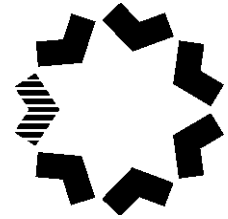


## **National Competition Council**

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Ref:jf102.3.4A

10 July 2006

Mr Gary Potts  
Presiding Commissioner  
Inquiry into Price Regulation of Airports  
Productivity Commission  
PO Box 80  
Belconnen ACT 216

### **Price Regulation of Airport Services**

Dear Mr Potts

Enclosed with this letter is a submission by the National Competition Council in relation to this inquiry.

Following the Council's usual approach, this submission was prepared by the Council's secretariat and approved by the Council. As you will be aware, Mr David Crawford, the acting President of the Council, is the chairman of Westralia Airports Corporation, the operator of Perth Airport. In accordance with the Council's established governance and administrative procedures Mr Crawford took no part in the development or consideration of this submission. The submission was approved by a quorum of Councillors excluding Mr Crawford.

The Council's submission has two substantive parts. One outlines the process for declaration under Part IIIA of the Trade Practices Act. This is the process by which bottleneck infrastructure services may be brought under price regulation in the form of arbitrated access conditions (including prices). As the Commission will be aware airside services at Sydney Airport have recently been declared on this basis. To assist the Commission, the Council has provided its perspectives on the factors and considerations that lead to that declaration.



The second substantive part of the Council's submission deals with price regulation of airports more generally. In this part of the submission the Council examines the role of access regulation and considers various possible options for regulation of airports. Of particular note is the Council's submission that the purpose of the access (price) regulation under Part IIIA is to ensure denial or limitation of access to services provided by bottleneck infrastructure does not prevent competition in markets where entry or participation is dependent on such access. While regulatory intervention on that basis may reduce "monopoly profits" earned from bottleneck infrastructure, this form of regulation is not intended as a means of reducing monopoly profits *per se*, or to apply in situations where competition in other markets is not dependent on access to the bottleneck. In short, it is the Council's view that Part IIIA is directed at promoting competition rather than controlling monopoly profits generally and that this should remain the case.

Within the second part of its submission the Council notes several in principle decisions the Government has already taken in relation to the operation of Part IIIA and in particular the declaration process. Some of decisions have advanced to the stage of being Bills before the Parliament, others are less well developed.

The Council believes that to the extent the Commission identifies deficiencies or limitations in Part IIIA it should also consider what effect the changes already contemplated might have in addressing these.

In particular the Council notes the intention to:

- Reinforce the scope and intent of Part IIIA through inclusion of a new objects clause viz:

*"The objects of this Part are to:*

- (a) *promote the economically efficient operation of, use of and investment in the infrastructure by which services are provided, thereby promoting effective competition in upstream and downstream markets; and*
- (b) *provide a framework and guiding principles to encourage a consistent approach to access regulation in each industry."*
- Specify the pricing principles that must be considered in arbitrating any access dispute within the Act, thus reducing uncertainty as to the basis for arbitral interventions.
- Reinforce that before a bottleneck service can be declared (and as a consequence opened up to the possibility of access regulation) there should be an assessment that such an action would promote a material increase in competition in a dependent market.
- Retain merits reviews of declaration decisions by the Australian Competition Tribunal, but ensure such reviews proceed on the basis of the

same evidence that was before the initial recommendatory body and decision maker, thus reducing the scope for divergent decisions at different stages of the process leading to declaration due to different factual evidence being adduced at different stages.

The Council believes it is important that the Commission consider the implications of these and any other legislative changes so that it can reinforce the need for relevant changes to be implemented (if they have not been by the time the Commission reports). Such an approach would also avoid the Commission making recommendations that are already accommodated by the foreshadowed changes.

The Council hopes that the Commission finds this submission of assistance. The Council would welcome any inquiries that the Commission may have in relation to the submission, or any other issues relating to this inquiry with which we can assist.

Yours sincerely

**John Feil**  
**Executive Director**

National Competition Council

Price Regulation of Airport Services

Submission to Productivity Commission  
inquiry

July 2006



# 1. Introduction

The terms of reference (clause 5) for the inquiry into the price regulation of airport services direct the Productivity Commission (the Commission) to have regard to the decision by the Australian Competition Tribunal (the Tribunal) to declare the airside service at Sydney Airport and subsequent consideration of this matter by the Federal Court.

The Tribunal's decision in this matter followed consideration by the National Competition Council (the Council) of an application by Virgin Blue Airlines Pty Ltd (Virgin Blue) for declaration of certain airside services provided by Sydney Airport. The Council had recommended that these services not be declared and that recommendation had been accepted by the decision making Minister. On "appeal" the Tribunal set aside the Minister's decision and declared the airside services provided by Sydney Airport for a period of five years from 9 December 2005.

