13 June 2003

Ms Deborah Cope
Acting Executive Director
National Competition Council
GPO Box 250B
Melbourne  VIC  3001

Dear Deborah

Application by Virgin Blue for Declaration of Airside Services at Sydney Airport – Request for Additional Information on Regulatory Costs

Sydney Airports Corporation Limited (SACL) has been requested by the NCC to provide further information regarding regulatory costs arising from price regulation. The Council has in particular asked for information related to indirect costs.

Direct Costs
While recognising that the NCC considered it had adequate information relating to direct costs of price regulation, SACL notes the estimates prepared by the New Zealand Commerce Commission\(^1\) that the direct costs of price regulation for a single airport are in the order of NZ$1.1m to $2.2m in a price review year, and NZ$0.5m to $1.1m in other years. This estimate includes the costs to the regulator of some NZ$0.5m to $1m in a review year and up to $0.5m in other years, and costs incurred by the airport of between $0.6m and $1.2m in a review year and up to $0.6m in other years.

Melbourne Airport has also previously estimated that its average annual compliance costs under price regulation, including Launceston Airport, were $0.5m\(^2\).

SACL separately accounted for the costs it incurred during the ACCC pricing review that culminated in the May 2001 revision to Sydney Airport charges. During this protracted process SACL’s costs were in the order of $3m.

Indirect Costs

Background to Indirect Costs

The New Zealand Commerce Commission was of the view that, while acquirers of airport services (airlines and indirectly passengers) would be expected to receive most of the benefits of price control, they would also bear the majority of the costs of control\(^3\). Of course, where regulatory costs are incurred by consumers, this affects the economy as a whole.

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\(^2\) Submission to the Productivity Commission Review of the Price Regulation of Airport Services, Melbourne Airport, March 2001, Page 40.

The New Zealand Commerce Commission considered indirect costs of regulation to be those arising from:

- **Allocative inefficiency** – where incorrect price setting distorts the provision or consumption of services and allocation of resources.

- **Excess returns by the airport operator** – where regulated prices take some time to move to efficient levels. SACL notes, however, that this would be difficult to assess because regulatory error (discussed below) means that regulated prices will not necessarily represent efficient levels either.

- **Productive inefficiency** – where the method of regulation produces a disincentive for airports to minimise costs.

- **Dynamic inefficiency** – where the uncertainty of future regulation creates a disincentive to invest.

The Productivity Commission observed that a key shortcoming of price regulation is that regulators are required to make pricing decisions based on imperfect information, including estimates of efficient prices and historical data that may not reflect true opportunity costs. That is, the nature of regulation leads to a high probability of regulatory error, where prices are set incorrectly and distort the consumption of airport services and investment in infrastructure. Given the significant importance of airports to gross domestic product, the economy-wide costs of regulatory error could be significant.

The risk of regulatory error has also been identified by the Network Economics Consulting Group, which defined the cost of regulatory error as being “efficiency costs to society of incorrect decisions by regulators about whether and how to intervene”. NECG suggests that incorrect pricing decisions lead to sub-optimal outcomes including: diminished incentives to invest; constrained ability for infrastructure providers to price efficiently; and encouraging inefficient investment in related markets. NECG also identifies another important indirect cost of regulation: wasteful strategic behaviour by producers and consumers seeking to enhance their position through an arbitraged outcome from regulators.

In summary, the key indirect costs of price regulation of airport facilities could be stated as:

- Inefficient production and distorted consumption of services because of incorrectly set prices.

- Sub-optimal investment in airport facilities where prices are set incorrectly and present a disincentive to invest, or because of the uncertainty of future regulatory decisions over the significant use of new infrastructure assets.

- Excessive operating costs where a disincentive exists under a regulatory framework to reduce costs.

- Wasteful strategic behaviour by airport operators and consumers of airport services.

