Virgin Blue Application for Declaration of the Airside Service at Sydney Airport

*Response to issues raised in submissions on the NCC’s Draft Recommendation*

Report prepared for Gilbert + Tobin

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Frontier Economics Network

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1. Introduction

Gilbert + Tobin has asked Frontier Economics to provide advice on certain issues raised in submissions presented to the National Competition Council (“NCC”) on its Draft Recommendation on Virgin Blue’s application for declaration of the airside service at Sydney Airport.

Specifically, Gilbert + Tobin has asked Frontier to comment on the economic arguments presented in the submissions prepared by SACL (and in particular the submission lodged by NERA on behalf of SACL), and by Bluestone Consulting on behalf of Melbourne Airport (also referred to as “the submissions” in the remainder of this paper). Gilbert + Tobin has also requested that we comment on some points raised in the submission of Peter Forsyth.

This report responds to these requests. It comments on:

- statements in the submissions regarding the expected effect of declaration on competition in the downstream market;
- the arguments raised in the submissions regarding the expected level and impact of price increases, and SACL’s (and NERA’s) arguments that airlines will price discriminate to avoid price sensitive customers bearing the costs of any increase in charges for the airside service;
- the arguments presented regarding the cost of declaration and in particular:
  - the cost of negotiation increasing following declaration; and

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1 The term 'the airside service’ has the same meaning in this report as in Virgin Blue’s Submission in Response to the National Competition Council’s Issues Paper 7 March 2003

2 Submission in Response to the National Competition Council Draft Recommendation on the Virgin Blue Application of Declaration of Airside Services at Sydney Airport, Sydney Airport Corporation Limited, August 2003 (referred to as the SACL submission in the remainder of this paper), and Costs and Benefits of Declaring Airside Services at Sydney Airport - A submission to the National Competition Council, Prepared on behalf of Sydney Airport Corporation Limited by NERA, August 2003 (referred to as the NERA submission in the remainder of this paper)

3 Virgin Blue Application to have certain Services Declared under Part IIIA of the Trade Practices Act 1974, Response to the Draft Recommendation of the National Competition Council, prepared by Bluestone Consulting for Melbourne Airport, August 2003 (referred to as the Melbourne Airport submission in the remainder of this paper)

4 Peter Forsyth, “Declaring Airports for Access: A Comment on the National Competition Council Draft Recommendation”, August 2003 (referred to as the Forsyth submission in the remainder of this paper)
• the risk that declaration will result in under or over investment in airport facilities.
2. Promotion of competition in the downstream market

The submissions from both SACL and Melbourne Airport note that to recommend that the airside service be declared the NCC must, amongst other things, be satisfied in relation to criterion (a) of section 44G(2) of the *Trade Practices Act* 1974 (“the TPA”). That is, the NCC must be satisfied that access (or increased access) to the service would promote competition in at least one other market (whether or not in Australia), other than the market for the service.

The submissions both argue that the relevant issue in considering criterion (a) is not whether declaration could affect the level of prices and consumption, but whether it would affect competition in the dependent market. SACL’s submission, and the papers prepared for SACL by NERA and Mallesons Stephen Jaques, go on to argue that the NCC has failed to properly consider criterion (a), and that criterion (a) is not satisfied in the case of the airside service. The Forsyth submission is critical of the detail provided by the NCC with respect to criterion (a).

We concur with the proposition that, in relation to criterion (a), it is not sufficient merely to establish that declaration is likely to affect the level of prices and the level of demand. The NCC must also be satisfied that declaration will have the effect (via changes in expected prices or some other way) of promoting competition in a dependent market.

Despite the assertions in the SACL and Melbourne Airport submissions that the NCC has not adequately addressed criterion (a) in its Draft Recommendation, those submissions contain little evidence or argument about the effects of declaration on competition in the dependent market.

This was one of the principal issues that we discussed in our report prepared for Gilbert + Tobin dated 7 March 2003, which Gilbert + Tobin subsequently submitted to the NCC. Below we outline the expected effect of declaration on competition in the dependent market. We have previously defined the relevant dependent market to be the market for air transport services to and from Sydney.

