Pricing

Productivity Commission inquiry into price regulation of airport services

Background

In 1997 and 1998 the Federal Government privatised 17 of the 22 airports it owned and operated through the Federal Airports Corporation (FAC). The airports were leased for 50 years with an option to renew for a further 49 years. The Government has announced it will privatise the five remaining airports over the next year or so.

Before privatisation the Government established a comprehensive system of regulation to apply to the private airport operators. This includes:

- prices oversight;
- access arrangements;
- quality of service monitoring; and
- public reporting of financial and other types of performance.

After almost four years of operation the Government has asked the Productivity Commission to review the need for such arrangements and to advise on what form any future regulations should take.
The Productivity Commission received its terms of reference on 21 December 2000 and is due to issue its final report on 21 December 2001.

The ACCC provided the inquiry with a detailed submission, as well as a supplementary submission on access to airport services.

Outline of submissions

Why regulate airports?

It is widely accepted that vigorous and effective competition is normally the best way to promote economic efficiency. In some markets, however, competition may not be possible. This can be the case with airports. Airports often face limited direct competition in the provision of aeronautical services either from other airports or other forms of transport. Furthermore, barriers to entry, at least for larger airports, tend to be high. Reasons for high barriers include:

- planning restrictions and limited availability of large land sites in or near large cities;
- the lumpy[1] and sunk[2] nature of new airport investments;
- economies of scale and scope in the provision of airport services; and
- network externalities in the provision of airport services.[3]

Combined with limited substitutability on the demand side these barriers to entry can give rise to significant market power.

Failure to address the consequences of such market power may have significant implications for economic efficiency. Airlines providing international services to and from Australia generally operate in a competitive environment. New airline entry has increased competitive pressures in the domestic market. In both cases

1 Investments are 'lumpy' when capacity can only economically be added in large increments.

2 An investment is 'sunk' when its cannot readily be converted to another use — it is costly to exit such an industry and this in turn increases the risks of entry.

3 Network externalities arise when the value of a service to a customer is positively related to the number of users of the service. As an example, a telephone service is more valuable to a user if more people can be called using the service.

the impact of increased airport charges is likely to be passed through to the travelling public as higher airfares.

These higher airfares can result in allocative inefficiency — as explained by the Productivity Commission in its review of the national access regime:

> In the first instance, these effects stem from a higher price for, and lower use of, the final service, relative to the situation in which prices were set to encourage efficient use of that service. In the simple monopoly model, lower use of the final service is a cost to 'allocative' efficiency.[4]

There are further allocative efficiency implications if the service is also an intermediate input. High prices can distort production and consumption patterns of the goods and services using air travel as an input. For example:

- air travel is a business input for many companies — higher prices can affect business input costs and the ability of such companies to compete in Australia and overseas; and
- air travel is critical to the development of the tourism industry which is a major contributor to the Australian economy — high airport charges have the potential to damage both domestic and international tourism.

The major role played by the aviation industry in Australia makes regulation of airport charges particularly important.

One of the arguments advanced in favour of deregulating airports is that demand for airport services is inelastic.[5] The argument seems to be that the allocative efficiency losses from increases in prices are limited when demand is inelastic — in other words that price rises would do little to change the behaviour of airlines and their passengers.

The Commission's submission counters this argument. While it is true that the welfare losses associated with a given price increase will be lower the less elastic the demand, the real issue is what prices might be in the absence of regulation. A rational company will set prices to maximise profits. The less elastic the demand, the higher the profit maximising price and the larger the allocative efficiency losses. In setting prices firms trade off the additional revenue and profit from higher prices against the reduction in revenue and profit as customers stop using the service. If, as is argued, the demand for airport services is relatively inelastic the resulting profit from maximising prices will be high, well above the charges currently levied. It follows that the less elastic the demand, the stronger the case for regulation.

If airports were in a position to price discriminate between different customers, the allocative efficiency losses resulting from monopoly pricing might be mitigated. If they were able to perfectly price discriminate, the deadweight welfare losses to society could be eliminated altogether.

However, the Commission considers this irrelevant given practical realities. The evidence to date suggests that airlines and airports have little capacity to price discriminate in relation to aeronautical services.[6] Even if they could, the information requirements to enable such pricing behaviour are likely to be extremely high.

