Declaring Airports for Access: A Comment on the National Competition Council Draft Recommendation

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Introduction

In a recent Draft Recommendation the National Competition Council (NCC) has recommended that the airside services of Sydney Airport should be declared for access (NCC, 2003). If accepted, this could lead to a major change in the way Sydney, and other major airports, are price regulated (for a review of recent policy decisions and price monitoring, see Forsyth, 2003a, 2003b). Rather than the present light handed system of price monitoring, declaration would pave the way for a system of explicit price regulation, operating through the arbitration powers of the ACCC. To the extent that the ACCC, when called upon to arbitrate in access disputes, would opt for lower charges than would eventuate under price monitoring, airlines would seek to use the access provisions, and the arbitration process would dominate, rendering the price monitoring system irrelevant.

For a facility to be declared under the Trade Practices Act, several conditions must be met. One of these - necessary - conditions is that declaration would promote competition in another market. In the case of airports, relevant other markets would be airline passenger and freight markets. The NCC argues that declaring the airside services of Sydney airport would promote competition in the domestic passenger market. Given the centrality of this condition, it would be expected that the NCC would analyse the airline competition issue in some depth. This is especially so given that, for a change which impacts on all competitors equally, the normal expectation would be that competition would not be affected. In fact, it provides very little analysis of the issue, and it appears to on trust claims put forward by the applicant for declaration, Virgin Blue. It has not established that, under plausible conditions, declaration will promote competition in the airline market.

It is argued in the Draft Recommendation that when airport charges are higher, and both major airlines, the full service carrier (FSC), Qantas, and low cost carrier (LCC), Virgin Blue, face the same higher charges, the latter will be disadvantaged, and in some cases, may be forced to exit. Note that Virgin Blue is not a typical LCC, with its network based on dense routes and accessing of business traffic. The FSC is claimed to have an advantage, and that it can simply add the extra charge to its high yield traffic, which is less price elastic, thereby giving it an advantage in the low fare traffic. What is missing is any analysis of how the FSC is likely to behave, or the constraints it is likely to be operating under. This is fundamental; it is not possible to determine the impacts on competition without examining the FSC’s response to different airport charges.

The normal expectation would be that decrease in charges, enjoyed by all competitors equally, would not promote competition. This expectation is confirmed when the behaviour of the FSC is analysed- in almost all circumstances, there will be no change in competition. There is a specific case, however, in which competition may be promoted when there is a decrease in airport charges being faced by the airlines. In this case, the charges decrease could lead to the entry of a competitor. While competition will have been promoted, overall welfare will decrease- this is so because entry would result in an excessive number of competitors given the market size and cost structure. In this situation, ceteris paribus, it would not be in the public interest
for the facility to be declared. While the declaration could be justified on the promotion of competition ground, it would fail the public interest test.

For purposes of this paper, much of the characterisation of the problem as put forward by the NCC will be accepted. It will be assumed that declaration will lead to lower airport charges—this is because the airport will be assumed to use the market power it possesses, in the future, even if it is not using it at present. It will be assumed (not very plausibly) that the regulation embodied in the arbitration process will not have any impact on incentives and costs, and thus airport charges in the longer term. However, in contrast to the NCC’s preference, a city pair definition of market will be used, in conformity with international practice. This does not affect the arguments presented.

It is not clear, from the Draft Recommendation, what is meant by a “promotion of competition”. One interpretation is that promotion would mean more competitors in the market. However, a broader view could be taken. For example, if conditions changed such that the same number of competitors in the market competed more intensively, and prices fell closer to costs (i.e. the Lerner index of market power falls), this too could be interpreted as promotion of competition.

**Promoting Competition in a Vertically Integrated Industry**

The requirement that declaration for access result in promotion of competition in another market can be readily understood in the context of an industry with a vertically integrated firm which owns an essential facility. If a competitor is to compete with the vertically integrated firm in a market for a downstream product, it will need to obtain access to that firm’s facility. Thus a firm which wishes to sell mobile telephony products will need to obtain access to Telstra’s local loop. The access price will influence the level of competition in the downstream market. If the price for access is prohibitive, the new competitor may not enter at all. Even if it does enter, but it is require to pay a price for access to the facility determined by its owner, competition will not be very strong, since the owner will seek to preserve its profits. Prices will remain high relative to costs, and the intensity of competition will not increase. Here, declaration for access, along with regulation of the access price closer to cost, will promote competition either in the sense of more competitors in the market, or greater intensity of competition in the case in which it does not increase the number of competitors.