The Tribunal's decision is the subject of further proceedings brought by Sydney Airport in the Federal Court. These proceedings seek to challenge the Tribunal's decision on the basis of error on points of law. As at the time of finalising this submission, the Federal Court has heard the challenge but not determined it.

The effect of Tribunal's decision is to bring access to airside services at Sydney Airport within the regulatory scheme established under Part IIIA of the *Trade Practices Act 1974* (The TPA). This provides access seekers with an enforceable right of access to such services, and enables the Australian Competition and Consumer Commission (ACCC) to arbitrate disputes over access terms and conditions if commercial negotiations between the airport operator and user(s) fail.

As a result, the regulatory environment for Sydney Airport departs from the apparent intent of the 'light handed' monitoring regime implemented in 2002—notwithstanding that declaration, and potentially arbitration, were not ruled out by price monitoring.

In this submission the Council seeks to assist the inquiry by outlining its experience with the regulatory framework that governs access and pricing matters for natural monopoly infrastructure services, with particular reference to the Sydney Airport decision.

This submission is presented in two parts.

- **Section 2** describes the declaration process, and outlines the consideration of Virgin Blue's application firstly by the Council and the Minister, and then by the Tribunal and the subsequent consideration by the Federal Court.

- **Section 3** provides a more general discussion of airport regulation, responding to a number of matters raised in the Commission's Issues Paper.

## 2. The declaration process

The national access regime, introduced in 1995 and operating through Part IIIA of the TPA, focuses on infrastructure services that are essential inputs to other markets.

Many major infrastructure facilities such as airports, rail networks, electricity grids, and some communications networks, are natural monopolies—a single facility can meet market demand at less cost than two or more facilities. This means that duplication would be uneconomic.

The owners of these facilities can enjoy a strategic position in an industry where access to such facilities is essential for businesses operating in upstream or downstream markets. For example, generators must have access to an electricity grid to deliver their product, gas producers need access to gas pipelines and producers of rail services need access to rail tracks.

These attributes are of particular concern where vertical relationships arise such that the facility owner also operates in upstream or downstream markets. In such circumstances, the owner may control access in a way that favours the related entity over other actual or potential users, or may even deny access to other users. A facility owner may charge monopolistic prices that effectively foreclose the dependent market and damage competition.

Part IIIA aims to prevent the misuse of market power in such ways by facilitating access to 'bottleneck' infrastructure facilities. This enables new firms to enter upstream and downstream markets and provides consumers with a wider choice of supplier in the related markets, and therefore a better range of services and/or lower prices.

To be declared under Part IIIA, the service must satisfy criteria directed primarily at establishing that a facility is a natural monopoly of national significance and that access to the service would promote competition in a related market. Declaration gives the access seeker the right to negotiate with the service provider, with provision for arbitration via referral of a dispute to the ACCC if agreement cannot be reached.

Any person may apply to have a service declared. The Council is required to make a recommendation to a designated Minister—in the Virgin Blue matter, the Parliamentary Secretary to the Treasurer.

The Council cannot recommend that a service be declared unless it is satisfied that criteria (a)–(f), set out in s.44G(2) of the TPA are all met (box 1). The designated Minister cannot declare a facility unless similarly satisfied.



## Box 1: The declaration criteria

The Council cannot recommend that a service be declared unless it is satisfied of all of the following matters:

- (a) that access (or increased access) to the service would promote competition in at least one market (whether or not in Australia), other than the market for the service
- (b) that it would be uneconomical for anyone to develop another facility to provide the service
- (c) that the facility is of national significance, having regard to:
  - (i) the size of the facility or
  - (ii) the importance of the facility to constitutional trade or commerce or
  - (iii) the importance of the facility to the national economy
- (d) that access to the service can be provided without undue risk to human health or safety
- (e) that access to the service is not already the subject of an effective access regime
- (f) that access (or increased access) to the service would not be contrary to the public interest

*Source: s44G(2) of the Trade Practices Act 1974 (Commonwealth)*

Depending on the decision made, the access seeker or the service provider can apply to the Tribunal for review of the Minister's decision (s.44K of the TPA). The Tribunal's review is a reconsideration of the matter—meaning that fresh arguments and submissions may be made, new evidence may be adduced and the Tribunal is not obliged to have any particular regard to the Council's recommendation or the designated Minister's decision.