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4 Ibid, pages 181-185
5 Price Regulation of Airport Services, Productivity Commission, 23 January 2002, Page 93.
Specific Examples of Indirect Costs of Regulation

SACL is able to cite a number of examples where price regulation has led to actual or potential indirect regulatory costs. While we have not attempted to place a dollar value on these examples, they serve as an important indication of the distortions that can arise from price regulation.

May 2001 Major Pricing Decision

While subject to regulation under the Prices Surveillance Act, SACL put forward a proposal to the ACCC to move its aeronautical charges to a location-specific, economically efficient basis. This included seeking recovery of the cost of investment in the major SA2000 project that expanded and upgraded the airport in preparation for the Olympics.

In terms of direct costs, this was an unwieldy process, commencing in 1999 with a final ACCC decision in May 2001, and costing SACL approximately $3m to undertake. The ACCC and airlines and airline representative bodies presumably incurred substantial costs over this period also.

This process also served as an example of a range of indirect regulatory costs.

Arguably SACL and airlines all engaged in wasteful regulatory ‘gaming’ during this process. Rather than engaging meaningfully with one another to negotiate a satisfactory pricing outcome, aspects of submissions to the ACCC took strategic positions and presented extreme views with the aim of securing a better, arbitrated outcome. For example, SACL would have been expected to err towards ensuring that all operating costs and asset values were fully recognised in its pricing proposal, while airlines would be incentivised to take extreme alternative views as to aspects such as appropriate operating costs, cost of capital, and land value.

In SACL’s view, the prices determined by the ACCC contained aspects that represented regulatory error. In determining the value of land incurred in providing aeronautical services, the ACCC recognised that an opportunity cost valuation would be most appropriate, but did not consider that it had adequate information to determine this form of cost and adopted instead an indexed historic cost7. This was a clearly flawed second-best measure and led to prices for aeronautical services that do not fully reflect the cost of land incurred, thereby creating an allocative inefficiency.

A further, more serious regulatory error was averted by Government intervention in the form of a direction to the ACCC. The ACCC had proposed that charges for aeronautical services should be arbitrarily subsidised by revenues generated from non-aeronautical services such as retail and car parking facilities. By seeking to continue the so-called “single till”, the ACCC risked entrenching a significant allocative distortion where users of aeronautical services paid only a portion of the cost of providing those facilities, thereby providing the wrong investment signals, combined with a disincentive for airport operators to invest in aeronautical assets.

The prolonged ACCC assessment process also posed the risk of delaying the development of infrastructure required to facilitate Olympics traffic through Sydney. Recognising the important public interest considerations of the development, SACL took a substantial

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business risk by deciding to proceed with the $600m investment in aeronautical facilities associated with the SA2000 project, despite not having secured regulatory approval for the recovery of costs through aeronautical charges.

Structural Upgrade of the East-West Runway

In mid 2002, SACL undertook an overlay of the airport’s East-West (07/25) Runway, incorporating elements of maintenance and structural upgrade. Although an overlay of only 45mm was required for continued safe operation of the runway, the total $4.6m capital cost provided for an overlay of 100mm. This was judged by SACL as providing the best overall solution by ensuring the structural integrity of the tarmac, catering for larger aircraft, and minimising the longer term costs of maintaining the asset.

The ACCC’s guidelines for cost recovery of “necessary new investment” provides only for recovery through aeronautical charges of investment in new or enhanced infrastructure. The ACCC’s position specifically excludes the prospect of recovery of maintenance investment, arguing that this is implicitly provided for with existing charges.

This position in itself leads to indirect regulatory costs. In the first instance, aeronautical charges established under the methodology accepted by the ACCC provide for a return on assets through the cost of capital component, while the depreciation component provides a return of the initial investment in the assets. Depreciation does not in itself cover asset maintenance or replacement, and unless maintenance is specifically factored into operating costs, it would be unfunded.

This provides a disincentive for airport operators to undertake maintenance works; and leads to charges that do not fully reflect the cost of providing aeronautical facilities. It also promotes strategic regulatory behaviour as airport operators have an incentive to attempt to classify works as an upgrade to secure cost recovery, while airlines could be expected to attempt to maximise the allocation to maintenance.

