Australian Airports Association

Sydney Basin Airports

"Setting the Scene – The Way Ahead"

"The ACCC Role in Sydney Airport Regulation "

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INTRODUCTION

The impact and coverage of the Trade Practices Act (the TPA) and the ACCC has increased significantly during the past decade.

What is not well known and even less understood is the role ACCC has been given in terms of additional powers and responsibilities to regulate service sectors such as airports, electricity and telecommunications which were being opened up to greater competitive pressures.

These services were often government owned and in many cases effectively run as part of government. Their revenue was part of government revenue and pricing policies were influenced by government social policy.

A significant reform process was set in train with the separation of those areas of activity that were contestable. In some cases privatisation occurred. Otherwise the monopoly component remained in government ownership, but as separate independent corporations.

The issue became what type of oversight was required to foster this new kind of regulation. The potential mix of regulatory options was multi-faceted and in the Australian context, with a federal political system, another layer of choice was added with the possibility of regulation at either the State or Federal level.

Of the broad regulatory models available, Australia has embarked upon institutional integration with competition law, and general rather than sector specific regulation combined in a single national body (the ACCC).

Particular state variations to this overall schema do occur as individual states conduct some technical regulation and share in some of the economic regulation of particular utilities. Nevertheless, the pervasive institutional structure in Australia is that of a national body which administers both competition law and economic regulation.

With an integrated national organisation there is an increased likelihood of formulating regulations that are relatively consistent for all competitors in the market. There is also a greater chance of formulating regulations that have a constant eye to imitating competitive conditions and therefore of achieving outcomes comparable to those which could be achieved under competitive conditions.

When economic regulation is located within a competition agency there is likely to be less resistance to losing functions as reforms progress. In fact priority can be given to the important task of easing back on regulation as competition develops.

These factors were particularly relevant in determining the institutional structure adopted in Australia. What was favoured was "light handed" incentive based mechanisms and the enhancement of regulatory arrangement in the recognition of the development of national markets.

Also, reform coincided with efforts in some jurisdictions to privatise public utility enterprises and to apply cash returns (after costs) from privatisation to budget programs or to debt reduction. This increased the need for regulation to be carried out by an independent body not beholden to achieving the revenue or capital return objectives of government.

This brings me to the subject for discussion today, Sydney Airport, an airport of central importance to the region and, indeed to Australia as a whole. In the last financial year, it serviced over 23 million passengers and generated over 300 million dollars in revenue. It is the largest Australian airport, facilitating a range of services that includes freight, maintenance and retail, in addition to the basic aeronautical services provided to airlines.

This bundle of services is generally most efficiently provided by a monopoly operator, able to capture the benefits of economies of scale and scope inherent in the provision of aeronautical services. Yet therein lies the case for regulation, as the higher prices that may prevail in the absence of regulation can limit use of the services to the detriment of the broader economy.

This presentation covers four elements:

- existing regulatory arrangements for Sydney Airport, and the Commission's approach to regulation;
- the Commission's recent decision regarding aeronautical charges at Sydney Airport and the implications of that decision for the future owner;
- some possibilities for future regulation of Sydney Airport; and
- the Commission's views on the future of airport regulation more generally.

CURRENT REGULATORY FRAMEWORK – SYDNEY AIRPORT

Sydney Airport, like airports elsewhere, provides a range of facilities and services. The legislative framework does not, however, seek to regulate all these services. It makes important distinctions between them.

In particular, the *Prices Surveillance Act* makes a distinction between three categories of airport services –

- aeronautical,
- aeronautical *related* and
- non-aeronautical services.

Only those specified as 'aeronautical' services – namely, aircraft movement areas and passenger processing areas - are subject to price regulation.

Aeronautical services at Sydney Airport are declared under the Prices Surveillance Act for the purposes of prices surveillance. This means that Sydney Airport must notify the Commission in the event that it wishes to raise the prices for these services. The Commission then makes an assessment of whether the price increase is justified.

The Government has also made a direction to the Commission under the PS Act which provides for increases in aeronautical charges as a result of necessary new investment. It should be noted, though, that this is not a blanket definition. The Commission's decisions in relation to the privatised airports, and its published position paper, provide a guide as to the types of investment that it considers 'necessary' and 'new'.

Aeronautical *related* services, which are specified in a separate Government Direction, include activities such as refuelling services, check-in counters, aircraft maintenance and car parks. These services are *not* subject to price regulation, but are subject to price monitoring by the Commission. Prices monitoring involves airport operators reporting to the Commission on the prices, costs and profits associated with aeronautical related services. Part of the Commission's role here involves recommending stricter forms of prices oversight if any market power in these services is being exploited.