The Tribunal must establish on the evidence made available to it whether or not the declaration criteria are satisfied. Where the designated Minister declared the service, the Tribunal may affirm, vary or set aside the declaration. Where the designated Minister decided not to declare the service, (or where the Minister did not make a decision within the specified timeframe and the matter is deemed to be a decision not to declare the service pursuant to s.44H(9) of the TPA), the Tribunal may either affirm or set aside the designated Minister's decision<sup>1</sup>.

Beyond the Tribunal there is a right of appeal to the Full Court of the Federal Court of Australia but only on points of law.

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<sup>1</sup> The role of the Tribunal in Part IIIA is of particular importance. In practice, nearly all applications for declaration have been determined by the Tribunal and the jurisprudence established by the Tribunal is highly influential on the analysis and approach adopted by the Council in making its recommendations.

## 2.1 The airside services of Sydney Airport— consideration by the Council

On 1 October 2002, the Council received from Virgin Blue an application under Part IIIA for a recommendation to declare certain services provided by Sydney Airports Corporation Limited (SACL). Initially the Council issued a draft recommendation to declare the relevant services. However, after further consideration, including consideration of new information provided in response to the draft recommendation, the Council ultimately recommended that the designated Minister not declare the services. Throughout the declaration process, the Council focussed particularly on criteria (a) and (f).

### Criterion (a) – ‘promotion of competition’

The purpose of criterion (a) is to limit declaration to circumstances where access would promote competition in dependent markets.

The Council determined that SACL’s ability and incentive to exercise market power to raise prices above competitive levels are not significantly constrained by the potential impact on its non-aeronautical revenues.<sup>2</sup> The Council considered that SACL would continue to have some incentive to raise charges above competitive levels up to the point where the threat of re-regulation imposes a constraint.<sup>3</sup>

The Council further considered that an exercise of market power by SACL would be more likely to adversely affect low cost carriers (such as Virgin Blue) than full service carriers (such as Qantas). However, the Council was not convinced that the differential impact on such carriers would adversely affect competition in a related market. The Council concluded that:

*...the impact of an increase in charges for the Airside Service by SACL is likely to fall more heavily on low cost carriers as overall the airside charge is likely to represent a higher proportion of airfares. It is not clear, however, that low cost carriers have less capacity than full services carriers to absorb a price increase or price discriminate in the way they pass on any cost increases to their passengers so as to minimise effects on demand. Consequently, it is unclear that the impact on low cost carriers will be greatly different from the impact on full service carriers. (NCC 2003, para. 6.271)*

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<sup>2</sup> It is often argued that the potential earnings from passenger spending on nonaeronautical services such as retailing, car parking and restaurants provide airports with an incentive to temper their charges for aeronautical services so as not to reduce passenger numbers.

<sup>3</sup> The Government reserved the right to bring forward a review slated for five years after the ‘probationary’ period of light handed regulation and re-impose price controls if airport operators were found to be abusing their market power by unjustifiably raising prices.

More generally, the Council observed that:

*It is not clear ... that even a significant increase in airside charges (100 per cent for example) would have such a material impact on demand as to lead to a possible exit or contraction in the number of services offered on Sydney routes such that competition on Sydney routes, and hence the Domestic Passenger Market, would be adversely affected.* (NCC 2003, para. 6.271)

## Criterion (f) – ‘public interest’

The Council considered two main issues with respect to criterion (f):

- the extent to which declaration would be contrary to the public interest because it may conflict with government policy, and
- whether the costs of declaration outweigh the benefits.

The Council recognised that the Australian Government intended that Part IIIA would be available during the probationary period of light handed regulation and therefore did not consider that declaration would be contrary to government policy.

In considering whether the costs of declaration outweigh the benefits, the extent of these benefits depends on the likely effect on competition in related markets—that is, issues considered under criterion (a). A recommendation not to declare where criteria (a)–(e) are satisfied would require that the costs of regulated access outweigh the benefits. The costs of regulation identified by the Council include:

- the benefits forgone as a result of not allowing the light handed regulatory approach to operate for the probationary period of five years. Most importantly, declaration (with the prospect of binding ACCC arbitration) would foreclose the opportunity for commercially negotiated outcomes to be achieved in the light handed regulatory environment, an approach the Council considered likely to allow SACL to be innovative and flexible in developing terms and conditions of access. In reaching this conclusion, the Council was influenced by the Commission’s 2002 report, which described the benefits of encouraging more flexible pricing structures for airports.
- indirect costs such as distorting efficient investment or production decisions, and direct costs of access regulation such as the cost of the arbitration process in the event of an access dispute.

The Council was not affirmatively satisfied that competition would be promoted by regulated access. Consequently, given declaration would not lead to material benefits, the costs of regulation would outweigh the benefits and access would be contrary to the public interest.

As a result of this analysis the Council recommended against declaration.