Importantly, the regulatory framework encouraged SACL to undertake the minimum investment required to continue safe operation of the runway. While this would have led to higher overall costs in the longer term, the rational decision would have been to defer maintenance expenditure in the hope of a more favourable future regulatory position in relation to maintenance recovery. This may also have reduced the airport’s ability to use the 07/25 runway for noise sharing operations, particularly for larger aircraft, imposing a cost on the community through altering noise exposure patterns. Despite the incentive to defer expenditure, SACL decided to undertake the optimal 100mm overlay, determining that, with the prospect of price deregulation, SACL may be able to negotiate a more sound cost recovery outcome with airlines.

Acquisition of the Former Ansett Terminal

In May 2002, SACL acquired the terminal formerly owned and operated by Ansett.

The regulatory instruments under the Prices Surveillance Act that applied to Sydney Airport at the time specifically carved out those facilities and activities subject to a lease when the Sydney Airport lease was granted. This had the effect of excluding from price control the domestic facilities operated by Ansett and Qantas. SACL was of the view that, under

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continued price regulation, the former Ansett terminal would be subject to price control if acquired by SACL.

SACL faced significant regulatory risk in acquiring the terminal. The ACCC was not prepared to provide an indication to SACL in advance of a purchase, of its expected position in relation to charging for terminal services\(^9\). Under a deregulated regime, SACL would have been entitled to agree a pricing approach with prospective users in advance of purchase of the terminal, thus ensuring that it paid for the terminal only what could be recovered through user charges. Under price regulation, however, SACL was required to take the risk of purchasing the terminal prior to the ACCC determining a user charge, with no guarantee that this would be adequate to justify the investment.

In addition, the market for the acquisition of the terminal was distorted because prospective purchasers potentially faced a different regulatory position from SACL. It was not clear that the terminal would be subject to price control if acquired by a private sector operator, nor was it clear that prospective private sector purchasers perceived the risk of price regulation. This could have led to a private sector purchaser paying a higher price for the terminal than SACL was willing to pay because of regulatory risk, potentially leading to higher user charges and sub-optimal utilisation of the airport with the terminal operated independently of other airport facilities.

It is also worth noting that, had SACL remained subject to price regulation, there was the prospect of the former Ansett terminal being subject to price control under SACL ownership, while the adjacent Qantas domestic terminal remained unregulated. This incongruous outcome would have had implications for allocative efficiency.

SACL remains subject to price control for regional (intrastate) services. This restricts charges for regional users of the former Ansett terminal to an amount no higher than levied prior to 30 June 2002, despite the significant difference in the quality of the terminal and underlyng costs compared with the temporary terminal in use at that time. As a result, domestic passengers effectively subsidise regional users, who pay $2 per passenger less than domestic passengers to use the same terminal facilities.

**Apron Parking for Overnight Freighter Aircraft**

In January 2002, SACL applied to the ACCC to correct a distortion in its charging regime that did not permit it to charge apron parking fees to overnight freight operators. This provided curfew hour operators with a competitive advantage over freight operators not permitted to operate during curfew hours.

Despite this clear allocative distortion, the ACCC was initially reluctant to approve a charge for apron parking for curfew freight operations, on the basis that this may theoretically allow SACL to generate insignificant excess returns on apron assets. The ACCC did decide to approve a charge\(^10\), however, on the condition that revenues generated be offset by reduced revenues elsewhere, paving the way for an arbitrary distortion to the charges levied to other users for airport facilities.

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\(^10\) ACCC Decision: Proposal to levy a charge for apron parking during curfew hours by certain freighter aircraft at Sydney Airport, February 2002.
Recovery of Mandated Security Costs

ACCC\textsuperscript{11} and Department of Transport and Regional Services\textsuperscript{12} guidelines provide for airport operators to fully recover the direct costs of providing government mandated security services.