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5 See in particular *Response to the NCC’s Draft Recommendation for Declaration of the Airside Service at Sydney Airport*, Mallesons Stephen Jaques (referred to as the Mallesons submission in the remainder of this paper), pages 3-6

6 Forsyth submission page 2.

7 *Sydney Airport declaration application by Virgin Blue – Report prepared for Gilbert + Tobin*, Frontier Economics, 7 March 2003

8 See section 4.1 *Sydney Airport declaration application by Virgin Blue – Report prepared for Gilbert + Tobin* Frontier Economics, 7 March 2003
2.1. Effect of monopoly pricing on competition in the dependent market

It is convenient to think of competitive pressure in any market as coming from two principal sources:

- from incumbents who have already entered the market; and
- from potential entrants to the market.

As we argued in our Report of 7 March, SACL has the ability and the incentive to raise its prices to monopoly levels. This would detrimentally affect competition in the market for air transport services in and out of Sydney in two ways.

In the first place, it would deter entry to the dependent market by increasing the costs of operating in that market, and consequently decrease the expected profits of incumbents and new entrants. The result may well be that (in some long-run) the market has fewer incumbents than would be the case if SACL’s prices were set at competitive levels. And this, as the Tribunal observed in *QCMA*, is why the condition of entry is so critical to the state of competition in the long run.9

> For it is the ease with which firms may enter which establishes the possibilities of market concentration over time; and it is the threat of entry of a new firm or a new plant into a market which operates as the ultimate regulator of competitive conduct.

The argument that lower prices for the airside service may promote competition by encouraging entry into the passenger market is also proposed by Peter Forsyth.10 But he also mentions that possibility that this may damage efficiency by promoting excessive entry.11 This latter argument is dependent on very special assumptions about the shape of cost functions which Professor Forsyth does not attempt to substantiate.

The second way in which declaration may promote competition in this dependant market is again by restricting the ability of SACL to charge above-competitive prices. The prices charged by SACL directly impact the incremental costs of operating an airline in and out of Sydney. The precise form of incremental cost will depend on whether the price increases with the number of flights or the number of passengers and this choice might be critical for understanding the effects of the price on patterns of competition in the dependant market. If the charge is predominantly related to flights or size of aircraft, the charge will affect the incremental cost of adding another

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9 Re *QCMA* and *Defiance Holdings* (1978) ATPR 40-012 page 17,246.

10 Forsyth submission page 2.

11 Forsyth submission pages 6 and 7
flight. If the charge is predominantly related to passenger numbers, it will also affect the incremental cost of adding a passenger to a flight that is already scheduled.

However, the big point is that SACL’s prices will affect the incremental costs of the airlines that use the Sydney airport. The higher those incremental costs, the higher the prices that will be charged in the downstream market.

If charges for the airside service are levied on a per passenger basis, it will (as discussed in section 3.4) be expected to generate the greatest reduction in the demand of the most price sensitive customers. High per passenger charges for the airside service will reduce the ability of any incumbent or potential entrant to adopt a competitive strategy that involves setting low airfares to increase demand for air travel.

Consequently, if declaration increases the likelihood that incumbent airlines and new entrants will be able to access the airside service at prices that reflect competitive levels, it can be expected to promote competition in the dependent market.

2.2. The problem of commitment

In our report of 7 March, we also noted that SACL has an incentive to limit the number of airlines with which it deals. This incentive comes from the difficulty that any monopoly has in committing to the charging of monopoly prices. This standard proposition in economics seems to have been neglected by the Mallesons submission when it attempts to draw a firm distinction between pricing in the primary market and the promotion of competition in the dependent market: 12

In short, the Council has misinterpreted and misapplied the access provisions of the TPA, by mistakenly asserting that Part IIIA is about pricing at “competitive levels”, rather than about access or increased access which would promote competition in another market.