The Minister accepted the Council's recommendation and on 28 January 2004 decided not to declare the service.

On 18 February 2004, Virgin Blue lodged an application for review to the Tribunal.

## **2.2 The Australian Competition Tribunal decision to declare airside services**

On 12 December 2005 the Tribunal handed down its decision on the application for review sought by Virgin Blue. The Tribunal determined that the Minister's decision be set aside and the airside service be declared for five years from 9 December 2005. The Tribunal examined in detail criteria (a) and (f), as it agreed with the Council that criteria (b)–(e) were not in contention.

### **Criterion (a)**

In its examination of criterion (a) the Tribunal considered, among other matters:

- the meaning of 'access' and 'increased access', and
- 'promotion of competition' in a dependent market.

### **Access and increased access**

While there was divergence in the parties' submissions, they generally agreed that access means a right or opportunity to make use of the service and that increased access therefore means an enhanced right or opportunity to make use of the service. Furthermore, the parties concurred that the concept of 'access' is broader than just physical access and includes the terms and conditions on which access is made available.

The Tribunal found declaration would result in increased access because the terms and conditions of access would change and the right of access would be enhanced. Post-declaration, the charges or terms or conditions of access to the service could be challenged, negotiated or ultimately referred to arbitration by the ACCC in the event that the parties are unable to negotiate a mutually acceptable resolution.

## Promotion of competition in a dependent market

The test the Tribunal adopted to determine whether access or increased access would promote competition in a dependent market was ‘to undertake an analysis of the future with declaration (referred to as the “factual”) as against the future without declaration (referred to as the “counterfactual”).’ The Tribunal stated that the test involves asking:

*...whether past or present conduct of the service provider informs us as to the likely future conduct of the service provider and the effect on competition in the dependent market of such conduct. If such conduct has, or is likely to have, an adverse effect on competition, then one looks at declaration and asks whether that will enhance competition in the dependent market by creating opportunities and an environment in which the impact of such conduct and its effect on competition may be lessened or diminished.* (ACT 2005, para. 151)

What is critical is ‘whether there will be an enhancement of the competitive environment and greater competitive opportunities in the dependent market.’ The Tribunal stated:

*Whether competition will be promoted depends upon the extent to which a service provider has the ability, in the absence of declaration, to use market power to affect adversely competition in the dependent market. If a service provider has market power and the ability to use it in a way that adversely affects competition in a dependent market and if the service provider has a history of so acting, declaration involving increased access to the service ... would be likely to improve the environment for competition in the dependent market.* (ACT 2005, para. 156)

The Tribunal affirmed that, in making its determination, it is not to have regard to the possible outcomes of arbitration by the ACCC in assessing the factual.<sup>4</sup>

The Tribunal considered first whether SACL has the ability, in the absence of declaration, to use its market power and, second, has so used it, to adversely affect competition in the dependent market. The Tribunal considered that whether SACL misused its market power required analysis of:

- whether that exercise of power is in a manner which would not occur in a competitive market, and
- whether there are any effective constraints on the manner in which SACL can exercise its monopoly power.

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<sup>4</sup> Presumably this reflects that declaration is a ‘coverage’ matter rather than a regulatory matter *per se*. Moreover, there have been no arbitrations under Part IIIA to date.

It appears that the decision by SACL to change the basis for calculating its Domestic Passenger Services Charge (DPSC) from a maximum take-off weight basis to a per passenger basis was crucial to the Tribunal's decision. Qantas supported SACL's decision. On the other hand, Virgin Blue asserted that the pricing was discriminatory because, as a low cost carrier, it generally operates smaller aircraft, carrying a greater number of passengers than a full service airline. Accordingly, Virgin Blue contended that the change in the basis for the DPSC would place it at a competitive disadvantage to Qantas.

The Tribunal agreed that the different Virgin Blue and Qantas business models mean that a tariff structure calculated on a per passenger basis would affect the airlines differently. It then considered whether the changed tariff structure is an exercise of monopoly power by SACL that could not be sustained in a competitive market and that would have an adverse effect on competition in a related market.

The Tribunal considered that 'Qantas had either told SACL, or it was clearly apparent from the discussions that SACL had had with Qantas, that Qantas saw the DPSC as putting Virgin...at a competitive disadvantage to Qantas in relation to its use of Sydney Airport.' Most importantly, the Tribunal held that "Qantas' preference for a passenger-based charge was one of the reasons why SACL introduced the change in tariff structure." While in making its recommendation the Council had considered any difference in impact of the revised charging regime was unlikely to have a significant effect on the competitive position of Qantas vis-à-vis Virgin Blue, the Tribunal appears to have considered Qantas's actions indicated that Qantas thought it would gain an advantage from such a change.