***Non*-aeronautical services** refers to the remaining services provided by Sydney Airport. The distinction between categories of services (and the associated degrees of

regulation) reflects the Government's underlying views about the nature of the market power present in the provision of these services. This issue is addressed later in the context of the Commission's Sydney Airport decision.

A further significant element of the regulatory regime applying to Sydney Airport is the access regime of Part IIIA of the *Trade Practices Act*. Services meeting certain specified criteria can be declared for the purposes of Part IIIA. In general, "airport services" are likely to meet these criteria. A key criterion for such declaration is that the facility providing the service "be uneconomic to develop another facility". The service distinctions that apply under the *Prices Surveillance Act* are therefore not directly relevant to the question of airport access.

Here it should be noted that certain vehicle access services and some non-aeronautical services are likely to be covered by the access provisions. The Australian Cargo Terminal Operators (ACTO) decision means some services at Sydney Airport *are* already declared. These services relate to the use of freight aprons and the provision of areas for ramp handlers to store equipment and transfer freight.

The access provisions aim to encourage airport operators to negotiate and provide access on commercial terms to access seekers. If negotiation fails, the Commission can be called upon to arbitrate an outcome. An advantage of this approach is that it allows for some flexibility in relation to the terms and conditions of access, rather than simply regulating price.

Other aspects of the regulation of Sydney Airport concern quality of service monitoring, and regulatory accounts reporting. The *Airports Act* gives the Commission responsibility for collecting and disseminating this information. The Commission reports on an annual basis – to date, two such reports have been released.

SYDNEY AIRPORT AERONAUTICAL PRICING DECISION

The Commission's recent decision regarding the aeronautical pricing proposal at Sydney Airport, released in early May, followed an extensive public consultation process, including two rounds of written submissions and public forums in Sydney and Melbourne. It included a revaluation of the assets and land at the airports, changes to charging structures, incorporated updated volume forecasts and included the recovery

of costs associated with the SA 2000 project. Effectively, the decision sets the starting point prices for the Airport's sale.

The proposal was submitted to the Commission by SACL in October 2000. It sought to increase and restructure certain aeronautical charges at Sydney Airport. The increase in revenue proposed was around 130 per cent – from around $93 million to $211 million.

In its final decision on the proposal, the Commission endorsed a somewhat lower increase. The decision is nonetheless estimated to increase SACL's aeronautical revenue to around $183 million. This is approximately 76 per cent of the increase sought by SACL.

The Commission considered that the increases were required to give SACL a reasonable return on its investments and to compensate SACL for major new investments undertaken in the lead up to the Olympics.

Nevertheless the decision did not approve all of the increases sought, as the Commission had concerns about a number of aspects of the proposal. In particular, the Commission considered that the land valuation proposed was too high and that SACL's proposals did not take into account likely reductions in operating and maintenance expenditures.

The decision addressed these issues by making two main changes to SACL's proposals.

- The first was to use an inflation-adjusted historic cost valuation of land as recommended by independent consultants.
- The second was to model costs and revenues over a five-year period instead of a one year period.

Land valuation

SACL valued aeronautical land by estimating the site's market value in its best alternative use. The valuation adopted was based on use of the site in mixed residential, commercial and industrial uses. SACL argued that the market value of $705 million captures the opportunity cost of the land and sends the right signals for using the land and investing in land.

The approach adopted in the decision generally supported the principle of using opportunity cost, but raised issues associated with its implementation. There were two

main concerns about SACL's approach. The first was that SACL had not taken into account the costs of converting the site to alternative uses, for example the costs of demolishing facilities on the site. The second was that SACL had only considered the private costs and benefits of selling the site.

In light of the difficulties of identifying and quantifying opportunity cost, the Commission considered the historic cost of the land as an alternative basis for valuing the site.

Historic cost has three main advantages.

- first that the historic cost of land is generally more readily identifiable than opportunity cost.
- second it provides compensation to the owner of Sydney Airport for investments into land already undertaken by providing a rate of return on the investments.
- third it provides appropriate incentives for an airport operator to acquire additional land.

One of the reasons given by SACL in support of the large price increases, and in particular the high land valuation adopted, was that the higher prices would help to address congestion problems at the airport. However, the Commission considered that SACL did not demonstrate how the proposals would address the problem.

Congestion needs to be addressed through restructuring of prices *as well as* price increases. An effective way of doing this is to restructure prices to encourage airlines to reschedule flights to off-peak periods or use larger aircraft. The Commission's view is that the revenue levels implicit in the recent decision should be sufficient to address any congestion issues that arise over the next five to ten years if combined with appropriate price restructuring.

Operational Costs

The ACCC's second main change to SACL's proposal was to model costs and revenues over a five-year period instead of a one-year period. There are two reasons for taking this approach.