…

In the current application, no one is alleging that they cannot obtain access (or increased access) to the Airside Service at Sydney Airport. No one is complaining that they are unable to compete in another market by reason of any refusal or constructive refusal by SACL to provide access or increased access. No one is alleging that SACL has any interest in restricting competition in another market. No one is alleging that they have been unable to negotiate reasonable terms and conditions with SACL, whether as to price or other matters. In fact, the reverse is quite clearly demonstrated. In addition, and especially in light of the Council’s analysis … , no one is able to claim that SACL’s pricing proposals will adversely affect competition in another market.

The monopoly controller of an essential facility, such as SACL, will frequently have high fixed costs and low marginal costs. In this case, we might think of marginal costs

12 Mallesons submission, paras 1.5 and 1.7.
as the cost incurred by SACL if it permits one more plane to land or take off. The monopoly price will be well above marginal costs. This is the basis of the commitment problem for a monopolist.

The commitment problem is that customers will only pay the high monopoly price if they feel that they have no choice. But once the monopolist has charged a high price, it will be tempted to entertain offers of incremental business at a price that covers its marginal cost.

In our case, SACL may decide to charge a monopoly price to the established airlines. In such a case, a new entrant might convince SACL that, because of this monopoly price, its entry to the Sydney market would not be viable. SACL may then be tempted to offer the new entrant a price below that which it charges the incumbent airlines. SACL would be able to increase its profit in the short-run through this deal because the price covers the marginal costs incurred by the airport.

The danger to SACL of doing this deal is that the incumbents will hear of it. They will then demand the same deal for themselves. Indeed, an incumbent may well have one or two flights that are only marginally profitable and may threaten to end those flights unless it gets a deal similar to that of the new entrant.

Given this incentive that any monopoly controller of an essential facility has, the monopolist has a problem in persuading customers that it will not entertain deals at a price less than the monopoly price. This is known as the commitment problem: how does the monopolist convince its customers that it will refuse to do deals below the monopoly price?

One strategy mentioned by Rey and Tirole would be to reduce the number of persons with whom it does business in the related market. That is, the standard difficulty for a monopolist in committing to a monopoly price will create an incentive for it to limit the number of persons with whom it trades. By reducing the number of persons with whom it trades, the monopolist will reduce its incentive to make marginal deals and increase the likelihood it will be able to continue to charge a monopoly price.

It is remarkable that the Forsyth submission does not refer to this literature that is based on the bargaining framework that has come to dominate industrial economics in the last twenty years. The great advantage of analysing the relationships between firms in a bargaining framework is that it facilitates considerations of market power that were ruled out of contention in the 1960s and 1970s by the special assumptions of Chicago-school authors such as Bork. Professor Forsyth is careful to say that the value of Bork’s work on vertical arrangements is that it alerted the economics profession to the need to say precisely why the upstream monopolist could gain by

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13 See Patrick Rey and Jean Tirole, “A Primer on Foreclosure”, Forthcoming, Handbook of Industrial Organization.
restricting the number of downstream customers.\textsuperscript{14} Later writers, such as Rey and Tirole, have been able to answer that challenge by using bargaining models.

The Mallesons submission ignores two important links between the monopoly pricing of the owner of the essential facility and the effect on competition in the related market:

- As we outlined in section 2.1 above, monopoly pricing itself can affect competition in a related market by reducing incentives to enter and by affecting the marginal costs of the firms in that market; and

- As we outlined in section 2.2 above, monopoly controllers of essential facilities have an incentive to reduce the number of customers they service if this helps them cope with the commitment problem which otherwise restricts their ability to extract monopoly prices.

\textsuperscript{14} Forsyth submission page 4.
3. Expected level and impact of increases in the price of the airside service

The SACL and Melbourne Airport submissions make a number of surprising claims in relation to:

- the current price of the airside service, and in particular the assertion that SACL’s current price is below the competitive level;
- the expected increase in the price of the airside service;
- the impact of price increases on demand; and
- the way in which price discrimination could be used to minimise the impact on profits and ensure price sensitive customers do not face any increase in airfares if the price of the airside service increases.

Each of these arguments is discussed below.