The Tribunal found that efficient pricing of SACL's airside services requires consideration of the cost drivers underlying the provision of the service by reference to the nature of the aircraft using those facilities, rather than the number of passengers travelling in such aircraft. Therefore, when SACL changed the basis of the calculation for the DPSC it did so contrary to what would be efficient pricing.

In its recommendation to the Minister, the Council had focussed on whether SACL had the ability and the incentive to exercise its market power such that it would adversely affect competition in a dependent market.

While agreeing with the Council's approach, the Tribunal considered that the focus 'should be on the ability to exercise market power, and whether that ability has been translated into conduct in the past and is likely to be translated into conduct in the future.' It found that:

*If, in the past, SACL has exercised its monopoly power in a manner which it could not have done in a competitive environment and which adversely affects competition in the dependent market, it is likely that SACL will continue to so act in the future without declaration. It is the objective fact of SACL's past conduct which provides a basis for judgement as to its future conduct. We do not consider that it is*

*necessary to find an incentive on SACL's part to exercise monopoly power in a manner which adversely affects competition in the dependent market before we can form a judgement as to its future conduct. However, if SACL has demonstrated an incentive so to act in the past, this reinforces a judgement based on past conduct that such behaviour will continue in the future.* (ACT 2005, para. 296)

The Tribunal also found that the fact that SACL supplies a small number of airlines at Sydney Airport, including one airline with considerable market power, 'undermines the assumption that SACL's only incentive will be to act in a manner which promotes competition in the dependent market.' Accordingly, the Tribunal was not satisfied 'that SACL lacks the incentive to exercise its market power such that its use will have the effect of adversely affecting competition in the dependent market.'

As mentioned earlier, SACL indicated to the Tribunal that it was considering implementing new charges. In respect of this possibility, the Tribunal found that:

*...without declaration, SACL will seek to increase its revenues by reference to charges imposed either directly or indirectly on airlines by creating specific new charges calculated to increase revenue in a manner which will not be the subject of supervision or control and will be implemented in a manner which would not otherwise occur in a competitive environment.* (ACT 2005, para. 366)

The Tribunal reviewed the evidence concerning SACL's conduct in negotiating 'conditions of use agreements' with Ansett, Qantas, Virgin Blue and Jetstar and found that such negotiations were less than smooth. The Tribunal concluded that 'in the absence of declaration ... any commercial negotiations in the future ... between SACL and the airlines would be likely to be contentious, protracted and inefficient.' Furthermore, the existing conditions of use agreements and the draft Aeronautical Services Agreement contain no arbitration process by which to resolve disputes. The Tribunal considered that in a competitive environment such contractual arrangements for access could be expected to do so. It concluded that the consequence of this would lead SACL 'in the absence of declaration under Pt IIIA of the TPA, to act in a monopolistic manner to the disadvantage of airlines using Sydney Airport which would not occur in a competitive environment.'

Overall the Tribunal found that without declaration:

- there would be protracted negotiations over contractual arrangements for the conditions of use of Sydney Airport
- SACL may not establish minimum service standards
- SACL may increase substantially the revenue it obtains from the imposition of the Airside Service charge and impose new charges (either directly or indirectly)

- airlines are likely to face increased risk and costs, and
- services will be carved out of existing services and the airlines will be subject to extra charges and imposts.

The Tribunal's analysis concluded that:

*...a comparison of the circumstances and the state of competition between the factual and counterfactual discloses that declaration of the Airside Service would bring about increased access (that is, access on different terms and conditions) to the Airside Service at Sydney Airport which would promote competition in the dependent market. The environment for competition in the dependent market will be enhanced if declaration of the Airside Service is made compared to the state of competition in the dependent market if the Airside Service is not declared. (ACT 2005, para. 584)*

### Criterion (f)

The Tribunal found criterion (f) to be satisfied. It rejected the Council's view on the benefits of commercial negotiations in the absence of a binding dispute resolution process, finding that the:

*...availability of a binding dispute resolution process provides an incentive for parties to negotiate in a realistic, practical and positive manner in an attempt to resolve differences which affect, and have a real impact on, their daily commercial activities. ... we consider that the availability of a binding dispute resolution process will bring about a more efficient outcome than a situation where no such process is available. (ACT 2005, para. 604)*

The Tribunal stated further that, 'where there is significant bargaining asymmetry ... a binding dispute resolution process will address such bargaining asymmetry and provide a better framework for commercial negotiation.'

The Tribunal rejected SACL's submission that declaration is contrary to the policy of lighter-handed regulation and concluded that declaration is consistent with the underlying objectives of government policy.

