedom” (p. iii).

MTAA Superannuation suggests a lighter-handed approach to regulation – with price monitoring and using the TPA if necessary, but no active regulatory involvement. Although it concedes product efficiency under a heavy-handed approach, this trade-off would allow allocative and dynamic efficiency. MTAA therefore recommends that governments should only intervene if convinced that intervention will unambiguously improve efficiency and equity.

This submission further argues:

- airlines possess significant counter-veiling market power;
- in the absence of detailed information about a firm and its markets, regulators run the risk of generating efficiency costs with price controls;
- current price controls have impacted adversely on productive and allocative efficiency;
- investment incentives have been skewed away from aeronautical-related investment and efficient upgrading of quality and capacity has been inhibited, as the regulatory system drives investors’ perceptions of increased risk;
- airport charges account for a lower proportion of air travel costs than either travel agent fees or government departure tax, the latter applying only to international travelers. Any resulting price increases will have small effects on the cost of air travel.

23) Department of State & Regional Development (VIC)

The Department of State & Regional Development concedes that airports have monopoly power in their core aeronautical business, but argues that regulation should differentiate between aeronautical and non-aeronautical services.

The submission recognizes that:

- airlines have significant counter-veiling market power;
- price capping should be avoided in favour of price monitoring;
- airports should be allowed to earn a reasonable return to facilitate the necessary investment in infrastructure. In particular, investment in airport infrastructure has positive and negative externalities for the region as a whole and these should be considered when setting incentives for airports to invest.

24) Department of Transport and Works (NT)

This submission argues that price regulation – including its compliance costs – seriously affects the profitability of Alice Springs and Darwin Airports and should be discontinued to be replaced with the standard provisions of the TPA.

25) Northern Territory Airports Pty Ltd.

This submission argues that:

- compliance costs of price regulation are excessive;
- airlines have sufficient counter-veiling market power to reach agreements through negotiation; and
- the Necessary New Investment (NNI) arrangements are not achieving their objectives.



26) Board of Airline Representatives Australia Inc.

[A] monopoly, with a cushion of monopoly profits, does not need to minimise costs to survive. Crew and Kleindorfer, cited by BARA, (p. 3)

This submission is an initial one. BARA intends to provide others over the course of the inquiry. Its comments are restricted to International Air Services. The submission argues that airports have significant market power due to the lack of substitutes. Abuse of this power will have flow on effects to tourism and the international business sector. Current regulation partly curtails airport market power while encouraging efficient investment; therefore, there should be a broad regulatory regime and a single till approach.

The economic basis for regulation of airports is as follows:

- without airport services, airlines would be unable to provide air services to customers; although the airline industry is subject to competition, airports are not;
- if unregulated, airports will drive prices up to monopoly levels resulting in a significant increase in air ticket prices. Low price responsiveness of demand means that profit maximising prices are well above current prices;
- due to lack of competition, airports have reduced incentives to control their costs (generate so called 'X-efficiencies');
- quality will fall in absence of regulation since airports will not maintain facilities and levels of customer service and the resulting cost will be borne by airlines;
- without regulation, airports may deny access to certain services as a 'bargaining chip' in unrelated negotiations;
- airports could restrict access to off-airport competitors for some services – for example, Valet Parking companies competing with their own car park business.

BARA presents the important 'Cluster of Services' Argument. This argument centres around the economies of scope of airport services. It is argued that once an airline chooses to use an airport it has no choice but to use a 'cluster' of airport services. Basically, an airline or customer must purchase a package of services including food, access to retail outlets, parking and so on. The key point is that airports control access to all services provided on airport land. Thus, there exists a location specific market for the provision of a cluster of infrastructure based services at airports. All these services are used by airlines.

BARA argues airlines have no counter-veiling market power because of lack of substitutes in the markets they wish to serve.

When considering the economic efficiency consequences of allowing airports to take advantage of market power, the submission focuses on the "under consumption of airport services and welfare implications".

These include:

- reductions in business and tourist travel and freight services;
- adverse employment and efficiency effects on other industries;
- reduced international trade, increasing business costs, thus damaging our competitiveness.



27) Sydney Airport

[C]omplete economic deregulation of Australian airports will deliver the greatest net benefits. (p. i).

This submission supports complete price deregulation. However, it does not contest regulation in relation to safety and operational issues; the movement cap; curfew or regional airline access arrangements.

The submission argues that:

- the current regime “cracks a walnut with a sledgehammer”;
- the ACCC’s implementation of regulation is inconsistent with government aspirations – in particular, the current situation discourages negotiated outcomes by encouraging regulatory ‘gaming’;
- a cost of regulation is under-investment, leading to congestion, over-crowding, poor quality outcomes and lack of innovation;
- airports are not vertically integrated and do not compete with their customers, thus there are no incentives for airports to restrict access to their facilities or provide inappropriate levels of quality;
- airlines have significant counter-veiling market power;
- an airport’s best interests would not involve abusing its market power by raising prices above inefficient levels – business growth is a more rewarding strategy;
- the threat of re-regulation is a substantial incentive not to abuse market power if regulation were revoked;
- a single till system is inferior because it allows airlines to capture significant economic rents that are not subsequently passed on to consumers;
- a price mechanism would provide superior outcome to current slot allocation system – in particular, ‘slot-banking’ by incumbents restricts access to, and growth of, competitors;
- regulatory role in deciding timing of new investment, generates substantial inefficiencies.

28) Australian Council for Infrastructure and Development

The Australian Council for Infrastructure and Development argues that airlines possess countervailing market power and regulation should not be continued.

Specifically, it argues:

- investors have bid for airports on the basis that regulation was an interim measure and those undertakings must be upheld;
- TPA provides sufficient protection for airports;
- If regulation is continued, it should only be in those markets where airports exhibit very strong market power;
- the dual till approach is preferable to single till regulation.



29) Stott

This submission is essentially directed against Canberra International Airport. It includes the following arguments:

- price cap only applies to aggregate charges – allowing substantial price discrimination against smaller users.
- general Aviation Charges – affecting small aircraft – have increased almost 300% but there was no aggregate violation of price cap.
- each airport service should be subjected to a price cap rather than an aggregate price cap for all airport services.

30) Virgin Blue

Virgin Blue argues that it is dependent on the availability of efficient low cost airport facilities to sustain its competitive strategy.

The submission further suggests:

- access rights for airport price regulation, which many of the airports have called for, would be inefficient and costly – explicit price regulation is required;
- airports retain substantial market power;
- the current framework for price regulation is poorly defined, uncertain and costly, particularly with respect to the necessary new investment provisions;
- access to airport facilities should be available at low costs and not subject to substantial uncertainty.

Virgin Blue therefore argues that future price regulation is necessary and should cover:

- capital cities and other major airports;
- all services provided by airports that are inputs into the provision of commercial aviation services.

Virgin Blue supports the CPI-X price cap; however, new investment should be considered when setting future CPI-X price caps.

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