3.1. Current level of prices

Both the SACL and Melbourne Airport submissions state that SACL’s current price for the airside service is below the competitive level.\(^{15}\)

In a previous paper we defined the competitive price for the airside service at an airport such as Sydney Airport as the level of prices that enables the airport to be financially viable. This means that if the airport is not congested, and the marginal cost to the airport of providing airport services for an additional flight is very low, the competitive price for the airside service will still allow the airport to cover operating and capital costs (taking into account revenue from non-aeronautical services).

This is consistent with the standard adopted by the Australian Competition & Consumer Commission (“ACCC”) in its May 2001 decision regarding SACL’s pricing proposals,\(^ {16}\) and the approach adopted in recent literature.\(^ {17}\)

There is no publicly available evidence that supports the statements by SACL and Melbourne Airport that the price for the airside service at Sydney Airport is below the

\(^{15}\) The SACL submission, page 9, and the Melbourne Airport submission, pages 6 and 13


\(^{17}\) See for example, Oum, Zhang, and Zhang ‘Concession Profits and the Efficiency Implications of Alternative Forms of Economic Regulation of Airports’, Presented at the American Economics Association’s Transport and Public Utility Group, December 2002
competitive level. SACL’s 2002 results show profit from ordinary activities before net borrowing costs and income tax (EBIT) of $215 million, and a return on assets of 6.7 per cent.\textsuperscript{18}

These results were achieved despite an unanticipated decrease in passenger numbers following the events of 11 September 2001, and the demise of Ansett Australia. It could be argued that, in the absence of the unanticipated decline in passenger and aircraft movements, SACL would have earned higher profits than would be regarded as consistent with pricing the airside service at competitive levels.

### 3.2. Expected level of price increases

As outlined in a previous Frontier Economics report,\textsuperscript{19} if we assume SACL sets prices to maximise profits, it is clear that it will have incentives to increase the price of the airside service by several hundred percent. However, as noted in the NCC Draft Recommendation and in other submissions, it is possible that the threat of re-regulation may mean that SACL sets prices below the profit maximising level.

The NCC states in its Draft Recommendation ‘that a price increase in the order of 100 per cent…. is of a magnitude that would likely attract criticism from the ACCC and risk a regulatory response from the Government (assuming that the price increase could not be justified as anything other than an exercise in market power)’.\textsuperscript{20} The NCC also commented that the ‘threat of re-regulation may constrain SACL from increasing prices to level below a 100 per cent increase’.\textsuperscript{21}

While we do not necessarily agree with the NCC’s position on the constraining effect of the threat of re-regulation, the SACL and Melbourne Airport submissions go substantially further than the NCC and seek to argue that the maximum increase in the price of the airside service that SACL could be expected to sustain without risking re-regulation is in the order of 25 per cent.

The NERA submission states:\textsuperscript{22}

> Notwithstanding our view that the current light-handed regulatory regime has constrained prices at Sydney Airport to competitive levels, for the purpose of this cost/benefit test we

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\textsuperscript{18} Sydney Airport Corporation Limited Annual Report 2002, pages 2-3

\textsuperscript{19} Virgin Blue Application for Declaration of the Airside Service at Sydney Airport: Profit Maximising Monopoly Prices for the Airside Service, report prepared for Gilbert + Tobin, Frontier Economics, June 2003

\textsuperscript{20} NCCC Draft Recommendation, page 87

\textsuperscript{21} Ibid, page 87

\textsuperscript{22} NERA submission, page 10
consider a rise in prices to 25 per cent above competitive levels to be well beyond any price level that SACL could sustain without re-regulation. This price increase would represent a return on capital that is approximately 50 per cent above a competitive market return.

NERA’s subsequent analysis of the impact of changes in aeronautical charges on the cost of, and demand for, air travel are based on a 25 per cent increase in price.

The Melbourne Airport submission states:\(^{23}\)

> As noted above, SACL is probably pricing at levels just below competitive levels. To achieve those competitive levels, SACL would need to increase prices by relatively small amounts, and certainly by no means by as much (in percentage or dollar terms) as Melbourne increased its prices in July 2002. The upper limit of SACL’s capacity to increase prices without attracting Government intervention is probably around 15%, possibly less. If greater increases were required to fund new capacity the case could be made and would be consistent with a forward-looking approach and workable competition.