Economic regulation is not new to airports or the airport privatisation process. Governments in Australia and overseas have recognised the potential for market failure in the provision of airport services. In every developed country governments have responded by regulating prices at privatised airports — except in New Zealand. There the outcomes of the so-called light-handed approach have been disappointing. Airport charges in New Zealand are considerably higher than Australia, and airport operators and their customers have been bogged down in lengthy and costly litigation processes. These results have prompted the government to reconsider the light-handed approach to regulation. It is moving to re-regulate services

4 Productivity Commission, *Review of the national access regime*, position paper, March 2001, p. 42.

5 See for example, Peter Forsyth, *Airport price regulation: rationales, issues and directions for reform*, submission to the Productivity Commission inquiry into price regulation of airport services, March 2001.

6 See for example Network Economics Consulting Group's report to the ACCC. *'Dual Till' at Sydney Airport*, May 2000. A copy of this paper is available at <http://www.accc.gov.au>.

in the energy and telecommunications sectors and it has instructed the New Zealand Commerce Commission to determine whether price controls should be implemented for airports.

Market power of airport operators

The Commission engaged Professor Stephen King to provide advice on an approach to determining the extent of market power at airports in Australia. Professor King proposed a six-step iterative framework for considering this issue and concluded that larger Australian airports have significant market power in a range of services.

Some airport operators argue they are unable to take advantage of market power because airlines have countervailing power. The argument seems to be that airlines may be in a position to withdraw or curtail services in response to price increases, or to change their existing or planned use of non-aeronautical services at the airport.

The Commission rejects this argument, as do independent observers. Professor Peter Forsyth describes countervailing power as a 'mirage'.[7] He states that 'airlines cannot credibly threaten to leave airports because they do not have substitute sources of supply'. Professor King also rejects the argument, at least about larger airports. In a case study of Melbourne airport he concludes:

> … because of its location in the second largest Australian city, it is not clear that even a major airline, such as Qantas, can credibly exercise countervailing power to Melbourne airport. It is likely that Qantas could not threaten to cease services to Melbourne or even to substantially curtail these services. If Qantas were to carry out such a threat, then this would undermine its own profitability and probably lead to significant gains to Qantas' rival carriers.[8]

The analysis does not deal with the possibility of airlines collectively threatening to cease services. Section 45 of the Trade Practices Act, however, generally prohibits such actions.

The Commission's submission argues that airport regulatory provisions should be targeted at those airports and services for which the market power of airport operators is significant. Price regulation should not apply to other airports and services. This means that the Commission supports the 'dual till' approach to regulation.[9] It considers that the dual till approach has advantages over the 'single till'[10] approach used in the past. In particular it is likely to provide superior investment outcomes.

Nevertheless, a dual till approach should only be adopted if the delineation between services that are and are not subject to regulation reflects the market power of the airport operator. The risk of applying a dual till that is too narrow is that the regulatory measures will be ineffective. The current arrangements already show signs of regulatory bypass. The current price cap aims to reduce airport landing charges over time. However, the introduction of fuel throughput levies at Brisbane and Perth airports has offset a substantial part of those reductions.

The Commission's application of Professor King's framework suggests that Sydney, Melbourne, Brisbane, Perth, Adelaide, Canberra and Darwin airports should be subject to continued price regulation. The submission recommends prices monitoring of the deregulated airports (Alice Springs,

7 Peter Forsyth, op. cit., p. 4.

8 S. King, *Market power and airports*, report to the ACCC, January 2001, p. 23.

9 The term 'single till' refers to narrow (aeronautical only) regulatory oversight of air services charges.

10 'Dual till' refers to broad (all services) regulatory oversight of air services charges.

Coolangatta, Hobart, Launceston and Townsville) as a transitional measure.

The Commission's application of Professor King's framework suggests that the services currently in the price cap should continue to be regulated. It also suggests that price cap coverage should be broadened to include aircraft refuelling, check-in and certain ground access services provided by the airport operators.

Incentive regulation

The Commission's submission considers three options for regulating prices at airports:

- negotiate–arbitrate models such as in Part IIIA of the Trade Practices Act;
- tariff setting (e.g. rate of return pricing); and
- incentive regulation.

The Commission submission favours the continued use of incentive regulation such as CPI-X price caps. Price caps provide clarity and certainty for all parties about pricing outcomes. They also provide strong incentives to service providers to reduce production costs. This approach is consistent with that adopted in regulating electricity and gas transmission and distribution in Australia and airports in the UK.