## 2.3 Concluding remarks

In its decision, the Tribunal observed that declaration with negotiation and arbitration has the potential to promote more efficient pricing of airside services but will not necessarily do so. It identified maximum take-off weight as the basis for charging that would occur in a competitive market. However, the Tribunal (para 583) noted that declaration does not mean that Virgin Blue will be able to require SACL to change the DPSC to an maximum take-off weight based charge or any other charge. Rather, declaration provides



Virgin Blue (and any other airline) with the opportunity to seek to negotiate the DPSC with SACL on mutually acceptable terms.

Following declaration, the way is open for the contentious pricing issues identified in evidence provided to the Tribunal (the value to be attributed to aeronautical land and assets, the asset beta to be used and projected passenger increases) and any other matters (including service standards) to be determined by negotiation between the parties and failing this, by binding ACCC arbitration.

Because the ACCC has yet to arbitrate in a declaration matter, the Council is not in a position to comment on how the ACCC might undertake this task. It notes however that COAG has agreed to inject pricing principles into Part IIIA to guide the regulation of access prices (see below) and that the ACCC has published arbitration guidelines explaining how it will exercise its dispute resolution powers under Part IIIA (refer ACCC 2006).

Clearly the ACCC's approach to arbitration of access disputes will be important. If the regulated price is set too low there is the possibility of adverse outcomes including in particular under-investment in airport infrastructure. If a regulated price is set too high competition in dependent markets may be reduced. A common perception that arbitration results in outcomes that inordinately favour one party over another would condition future commercial negotiations and possibly strategically induce or deter declaration applications for other airports. Of course, the regulated price and other terms of access are also important to investment in the dependent up or down stream markets.

Finally, to maximise the opportunity for commercial negotiation, arbitrations should not stray beyond the matters in dispute. In the context of Part IIIA arbitration should not be a vehicle for imposing regulation beyond that necessary to address the dispute that is the subject of an arbitration.

### **3 Airport regulation**

The major Australian airports have operated under a range of different environments—from government ownership through to privatisation variously under price regulation, Part IIIA and price monitoring. Table 1 provides an outline of airport regulatory regimes. While illustrative in nature, the table seeks to highlight efficiency objectives and also regulation to constrain airports from earning 'excess profits' more generally.<sup>5</sup> Although the latter objective may be distributional, it can have efficiency implications. In simple terms, the distributional effects of airport market power revolve

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<sup>5</sup> Part of the public concern with airport charges arises from the potential implications of the price paid by the Southern Cross Airports Consortium to acquire Sydney Airport. This has led to fears that the owners will need to increase airport charges substantially in order to achieve an adequate return on their investment.

around transfers between airports, airlines and consumers. The efficiency effects centre more on high prices that distort consumption of air travel, investment patterns and damage competition through inappropriate conditions of access.

The Council also notes the Australian Government's stated preference for airlines and airports to operate primarily under commercial agreements, and for airport operators and users to negotiate agreements for access to airport services.

Of the possible airport regimes outlined in table 1, three of the approaches have been used to date.

- Airports have been subject to Part IIIA since the inception of that part of the Act in 1995. In 1997 services provided by the freight handling facilities at Melbourne Airport were declared and in 2000, similar facilities at Sydney Airport were declared. As outlined above, in December 2005 airside services provided by Sydney Airport were declared.
- Price regulation comprising a five year, CPI-x annual cap on prices for aeronautical services was applied at 11 of the largest privatised airports following privatisation.
- In 2002, price caps were discontinued and price monitoring for seven large airports was introduced for a five year period with the current review of arrangements to be conducted at the end of this period. This followed a review by the Productivity Commission which found that while CPI-x price caps are superior to explicit rate-of-return regulation, the costs of the existing regime outweighed the benefits.