Neither submission provides any rationale or evidence to support their assertions about the maximum increase in the price of the airside service that SACL could be expected to sustain. There is no evidence to suggest that SACL will, because of the threat of future regulation, limit price increases to 15 or 25 per cent. Nor is this supported by recent evidence of the size of the price increases that have occurred at Melbourne, Perth, and Brisbane airports.

### 3.3. Effect of a price increase on demand

The Melbourne Airport submission commences its argument concerning criterion (a) by urging the Council to examine the effects of previous price increases by SACL. Two points are worth noting.

The first is that this method of determining the effects of changes in prices on demand is inadequate. The accepted way to measure the impact of one variable on another (in the presence of changes in other independent variables) is regression analysis. Indeed, the submission seems to acknowledge this at the foot of page 5.

Secondly, it is hardly surprising that this drawing of pictures ‘shows no evidence of the pricing events set out above having any material effect on domestic passenger numbers’\(^{24}\). That was the basis of our demonstration in our June Report that SACL had the ability and the incentive to increase its price massively for the airside service. It is because SACL can increase prices (from current price levels) without a drastic effect on passenger numbers that it is likely to be profit maximising for SACL to raise the price of the airside service by several hundred percent.

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23 Melbourne Airport submission, page 14

24 Melbourne Airport submission, page 4
3.4. Price discrimination

The NERA submission argues that any increase in prices by SACL would have little effect on passenger numbers (and therefore little effect on social welfare) because of the possibility of price discrimination. It then claims to have calculated the effect on passenger numbers of an increase in aeronautical charges of 25 per cent:

Because the optimal way to recover the increase in aeronautical charges would involve an increase in premium business fares, there is no increase in leisure fares and no loss of leisure passengers. This represents a modest 0.2 decrease in total passenger movements to Sydney Airport.

This reasoning flies in the face of the economic theory of third-degree price discrimination. We shall assume that SACL charges for use of the airside service on a per passenger basis. This implies that an increase in the price that SACL charges will increase the cost of carrying another passenger, i.e., increase the marginal cost of each passenger. The effect of SACL raising the price of the airside service on an airline’s marginal cost, and on the price of airfares is illustrated in the diagram below.

**Figure 1: Effect of an increase in marginal cost on price**

Business class travellers are charged a higher price than economy class passengers. The price that is charged to each group of customers is determined by the demand

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25 NERA submission section 3.1.4

function of that group of customers, and the point at which marginal revenue for that

group of customers is equal to the marginal cost.

If SACL increases the price of the airside service it will result in a uniform increase in

the marginal cost to the airline of carrying a (business or an economy) passenger. If

the marginal cost for both types of customer increases, the prices charged to both

types of customer must increase.

The NERA submission claims that, with a form of third degree price discrimination,

the ‘optimal’ way to respond to an increase in marginal costs is to increase prices only

to the group that is least price sensitive. This is not consistent with standard economic

theory. Economic theory states that, no matter what the structure of the market, if

marginal costs increase then prices will also increase.

NERA may attempt to argue that the increase in prices may not increase the marginal

costs of the airlines. This may be true if: (i) SACL does not price on a per-passenger

basis; and (ii) NERA is referring to a short-run notion of marginal cost. In that case,

the increase in SACL’s prices will not increase economy fares, but neither will it

increase business-class fares. If, because of these assumptions, an increase in the price

of the airside service is regarded as an increase in fixed cost, it may affect prices but

only indirectly due to changes in the capacity of, or capacity supplied by, the industry.

That is, changes in fixed costs will only affect prices in a long-run analysis.\footnote{Where the long-run can be defined as the period of time in which at least some of the costs of the airline are fixed.}
4. Costs of declaration

The submissions by Melbourne Airport and by SACL both address criterion (f) by arguing that declaration would produce certain costs. In particular, each argues that declaration would increase the costs of negotiating access agreements between SACL and the airline. Furthermore, each argues that the process of negotiation in the shadow of arbitration that would follow declaration may distort investment choices by airports, including those of Sydney Airport. These two arguments will be discussed in turn.