By contrast the Commission submission does not favour use of the negotiate–arbitrate model as the primary means for price regulation of airports. The experience with this model suggests it has some fundamental limitations, including:

- the high propensity for the parties to seek arbitration rather than negotiate outcomes;
- time consuming and costly processes;
- the potential for the negotiate–arbitrate model to give rent sharing outcomes;[11] and
- the potential in an airport context for the regulator to be involved in micro-management of aspects of airport operations.[12]

The negotiate–arbitrate model was originally described as a 'light-handed' model with arbitration only as a last resort. The experience since then suggests this is not the case.

Use of a price cap raises a number of implementation issues. These include the choice of price cap parameters, the legislative base for a price cap and new investment incentives.

Price cap parameters

Introducing new CPI-X price caps for regulated airports raises the question of how to set starting point prices and the X-values.

The Commission proposes that prices from the current regulatory framework should be carried over to form the starting point for a new price cap. The alternatives, such as setting starting point prices to reflect costs, are likely to result in significant increases or decreases in charges. Given that these starting point prices relate to existing, mostly sunk assets, there is little if any reason to make such a change from an economic efficiency perspective. Instead the main effect of such a change would be a distributional one, either a transfer from airlines and their passengers to airport operators or vice versa.

The case for this approach has been recognised in the UK where assets are not revalued as part of the current regulatory framework. Instead, and as proposed by the Commission, prices are carried over from one five-year regulatory period to the next.

For the X-values, the Commission submission proposes adopting the same approach as for the first five-year regulatory period; that is, to set the X-values on the basis of expected productivity gains, adjusted to take into account new investment.

Legislative base for a price cap

The Commission considers that the current Prices Surveillance Act does not lend itself to the regulation of airports through CPI-X price caps.

11 See S. King and R. Maddock, *Unlocking the infrastructure. The reform of public utilities in Australia*, Allen and Unwin, Sydney, 1996.

12 See for example the ACCC's Delta Car Rentals determination (discussed in chapters 5 and 13). The issues of concern to Delta raised a number of ground access operational issues which the ACCC could be obliged to consider as part of an arbitration.

The primary problem with the legislation is that compliance with the price cap is voluntary. The Act requires airport operators to notify the Commission of price increases, but does not prevent them from ignoring the requirements of the price cap. Other limitations relate to information gathering powers, processes for assessing notifications and the relationship between the Act and Ministerial directions made under s. 20. These are discussed in the Commission's submission to the airports inquiry and submission to the Productivity Commission's review of the Prices Surveillance Act.

As an alternative the Commission submission proposes that the relevant provisions of the Act should be substantially strengthened or that the price cap should be enacted as a new part to either the Trade Practices Act or the *Airports Act 1966*. On balance the Commission considers there are advantages in including the price cap in the Trade Practices Act rather than separate industry-specific legislation.

New investment

Price caps allow airport operators to improve their profit performance in two ways. One is to reduce costs, the other to increase revenues for any given cost structure. Airport operators will have strong incentives to carry out investments which achieve either of these objectives. In such cases price caps should achieve efficient investment outcomes without any additional investment incentive provisions.

However, in other cases, and in particular quality and capacity enhancing investments, price caps on their own may not provide adequate incentives for investment, even if airport users want the investment and would be prepared to pay for it. In general, price caps provide weak incentives for airport operators to carry out quality improving investments. This is because the relationship between the quality of airport services and traffic volumes (and in turn revenues) is likely to be weak except in extreme conditions.

Similarly, under certain circumstances capacity enhancing investments will not pay for themselves. Typically, capacity enhancing investments pave the way for traffic growth over time. In turn, under a price cap such increases in traffic volume translate into higher revenues. An airport operator will have strong incentives to carry out such investments if the additional revenues from the new facilities exceed the costs of constructing them. Whether or not this would be the case is an empirical question, dependent on the incremental cost of the new facility and the additional revenues generated by it. It may well be that the outcomes are such that capacity enhancing investments are not undertaken even if they are welfare enhancing.

Given this, investment provisions to provide additional incentives for quality and capacity enhancing investments would seem to be warranted.

In considering options for providing such incentives, the Commission sought advice from the Network Economic Consulting Group. The Commission submission draws upon this advice, and considers the following main options:

- set X-values to accommodate anticipated investment, so that the X-values are lower the more investment is factored in;
- increase prices to recover the costs of new investments as they come online (the current arrangements work in this way); and
- a hybrid of these two options.

The Commission favours a hybrid approach that would factor ongoing smaller investments into the X-value or other price cap parameters, but still provide for a pass-through of the costs of major projects such as major new terminal or runway works.

The hybrid approach combines advantages of the other two options. It would provide strong incentives for investment by directly linking price increases to cost. At the same time it would reduce the administrative burden of the current arrangements by limiting the pass-through provisions to major projects.