In January 2001, SACL sought approval from the ACCC for a charge of $0.72 per landed tonne to recover the costs of providing counter-terrorist first response security services. The Government had provided the ACCC with a direction to permit 100\% recovery of such costs for other airports, but this did not include Sydney Airport. Accordingly, despite finding the costs justifiable, the ACCC approved a charge of only $0.66 per tonne, representing a 75\% cost recovery\textsuperscript{13}.

This decision was not based on any sound economic or efficiency grounds, but on an administrative anomaly. As a result, SACL has systematically under-recovered the costs of providing counter-terrorist security services, incurring a shortfall of over $4m, while airport users were not required to meet the full cost of security services at Sydney compared with other major Australian airports. Consistent with the principles applying to security cost recovery, airlines have agreed to the recovery of this shortfall, however, this has the distortionary effect of requiring future airport users to meet the costs of providing past security services.

Domestic Passenger Based Charging

SACL proposed in August 2001 that it convert its tonnage based runway charges to charges levied based on passenger throughput. The ACCC did not object to the introduction of such charges for international services, but found that it did not have sufficient time within its statutory period to consider the potential implications for domestic services and on that basis objected to the proposed charge for domestic operations\textsuperscript{14}.

This deferral of a decision has seen the ongoing use of tonnage based charges for domestic operations, which do not reflect the opportunity cost of aircraft using Sydney Airport's runway assets and promote the inefficient use of airport facilities by encouraging smaller aircraft. This requires investment in gate and terminal facilities earlier than would otherwise be required, increasing the cost of domestic travel above efficient costs. As Sydney Airport runway capacity becomes increasingly constrained, this will also displace larger aircraft and potentially require investment in a second Sydney airport much earlier than necessary.

A decision to declare airport facilities for access purposes, with a subsequent rejection of domestic passenger based charges, would entrench this inefficiency and generate costs of using airport facilities that are higher than required.

\textsuperscript{12} Department of Transport and Regional Development: Pricing Policy Paper, November 1996.
\textsuperscript{13} ACCC Statement of Reasons: Sydney Airport Proposal to Recover the Cost of CTFR services, January 2001.
\textsuperscript{14} ACCC Proposal to Restructure Charges – Statement of Reasons for the public register for proposed passenger charges at Sydney Airport, August 2001.
Conclusion

SACL believes that these examples provide clear evidence of the nature of indirect costs arising from price regulation. They represent significant distortions and inefficiencies in the behaviour of airport operators and airlines, and in the manner in which airport facilities are used and developed. Such costs are clearly detrimental to the public interest, and justify the Government's policy decision to instigate a probationary period of price deregulation.

The Commonwealth Government determined\(^\text{15}\) that the major Australian airports should be subject to a probationary period of light-handed regulation having “taken into account the interests of airports, airport users and the travelling public”. It also noted that the "price monitoring arrangements will provide airports with greater scope to undertake efficient aeronautical investments and more flexibility to respond to a changing aviation environment".

The Government announcement went on note that the Government reserved the right to reintroduce price controls “if it were found that airport operators were abusing their market power by unjustifiably raising prices”.

While the provisions of Part IIIA of the Trade Practices Act were clearly retained as a safeguard, the Government intended them to provide “protection for access seekers that have been unreasonably denied access to services eligible under the legislation”\(^\text{16}\).

Virgin Blue has not been able to demonstrate that SACL's actions under light-handed regulation represent unjustifiable pricing behaviour. On the contrary, SACL's aeronautical revenues remain well below those required to generate a justifiable return on assets and costs, and the proposal to move to domestic passenger-based charges represents an economically sound response to the changing domestic aviation market and the need to encourage more efficient airport utilisation.

A decision to declare Sydney Airport airside facilities for access purposes in these circumstances would be clearly contrary to the Government's intentions with respect to light-handed regulation. Furthermore, in the absence of a demonstrated misuse of market power or denial of reasonable access to facilities, declaration under Part IIIA would introduce a significant element of regulatory risk to airport operators, with regulatory costs including distorted investment decisions.

Yours sincerely

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