| <i>Regulatory Regime</i>   | <i>Part IIIA + price control</i>   | <i>Part IIIA + monitoring (status quo)</i>   | <i>Part IIIA only</i>   | <i>Price monitoring only (airports excluded from Part IIIA coverage)</i>   |
|--|--|--|---|--|
| <i>Comment</i>   | Preceded the current light handed approach.<br>Discontinued when judged to have significant regulatory costs.            | The current 'light handed' regime.<br>Based on notion of constraints on pricing via implied threat of re-regulation and exposure to Part IIIA.   | An alternative to the current regime.<br>Would follow from a judgment that price monitoring is ineffective and price controls too costly.   | An alternative to the current regime.<br>May be contemplated on the basis that Part IIIA renders a completely light handed approach inoperable.                                      |
| <i>Scope to enable access on reasonable terms and conditions</i> | Yes  | Yes  | Yes.  | While denial of access <i>per se</i> is unlikely given that Airports Act stops vertical integration, access terms and conditions could be imposed in a way that damages competition. |
| <i>Scope to constrain excess profits/ monopoly rents</i>         | Yes. Could control prices at all functional levels for aero and non-aero. But compliance and efficiency costs a concern. | Yes, for aeronautical charges where monopoly rent damages competition in related markets.<br>More generally would depend on nature of implied threat of re-regulation. Therefore must be linked to a periodic review process.<br>'Excess profits' may reflect locational rents rather than misuse of market power. | Yes, for aeronautical charges where monopoly rent damages competition in related markets.<br>Not necessarily an appropriate instrument to address rents where these do not damage competition in a related market.<br>'Excess profits' may reflect locational rents rather than misuse of market power. | Critically depends on nature of implied threat of re-regulation after periodic review. If threat is weak, then price monitoring is a limited constraint.                             |
| <i>Scope for commercial negotiation</i>                          | Limited as prices likely to be set by regulation.  | Conditioned by the availability of binding arbitration.  | Conditioned by the availability of binding arbitration.   | Strong incentive, but negotiation may be on a 'take it or leave it' basis.   |

The shaded columns are alternative regulatory regimes that the Council considers most likely to meet regulatory objectives.

### **3.1 Part IIIA should continue to apply to airports**

Of the policies implemented to date, only Part IIIA ensures that access will be made available to participants in dependent markets on reasonable terms and conditions. It may be argued that an outright denial of access to airports is unlikely because s44 of the *Airports Act 1996*, by imposing a 5 per cent limit on airline ownership of an airport, effectively prohibits vertical integration<sup>6</sup>. However, it may still be possible for an airport owner to impose terms and conditions on access in ways that damage competition.

The Council is not aware of compelling public interest considerations that would justify excising airports from the economy wide application of Part IIIA. Certainly, in the Virgin Blue matter, none of the evidence made available to the Council or to the Tribunal provides any justification for excising airports from coverage. Indeed the evidence before the Tribunal lead it to determine that prices for airside services required regulation.

It is sometimes suggested that the threat of having to provide access has a chilling effect on new infrastructure investment. This issue was not prominent in the Virgin Blue matter. However had it been raised it is the Council's view relevant effects on investment could have been considered under the declaration criteria.

### **Proposed changes to Part IIIA of the TPA**

An important reason for the difference between the Council's recommendation and the Tribunal's decision in regard to criterion (a) is that the parties provided new and additional evidence to the Tribunal, particularly in relation to the rationale for SACL's change to the basis for calculating the DPSC.

In contrast to its approach with the Council, Qantas was represented by senior counsel and produced a number of industry and economic expert witnesses and important new evidence. A significant amount of critical evidence was put before the Tribunal that was not put to the Council when it was formulating its recommendation. The ability to approach declaration in this way provides an incentive for parties to 'game' the decision making process and can result in divergent decisions at different stages of consideration of a declaration application.

The Council therefore welcomes the decision of the Council of Australian Governments of 10 February 2006 (COAG 2006) to amend the Competition Principles Agreement to include a provision that, where merits review of

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<sup>6</sup> Vertical integration by a facility owner provides an incentive to deny access to competitors.

regulatory decisions is provided, the review be limited to the information submitted to the regulator. The Council considers that this change will allow appropriate re-examination of declaration decisions while reducing the regulatory uncertainty that can result from different factual information being adduced at different stages of the process.

The Council also supports other proposed amendments to Part IIIA, which include:

- introduction of time limits for various stages of the declaration process
- introduction of a new objects clause for Part IIIA providing that the object of the part is to promote the economically efficient operation and use of, and investment in, essential infrastructure services and encourage a consistent approach to access regulation across industries
- including pricing principles in legislation that include setting prices which are at least sufficient to meet efficient costs, and allow investment returns commensurate with regulatory and commercial risks
- reinforcing the requirement that declaration must promote a material increase in competition in another market.

The Council considers that these changes will streamline regulatory processes, improve the timeliness of decision making and reduce regulatory uncertainty.

In addition to these changes the Council has also suggested that where a decision maker does not determine a matter within the required 60 days, he or she should be deemed to have accepted the Council's recommendation, rather than to have declined the application in all cases. This would avoid the prospect of decisions, and appeals against decisions, for which there are no reasons.

### **3.2 Limiting monopoly rents**

The objective of Part IIIA is to promote competition in dependent markets by preventing bottlenecks from otherwise restricting competition. Part IIIA is not intended to remove or reduce monopoly rents where such rent extraction does not diminish competition in dependent markets. While it is likely that declaration (and subsequent negotiation/arbitration) will restrict the ability of infrastructure owners to earn monopoly rents, this is a by-product of declaration rather than its principal objective.