**Promoting Competition in a Vertically Separated Industry**

In the case of a vertically separated industry, such as airports and airlines, the impact of declaration on competition in the downstream market is less obvious. In the vertically integrated case, declaration worked through altering the competitive balance between the firms, by tilting the balance towards the entrant. In the case of the vertically separated industry, there is no necessary impact on the competitive balance in the downstream market. This would be clearest when all firms in the downstream market are comparable. Declaration would result in all the competitors paying less for an input, but the balance between the firms would not be changed. It
may well be that the facility owner was using market power, and that declaration forces prices down towards costs; however, all competitors will be comparably affected by this. There is no general reason to expect more firms to come into the market, or for the existing firms to change how they price in relation to cost. Here, declaration could have a desirable effect of lessening the extent of monopoly pricing, but this is not the purpose of the access provisions—their purpose is to promote competition in related markets.

It is worth remembering Bork’s argument about the incentives facing upstream sellers in dealing with downstream customers (Bork, 1978). Bork pointed out that it is in the seller’s interest to promote competition in the downstream market, not to restrict it. This is because increased competition at the downstream level leads to increased demand for the product, something from which the seller can profit. An airport will thus normally seek to increase competition at the airline level. Bork does not claim that the upstream seller will never restrict downstream customers, rather he notes that it will need to have a good reason to do so.

Thus, the normal starting point should be that access declaration of an essential facility, such as an airport, in a vertically separated industry, aviation, would not promote competition in another market, such as an airline market. This said, it may be possible to construct an argument to the contrary. However, given the prior expectation, such an argument would need to be tightly formulated, and strongly supported by the empirical evidence.

**Competition between a FSC and a LCC**

The crux of the argument in the NCC’s Draft Determination is that the two airlines are affected differently by an input price change, and that the competitive balance between the FSC and the LCC is changed, to the former’s advantage when the input price is higher. It will be able to load the cost increase on to high yield passengers and this will give it an advantage in competing with the LCC. This advantage may extend to the situation of forcing out the LCC from some city pair markets. This is asserted, not demonstrated— in fact, there is no analysis of how the FSC would rationally respond to the airport charge increase. (Here we speak in terms of an increase in charges—by this is meant that charges would be higher without than with declaration, not that charges will rise in real time).

For purposes here, it will be taken that both airlines are profit seekers—thus they will not be prepared to cross subsidise loss making services (in fact airlines may operate some services at a loss temporarily, hoping that they will become profitable). Airlines can add or subtract flights, and on a typical route, invariant and unavoidable costs are not a high proportion of total costs—economies of density are not so great as to prevent average and marginal costs from being close. This will not be so for low density routes, which are analysed later. The FSC and the LCC are not identical—rather, they are able to compete by possessing different advantages. The LCC is likely to have lower labour costs and more productive staffing arrangements, whereas the FSC will have the advantage of economies of scope (better networks, connecting traffic). The FSC may have market power in the high yield segment. However, it should be remembered that high yield passengers are also high cost passengers, and
they are not necessarily highly profitable. The notion of price discrimination in airline markets is more subtle than it seems –see Frank (1983). Interestingly, even though many have a strong position in high yield markets, FSCs around the world are not as profitable as the LCCs. The advantages of high yield traffic can be greatly exaggerated.

Consider the case where both airlines are setting prices for the low fare traffic at close to cost. The FSC may possess market power in the high yield market segment, and may or may not be charging high yield passengers more than cost. When there is an input price rise, for fuel or for airport services, the FSC will be able to increase prices to its high yield traffic. However, both it and its LCC competitor will find that costs exceed prices in the low fare market segment, and that this market segment is now unprofitable. Both airlines will cut back on supply of low fare seats, and their price will rise. Ultimately, a new equilibrium will be reached, in which both airlines are now covering costs in the low fare market segment. It is not possible to tell, without more detail in the model, which airline will cut back flights by more- most likely the responses will be similar. Granted the different elasticities of demand, the reduction in low fare traffic will be greater than the reduction in high yield traffic, and the FSC will have a higher proportion of its capacity occupied by the high yield traffic. If it was initially earning a profit on this traffic, this profit will have declined. If it was previously just covering its costs, it will need to increase prices by the full amount of the cost increase, and it will need to cut back supply of capacity to do this.

It might be suggested that the FSC could take advantage of this situation when it is earning profits in the high yield segment. It could keep prices down in the low fare market, by loading cost increases on to the high yield traffic, if it so chose. This would not be profit maximising however- why should it cross subsidise one traffic from another? A profit seeking airline will ensure that all traffic is profitable. If its intention was predatory, it could seek to drive its competitor out of the market by undercutting its fares. If this were so, why would it only be when the airport charges were higher that it chose to implement a predatory strategy, when if this is a rational strategy, it would have also been equally rational with lower airport charges? The FSC could be setting low fare prices below cost in the short term in the hope that in the long term, it will survive but its LCC competitors will not. It may get away with this (somewhat predatory) strategy, but it is not likely to make greater use of it when input prices are high- in fact, if anything the higher input prices will make this strategy more costly and thus less likely. Assuming that the FSC does not behave irrationally, or arbitrarily switch its strategy, declaration will not lead to promotion of competition, either in the sense of more competitors or in the sense of greater intensity of competition.