The first reason relates to the regulatory framework. Applying the building block methodology would result in falling prices over time, as traffic growth drives down unit costs and as operating costs and other expenses fall. Under the current regulatory framework there is no mechanism for the Commission to ensure SACL lowers prices in future in response to such changes.

The second reason for using a multi-period financial model is to mitigate the immediate price shock to airport users. The financial modelling 'smooths' prices, translating the cost and revenue data into a constant nominal price over the forecast period, providing an equivalent net present value of cash flows to SACL. This smoothed price generates steadily increasing revenues for SACL over the five-year period. An alternative scenario might be for larger price increases now with prices subsequently driven down in the future.

The rationale for modelling allowable revenues and prices over a *five-year* period is that this time horizon is commonly used for regulatory purposes. The price caps imposed on the privatised airports, for example, had a five-year horizon prior to review. Similarly in the UK, five years is the duration of the price-caps set by the Civil Aviation Authority (CAA) for application to privatised airports.

Dual Till

Perhaps, though, the major issue arising during the Commission's assessment was the question of the single or dual till. The single till approach takes into account the costs and revenues associated with *all* airport services in setting aeronautical prices. Until recently the single till approach to pricing aeronautical services was used to regulate airports in Australia and overseas. The single till approach has certain features that account for its widespread use. It ensures that airport operators earn a reasonable return on total assets, while preventing them from exploiting their market power. It is also practical to apply, as airport operators are free to recover costs through any charging structure they deem suitable. Furthermore, cost allocation issues do not arise using this approach.

However, the Commission sees disadvantages with the single till approach in terms of economic efficiency and in particular incentives for new investment. These are

recognised in both the Sydney Airport decision and the Commission's submission to the Productivity Commission in relation to the review of price regulation of airports.

The 'dual till' approach to pricing aeronautical services addresses many of these limitations. The dual till conceptually separates the regulated and unregulated services provided by the airport, and looks only at the costs and revenues associated with the former. Its advantages are now widely recognised. In Australia the Government favours a dual till approach in the regulatory framework covering privatised airports and Sydney Airport. In the United Kingdom the review of airport regulatory arrangements being conducted by the Civil Aviation Authority (CAA) appears to favour a dual till approach, but has raised questions about the boundary of the till – that is, which services should be defined as aeronautical - and the transition from dual till to single till.

The Commission's Sydney Airport decision supported SACL's use of the dual till methodology. However, it expressed reservations about SACL's *application* of the methodology.

In its draft decision the Commission took SACL's financial performance in providing "aeronautical-related" services into account. The rationale for taking this approach was that the resulting aeronautical prices would yield better economic efficiency outcomes and more effectively constrain market power than SACL's proposals. The aeronautical-related services taken into account included aircraft refuelling, check-in counters and car parks. They are already subject to prices monitoring under the existing regulatory framework.

To expand on this a little, the logic for taking the aeronautical-related services into account is that there is a bundle or package of services which airport users must use if they are to use the airport at all. Airport users are likely to make decisions on the basis of the entire package of services used and the prices paid for all of those services, not just the aeronautical services.

The point here is that the use of some of the services currently classified as non-aeronautical appear to be part of the package of services that must be used. In this sense they are non-discretionary. This issue is one that we hope will be addressed as part of the Productivity Commission's inquiry into airport regulation.

That said, the Commission's final decision moved away from this position. It adopted SACL's application of the dual till and did not take the financial performance of aeronautical-related services into account in making its decision.

The move from the position adopted in the draft decision was taken after the Minister for Financial Services and Regulation issued a new direction (Direction No. 22) pursuant to section 20 of the Prices Surveillance Act.

Such directions do not bind the Commission to taking a particular approach. However, the Commission must give them special consideration in making its decisions. In this case the Commission considered that the direction warranted a departure from the approach taken in the draft decision.

It should be noted that previous price notifications relating to Sydney Airport have adopted a single till approach. Until recently the Government had not clearly stated its position on the dual till or the boundary of the till. Direction No. 22 clarifies the Government's policy intent in relation to this issue.

In effect the Government's policy intent is to apply the dual till approach on a narrower basis than proposed by the Commission in its draft decision. In practical terms this means that aeronautical-related services and in particular car parks (where the Commission identified an issue of market power) should not be taken into consideration in setting aeronautical charges at Sydney Airport.

Implementation of the policy intent resulted in higher price increases than proposed by the Commission in its draft decision. This increase amounted to around $15 million per annum to SACL's revenues.