4.1. Cost of negotiation following declaration

SACL puts its argument that declaration will increase the cost of negotiation as follows: 28

SACL has a clear policy, advised to airlines, of negotiating commercial agreements once the airport Master Plan has been agreed by Government. We foresee these commercial agreements incorporating multi-year certainty of aeronautical charges, an agreed capital works program incorporated into prices, and agreement on service levels.

The ability of SACL to reach a satisfactory agreement with airlines will be significantly compromised by a declaration of airside services. Not only will the negotiation process be protracted, but some airlines may use the threat of ACCC intervention to reduce the prospect of agreeing an outcome satisfactory to all parties, effectively stymieing the type of commercial outcome that the Government sought from light-handed regulation.

It is true that declaration gives an access seeker a right to notify the ACCC of an access dispute if it cannot reach agreement on satisfactory terms of access with the party controlling the facility in question. Even if this right is not exercised, it may well affect the outcome of the negotiation because it creates an extra option for each of the parties to the negotiation.

However, the existence of this option does not necessarily increase the time or cost that will be expended in reaching an agreement. Indeed, Gans and Williams have argued in a series of papers that the ACCC might best fulfil its role under Part IIIA by developing clear rules for the arbitration of access disputes. These clear rules will facilitate the speedy conclusion of negotiations between the parties without recourse to the ACCC. The better the parties are able to predict the role that the ACCC would play if the matter went to arbitration, the more likely it is that the parties would be able to reach agreement without resort to the ACCC. To quote Gans and Williams: 29

28 Sydney Airport submission, section 4.2.3

The introduction of Pt IIIA to the Trade Practices Act is the most important change to Australia’s antitrust law since the introduction of the statute in 1974. The example that has been explored in this article suggests certain lessons as to how pricing regulation under Part IIIA should be implemented.

The first lesson concerns the value of certainty in the regulatory regime. The ACCC and the Tribunal should move as quickly as possible to develop pricing rules for arbitrations under Pt IIIA. The example presented above shows that the principles that the ACCC and the Tribunal eventually adopt for pricing arbitrations under Pt IIIA will constrain the range of pricing outcomes within which the parties can bargain for access.

Of itself, declaration neither increases nor decreases the cost and time that it takes parties to agree terms of access. The cost of, and time taken by, negotiations will depend much more on the extent to which the parties share common understandings about the alternatives available to each other. The closer are these understandings, the faster will they reach agreement and the lower will be the cost of the negotiation.

Declaration will only increase the cost and time devoted to negotiation if it decreases the extent to which the parties share knowledge about the options that are available to them. As Gans and Williams have argued, this is very much within the control of the ACCC. To the extent that the ACCC develops clear principles that govern its arbitrations, parties to access disputes will reach agreement more speedily. Indeed, the clearer these principles become, the more likely is it that declaration will decrease (rather than increase) the cost and time absorbed by negotiating the terms and conditions of access.

4.2. Effect of declaration on over or under investment in airport facilities

The NERA submission argues that indirect costs associated with regulatory failure are ‘potentially the greatest risks associated with of [sic] re-regulating Sydney Airport’ and that ‘the principle [sic] consequence of these risks is on the investment behaviour by SACL, and in particular any investment in a second Sydney airport.’

The submissions by Melbourne Airport and SACL propose three different ways in which, they claim, declaration may affect incentives to invest in airport assets. Each of these is discussed below.

4.2.1. The argument that declaration will increase the cost of capital

The first way in which the airports argue that declaration may affect incentives to invest is related to the argument mentioned in section 4.1 above: that declaration will increase uncertainty about the outcome of negotiations. Melbourne Airport argues that this will increase the regulatory risk associated with investing in any Australian

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30 SACL submission, section 3.2.2
airport; and this increase in regulatory risk will increase the cost of capital and, thereby, decrease investment: 31

The Council’s analysis in chapter 10 seems to acknowledge that declaration would effectively involve setting aside the Government’s previously stated policy without it being given the chance to operate. This will cause investors in SACL to increase SACL’s cost of capital to compensate for additional regulatory risk if only because matters which previously they thought were with SACL’s control would have effectively passed to the ACCC.