Another possibility is that both airlines are earning profits on their low fare traffic-prices exceed average and marginal costs. When they face an input cost increase, they will both increase fares in the low fare category, and the FSC will also increase them in the high fare category. Neither airline will be able to pass on the cost increase fully, and both will experience a fall in profit. As before, traffic will fall more in the low fare segment than in the high yield segment- however this does not imply that competition has been reduced. Again, the profit maximising response by the FSC is to increase the price of low fare seats in line with the price increase implemented by the
LCC. Again, the competition, as measured by the number of competitors, or by the price cost ratio, is unchanged.

It would be possible, though not very instructive, to develop this model further. The FSC and the LCC could be supposed to have different unit costs in the low fare segment. It is not clear which of these would have the advantage—i.e. it could well be that the FSC would be at a disadvantage, and would reduce its low fare offerings more than the LCC would. It could also be the other way around. Certainly, the two airlines cost functions are likely to be rather different, with the FSC having a more complex cost function. It is not really feasible to compare, from outside the firms, the advantages of economies of scope as against the advantages of lower labour costs. In short, it is unlikely that more complex models would yield clear-cut results which are empirically testable. To this extent, it does not seem likely that it would be feasible to show, in a plausible way, that declaration of airside services would promote competition in typical city pair markets with each airline offering a number of flights.

Marginal Markets

There is one circumstance in which an input cost increase could lead, with some degree of plausibility, to a reduction in the number of competitors in a market—thus declaration could promote competition. This is a situation when the two competitors are just covering their costs at current prices, and neither higher nor lower prices would do so (this is a tangency solution, with the demand curve tangent to the average cost curve aggregated for the two airlines). This could come about in a low density market, in which there are some invariant, unavoidable costs associated with each airline staying in the market. Essentially, there is a strong degree of natural monopoly in this market. An increase in input costs would shift the average cost up and it would not be feasible for both airlines to survive. One will exit (it could be either the FSC or the LCC). The remaining airline will then have more traffic, and lower per unit costs, and it will be profitable. It will be a monopoly, and will have some discretion over prices. As the experience of low density routes in Australia and elsewhere suggests, fares on these routes may be somewhat above fares on competitive routes.

In this situation, declaration of airside services may promote competition at the airline level. This result has nothing to do with there being an imbalance in favour of the FSC, or the ability of the FSC to load cost increases on to higher yield travellers—i.e. the argument advanced in the Draft Determination. The result depends on the route being exactly marginal—i.e. if both airlines are making small, albeit positive, profits, neither will exit unless the input cost increase is substantial. The argument also presumes that the response to prices falling below average is that one airline automatically exits. A more likely scenario is that both would stay on for some time, hoping for an improvement in conditions, and both being unwilling to leave a market, which could turn out to be profitable in the long run, too precipitately. There may be one or two city pair markets which fit this category, but they are, by definition, relatively small markets, and it may be questioned whether such a reduction in competition as may occur would be material.

While declaration may promote competition in this category of market, it will be unlikely to be in the public interest, if economic efficiency is taken as the criterion of
public interest. Declaration will increase competition, but reduce efficiency. This is so because it is a case where there has been excessive entry. (For excess entry models, see Suzumura and Kiyono, 1987). Exit will lead to one firm remaining in the market, and this firm will increase prices, at some cost in terms of monopoly deadweight loss. However, unit costs in the market will fall, since only one firm will be incurring the unavoidable costs of having a presence in the market. In most cases, these cost savings will outweigh the deadweight loss. Overall welfare increases if there is a reduction in the number of the firms.

Thus, it is possible that declaration of airside facilities for access will promote competition in some airline markets. To show that this is possible, it is necessary to demonstrate that low density and marginal routes exist, and that the number of competitors will be sensitive to airport charges. However, the existence of such routes is not sufficient for declaration to be justified- it has also to be in the public interest. In these types of cases, it is very likely that promotion of competition will not be welfare enhancing. To show the contrary, it is necessary for it to be shown that the deadweight loss from less competition outweighs the cost reduction achieved from having one less firm- something which is possible, though unlikely.

Conclusions

The general conclusion is that the NCC has not demonstrated that declaration of airside services at Sydney Airport will promote competition in airline markets. The argument which it sketches out, though does not develop rigorously, in terms of the greater of the full service carrier to price discriminate is irrelevant to the question of the impact of declaration on competition. Higher airport charges associated with the absence of declaration do not lead to an alteration in the competitive balance of the carriers, and the rational response of the full service carrier to the higher charges does not lead to a reduction in competition. Even if this airline is behaving in a predatory manner, there is no reason to expect it to be more predatory in the absence of declaration.

As with most propositions in industrial organisation, there are exceptions to the general rule. In a minority of cases, a (low density) route may be marginal for two airlines. Declaration could promote competition. However, in this case, because of the uneconomic duplication of the unavoidable costs of maintaining a route, additional competition is likely to be welfare reducing. To this extent, declaration would fail the public interest test.

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