The challenge with this approach is to provide clarity about what projects are eligible for a pass through. To achieve this the Commission submission suggests introduction of a clear and workable cut off between what can and cannot be passed through. The projects and dollar amounts factored into the price cap parameters should be made available to all interested parties.

Access regulation

The Commission made a supplementary submission on the subject of access regulation at airports. Under the existing regime some services provided by airport operators could be declared under Part IIIA of the Trade Practices Act. Section 192 of the Airports Act provides a mechanism for 'automatic' declaration of 'airport services' in relation to core regulated airports for the purposes of Part IIIA of the TPA. This means, among other things, that the negotiate–arbitrate model under Part IIIA is applicable to those services.

While there is significant overlap between the price cap regime established under the PS Act and the access regime established under the Airports Act and Part IIIA the scope of coverage of the two regimes (in terms of the services to which they apply) is not identical. Further, there is no mechanism for coordinating the determination of the scope of the regimes.

The coexistence of two separate but uncoordinated regulatory regimes applying to regulate the behaviour of infrastructure owners in relation to the provision of the same or a similar set of services results in considerable regulatory complexity and potential uncertainty. This may raise the cost of investment. It also creates a potential for forum shopping and gaming by interested parties if the regimes are not coordinated.

Unlike some other natural monopolies, airport owners/operators tend on the whole not to be vertically integrated for the services they provide. That is, there are few services provided at major Australian airports of which the owner/operator also operates in a related upstream or downstream market. It can thus be expected that the owner/operator will normally have little incentive to restrict access to its services. This suggests that disputes with customers or users of the airport about the services provided at the airport are likely to relate to price rather than whether access is granted or the non-price terms and conditions of access.

That said, experience so far with the access regime provides some indications that airport operators may have reasons for restricting access to certain facilities, either by denying access altogether or by imposing non-price terms and conditions that make it difficult for access seekers to compete in related markets. These reasons may arise independently of vertical integration.

In these circumstances there is a case for retaining a regime that allows third parties to have access to essential airport facilities and services, and that provides a mechanism for ensuring fair and reasonable terms and conditions for the use of those services and facilities. A stand-alone price cap regime is unlikely to achieve this under all circumstances.

Duplication of regulatory regimes has significant costs and disadvantages that should be avoided if possible. The Commission argues that there are strong grounds for coordinating the price cap and access regimes. As a matter of principle, the access regime should only apply where, or to the extent that, the price cap is unable to address the access problem.

On the mechanisms and criteria by which services should be declared for the purposes of access, there are several options. One is an up-front declaration of specified services at each airport. Others are applying the generic declaration criteria of Part IIIA, or more limited criteria such as those set out in s. 192 of the Airports Act. In the latter case the Commission submission recommends that the s. 192 criteria be aligned with the criteria of Part IIIA.
A further possibility is to combine an up-front list with the declaration criteria, thus enabling declaration of other services in the future when they can be demonstrated to satisfy the criteria, or removing services from coverage when it can be demonstrated that the criteria no longer apply.

The model of access regulation preferred by the Commission could include some form of 'standard access obligations' on airport operators rather than the negotiate–arbitrate approach of Part IIIA. These obligations could require that airport operators provide access to the declared services on the basis of non-discriminatory, objective and transparent terms and conditions. The obligations could also include an obligation to ensure that prices reflect costs.

An example of such a regime is provided by the regime applicable in the United States, whereby airports must provide access on non-discriminatory terms. The Federal Aviation Administration (FAA) has the power to enforce those obligations by means of its financial controls. In the context of Australian airports, the legislative obligations could be enforceable in the courts. Alternatively, or in addition, access seekers could be empowered to notify disputes for arbitration; then the arbitration should be limited to determining whether or not the legislative obligations have been complied with.

Conclusion

The Commission and other submissions to the inquiry into price regulation of airports are available on the Productivity Commission's website at: <http://www.pc.gov.au/inquiry/airports/subs/sublist.html>.

Before the final report is completed the Productivity Commission will issue a draft report and conduct public hearings.

The Commission is hopeful the review will result in a scheme of regulatory arrangements that allows for efficient use of, and investment into, Australian airports while minimising the complexity and costs of regulation. Ultimately, the benefits of such outcomes will be enjoyed by consumers.

Productivity Commission's review of the Prices Surveillance Act

The Productivity Commission (PC) draft report on the *Review of the Prices Surveillance Act 1983* was released in March 2001. The review is being conducted as part of the Competition Principles Agreement. The report contains a draft proposal for amending the generic national prices oversight regime currently embodied in the Prices Surveillance Act (PSA). The PC's proposal is summarised as follows.