The broader policy question then is whether airports should be subject to additional price regulation aimed at curtailing their ability to earn monopoly profits generally, and not only where competition in related markets is damaged.

## Price caps

The Council does not see price caps as supplementing access regulation. Price caps and other forms of price control have a broader intent than Part IIIA.

The Council considers a clear case for regulatory intervention exists where price or other terms of access to a bottleneck infrastructure facility are likely to limit competition in a dependent market (that is where the Part IIIA access criteria are met). However the case for more general intervention to cap what may be seen as high or even monopolistic prices is a different one. Furthermore it is necessary to consider why airports should be identified as a priority for such an action or whether in a value chain where competition may be limited at several levels only one level should be subject to direct regulation.

Airports are likely to exhibit natural monopoly characteristics in relation to many of the core services they provide and therefore the scope for them to extract monopoly profits clearly exists. In the absence of regulation, airport operators are likely to raise prices or restrict output and/or quality to maximise profits. Furthermore assets with similar economic characteristics to airports are commonly regulated. For example, electricity transmission and distribution facilities, telecommunications networks and ports are all subject to regulation that is generally more intrusive than that faced by airports. It is also likely that of the elements in the value chain from which air travel emerges, airports are the most likely and persistent source of monopoly power. Unlike airlines, for example, there is unlikely to be scope for changes in service providers or even fringe competition from other transport modes.

Price caps impinge significantly on the parties' ability to develop their own commercial relationships and there is the possibility that price caps would only serve to divert rents from monopoly airports to a domestic airline industry duopoly. The operation of price caps and similar regulation also inevitably involves regulators in commercial decisions including critical infrastructure investment decisions where the consequences of regulatory error may be high.

In the Council's view Part IIIA provides an appropriate basis and scope for regulation of airports (and other infrastructure) that serves the public interest in avoiding uneconomic duplication of facilities and ensuring third party access to such facilities is permitted in appropriate circumstances and on appropriate terms.

Whether additional regulation directed at limiting monopoly profits *per se* is desirable is a broader question, as is the form such regulation should take. In the end this requires a value judgement that the benefits to the Australian public from constraining monopoly profits earned by airports (by whatever means this is done) exceed the likely costs of doing so in the long term.

## Price monitoring

Price monitoring is often seen as a low cost alternative to more invasive price controls. The present system of price monitoring appears to be relatively low cost, however it generates only limited benefits.

The costs include compliance costs for various private parties and the administrative costs incurred by the ACCC. Generally these are likely to be less than those incurred under a full price control regime.

The main consequence of the present regime is the provision of accessible information on airport revenue and margins<sup>7</sup>. It is, however, apparent that for monitoring to be an effective constraint on airport charges (rather than merely a source of information), it must be accompanied by a credible threat of re-regulation if monitoring reveals unacceptably high price increases. However, it should be noted that what would be “unacceptable” is not defined.

The actions that might be taken to strengthen the present system seem to range, at one extreme, from approximating a return to the price caps approach. Alternatively, given the limited benefits from price monitoring, it could be discontinued in favour of relying on the generic provisions of the TPA, particularly Part IIIA and limiting the scope of concern about airports’ monopoly profits to situations where this has adverse consequences in related markets.

To the extent that the broad public interest lies in avoiding unnecessary duplication of facilities and ensuring access to bottleneck facilities does not preclude or limit competition in markets that are dependent on access to such facilities, Part IIIA is an appropriate basis for imposing limited regulation.

Broader regulation to address monopoly profits *per se* requires a separate cost benefit justification which is at the heart of the Commission’s inquiry.

## Other issues

In its issues paper, the Commission asks whether the development of a code of practice for access to airport services would improve dispute resolution and ‘make it less likely that the national access regime would be invoked’ and if there is a case ‘for a formalised airport-specific arbitration process?’

The Council’s starting point is that only in exceptional circumstances should processes that deviate from the overarching national architecture of Part IIIA be contemplated. The Council suggests that it would be preferable to see how

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<sup>7</sup> The information gathered under the current monitoring regime is limited and does not allow examination of profitability. It is also likely that much of the information made available would be available to airport customers in any event and airlines in particular have strong incentives to gather and analyse such material.

well the post-declaration negotiate/arbitrate process works before implementing a unique set of provisions for airports. Post-declaration negotiations are only now commencing at one airport. The Council believes that it is preferable to allow the parties to develop their own practices as the negotiation process matures before assessing whether provisions such as a government endorsed code of conduct are warranted.



## References

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