There is nothing in the Government’s policy or the Council’s Draft Recommendation to distinguish SACL from any other major Australian airport. Prudent investors would be entitled to conclude that every other major airport was subject to similar risk and as a consequence those airports would also experience an increase in their cost of capital. …

The impact of an increase in the cost of capital is clear. Projects that previously would have proceeded will be delayed or not occur at all … with investors seeking other avenues to deploy their funds.

As with the argument that declaration will increase the delay and cost associated with negotiations, this argument relating to the cost of capital relies on the proposition that declaration will increase the uncertainty surrounding the options that are available to the parties to the negotiations over access. As we noted in section 4.1, this assumption may or may not hold. Indeed, depending on the approach of the ACCC, it may be that declaration will reduce the uncertainty surrounding the outcome of negotiations.

4.2.2. The argument that declaration may bring investment projects forward

The NERA submission argues that one of the consequences of declaration may be to bring forward the construction of the second Sydney airport. The process by which this would occur is not entirely clear: 32

This can occur if declaration results in SACL receiving an above market return on their assets or if declaration causes inefficiencies that result in Sydney airport becoming constrained one year earlier than under the current light-handed regime.

The NERA submission does not point to the effect of higher airport charges on projections of future passenger growth. However, even though this particular elasticity might be low (as all submissions seem to agree), there will be some effect of higher airport charges on passenger numbers. To the extent that declaration might lead to ‘above market returns on their assets’ through higher airport charges and therefore to lower passenger numbers, it will (presumably) enable SACL to delay its investment in a second Sydney airport.

31 Melbourne Airport submission, pages 16-17. A similar argument seems to be put by SACL in section 4.2.1 of the SACL submission

32 NERA submission section 3.2.2
Notwithstanding this, NERA proceeds to estimate the cost of bringing forward the second Sydney airport by one year. The method by which this cost is estimated seems to be appropriate given that the cost is being estimated and not the benefit. However, the NERA submission does not consider the extra benefits that early construction will bring although these benefits are considered to be forgone if construction of the second Sydney airport is delayed. Similarly, when the NERA report comes to consider the cost of delay, it considers the costs but not the benefits of delay.

Of course, if prices are set too high or too low it may affect the timing of investment decisions and the timing of investment projects can affect the magnitude of the net benefits those projects confer on society. This is a factor that the ACCC routinely takes into consideration in its pricing decisions in regulated industries such as telecommunications. However, this risk exists with any pricing decision, irrespective of whether prices are posted, negotiated, or result from arbitration. This risk does not result from declaration.

4.2.3. The argument that declaration may cause investment projects to be delayed.

The only explanation NERA gives as to why declaration may cause investment in the second Sydney airport to be delayed is that: “In the second scenario we have measured the cost of SACL delaying the construction of the second Sydney airport due to declaration not providing sufficient returns.”33 It is hard to see how this might be reconciled with the proposition that higher returns will be generated by higher airport charges which will tend to restrict passenger numbers.

As noted in section 4.2.2 of this report, both negotiated and arbitrated prices may be too high or too low to provide proper incentives to invest. There can be no presumption that declaration will in any way worsen incentives to undertake investment, either by encouraging investment to be undertaken too soon or to be undertaken too late. That will depend primarily on the principles adopted by the ACCC for its arbitration of access disputes.

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33 NERA submission section 3.2.2
5. Conclusions

In summary, we consider that some of the key arguments presented in the SACL and Melbourne Airport submissions regarding:

- the expected effect of declaration on competition in the downstream market;
- the expected level and impact of price increases, and the ability of airlines to price discriminate to avoid price sensitive customers bearing the costs of any increase in charges for the air side service; and
- the arguments presented regarding to the cost of declaration,

are either not supported by the evidence or are inconsistent with standard economic theory.