The Prices Surveillance Act should be repealed. Instead, a new section should be inserted in the Trade Practices Act for inquiries and prices monitoring in nationally significant markets where there may be monopolistic pricing. This new section would be light-handed in its application.

The ACCC has previously made two submissions to the review. In the first it responded to the review's issues paper and in the second to the interim report. The ACCC made a submission in June 2001 on the draft report commenting on:

- the effectiveness of the proposed monitoring regime;
- the proposal not allowing for a generic price regulation function; and
- the proposal providing limited scope for prices oversight of oligopolistic industries.

On the need for a generic price regulation function, the ACCC reiterated that the role of price regulation would be limited to very specific circumstances of the industry being characterised by high market power, the benefits of regulation exceeding the costs and no other appropriate policy measures being able to be taken. It is envisaged that the focus of price regulation would principally be on monopolies although it may be justifiably applied to natural oligopolies in limited instances of strong market power.

The ACCC also noted that for price regulation to be effective the current regime would need to change to ensure its consistency and transparency. There should be greater scope for a range of price setting methodologies, including incentive-based regulation. The time frame for assessing proposed prices must also be reasonable and public input to the process should be possible. Importantly, ACCC decisions should be court enforceable and the need for regulation reviewed periodically.

The PC's proposal would reduce ministerial discretion to apply prices oversight. The ACCC argued that the need for a public inquiry to be held before the imposition of prices oversight might not always be appropriate; for instance if a quick response to perceived excessive prices or price rises is needed or if the need for prices oversight has already been identified as part of a deregulatory process.

The ACCC noted that the requirement for prima facie evidence of monopolistic pricing to exist before a public inquiry might be unduly restrictive in some instances. In particular, it may mean that inappropriate oligopolistic pricing could go unchecked. It could also be difficult to monitor industries where it is possible that inefficient pricing may occur as a result of changes to industry structure or the regulatory environment. It is, nevertheless, important that a requirement for such prima facie evidence is not so prescriptive or onerous that the conditions required to initiate a public inquiry are seldom met.

The ACCC agreed with the PC's view that there is an ongoing need for a price monitoring function as part of a generic prices oversight regime. However, in the ACCC's view, aspects of the PC's proposal are likely to reduce the effectiveness of such a regime. In particular, the PC's proposal does not contain a strong information-gathering power. Furthermore, monitoring could only be implemented following a public inquiry. A body independent of the regulator would be required to nominate the indicators to be monitored and the regulator would not be able to make determinations or recommendations using information gathered as part of the monitoring exercise. Finally, monitoring would automatically cease at the end of a given period, but no later than three years after implementation.

The ACCC recognised that the PC was seeking to separate policy formulation and policy implementation processes to ensure the independence of those processes. However, the ACCC's view is that this may not necessarily result in the best regulatory outcome. It submitted that the regulator should have full responsibility for implementing the regulatory policy decision, including the selection of appropriate indicators to monitor. This would minimise administrative costs and ensure consistency of regulatory approach.

The ACCC also submitted that an effective prices oversight regime must be backed by strong information gathering powers and a requirement for industries subject to monitoring to comply with information requests — moral suasion is no longer sufficient incentive for compliance in the Australian context.

In addition, the regulator should be able to comment on data collected to help the Government and community understand the monitored prices. An ability to make recommendations is also vital as it provides a feedback mechanism for an ongoing assessment of the appropriateness of prices oversight. Finally, the ACCC submitted that the need for ongoing prices oversight should be reviewed periodically, rather than lapsing automatically at the end of a given period. It is feasible that the pricing problem that gave rise to prices oversight may not be rectified within that period and that ongoing oversight may be necessary.

To summarise, the ACCC submitted that a generic prices oversight regime with price regulation, price monitoring and public inquiry functions is justified. It would feature:

- legislative criteria for the imposition of prices oversight for consistency and transparency;
- prices oversight of monopolistic industries and oligopolistic industries in certain limited circumstances;
- prices oversight that could be implemented without a prior public inquiry in certain instances;
- the regulator having full responsibility for the implementation of the regime;
- a reasonable time frame for assessing prices;
- public input for transparency;
- mandatory compliance with the regime by regulated firms;
- public comment by the regulator on the appropriateness of monitored prices and the ability to make recommendations where appropriate; and
- periodic review of the need for ongoing prices oversight.