Implications for purchasers

The decision has implications obviously, for the potential purchasers of Sydney Airport. The Commission determined aeronautical prices that it believes should apply for the next five years, and does not intend to revisit these prices, at least under the current regulatory arrangements. New investment can be dealt with by the provisions specified in Direction 18.

The Commission's decision modelled forward costs over a 5 year period and smooths prices over that time horizon. In the absence of any changes to Sydney's framework the

decision would therefore have the same incentive properties as a price cap. This means that if productivity gains are achieved, for example, by lowering operating costs, the airport reaps the benefits of increased returns.

This approach might also have implications for the Government's approach to regulation post-privatisation; particularly if it adopts a framework in line with the other privatised airports. Any imposition of a price cap which adopted the prices in the recent decision as a starting point would need to take into account the Commission's modelling. That is, the chosen X-value should allow for the cost savings already factored in to the Commission's decision.

The Commission's modelling did not, however, allow for future maintenance capital expenditure. Should a price cap on Sydney Airport be implemented we would like to see such expenditure incorporated into the X-value. The privatised airports currently have maintenance capital expenditure included in their 'X' values, with special

provisions to allow the pass through of costs associated with necessary new investment. Doing the same for Sydney would ensure consistency across all privatised airports, and simplify the administrative processes.

FUTURE REGULATION OF SYDNEY AIRPORT

It is likely that the regulatory arrangements that will be set in place for Sydney Airport post-privatisation will differ from those under which the recent decision was reached. The Commission does not determine the framework, and we therefore await with interest the Government's indications on this front.

The recommendations of the current Inquiry into price regulation of airports, being conducted by the Productivity Commission, and the Government response to its report are not likely to be available until after Sydney Airport is sold. The framework that is put in place will therefore not be based on the results of that Inquiry.

That said, it is likely that the framework that is put in place for Sydney will in many respects resemble what we have seen with the Phase 1 and Phase 2 airports.

APPROACH TO REGULATION AT PRIVATISED AIRPORTS

The Commission has now had four years experience in regulating privatised airports. To the extent that the framework for Sydney is likely to be similar, the lessons to date

will be relevant to bidders. In generally administering the regime the Commission is striving to achieve airport regulation that is efficient, transparent and consistent.

Some general observations can be made about the experience to date.

- Airports have in the main complied with the price cap. The qualification here relates to taxi charges, with the implementation of these fees leading to what the Commission considers to be breaches of the price cap at some airports. This issue is yet to be completely resolved.
- Good quality of service results have been recorded at the privatised airports. This suggests that, to this point, even in the face of price reductions, quality of service standards have not been sacrificed by airport operators in order to cut costs.
- The Commission has seen a move towards commercially driven aeronautical investment. All the major airports have brought significant notifications to the Commission in relation to capacity and quality enhancing projects. In the case of some airports, for example Brisbane, the new investment proposals come with the strong support of users.

The Commission aims to overcome problems, such as excessive pricing, in markets that have monopoly characteristics, while at the same time encouraging efficient investment.

One of the most important, yet understated, aspects of the Commission's approach to airport regulation is determined by the fact that it operates within the bounds set by the legislative framework formulated by the Government. This limits considerably the discretion of the Commission.

The Commission's role is to administer the formal framework handed to it by the Government. Within this framework, there is sometimes a need for interpretation of certain aspects that have not been specifically defined, or that are unclear from an operational sense. The Commission's approach has been to provide public clarification on these aspects, in the form a public consultation processes, involving issues papers, and submissions.

Two examples of where the Commission has attempted to clarify a general principle in its framework were seen in the Commission's interpretation of "new investment" in the context of the necessary new investment provisions, and in the definition of "direct

costs" in the context of passing-through security changes in the price caps applicable to privatised airports.

The Commission considers that the publication of these two guidelines has contributed much higher levels of certainty, clarity, and transparency in the operation of these aspects of the framework.

A related and equally important aspect of the Commission's approach to airport regulation is the relationship between the Government and the regulator. In an airports context the Commission takes its legislative framework as a given; that is, the conduit by which government intent and policy flows through to the regulator is the formal legislative instruments enacted or directed by government. The Commission then administers and applies this given framework. The corollary to this is that if the Government is not satisfied with certain elements of the framework, then the path to change is clearly to change the formal instruments or legislation.

At the same time, the application of the regulatory system by the Commission is not set in concrete. The Commission's decisions are appealable through Administrative Decisions Judicial Review processes. The ability to seek this path is another thing that guides the Commission's approach, as it implies that it is important that we follow due and fair process in our decision making. Another thing to note is that in the event of an ADJR review, the Courts place primary emphasis on the formal legal instruments, and are not likely to place any store on behind closed door discussions.

The Commission's interpretation of taxi access charges as charges relating to landside roads – a declared aeronautical service under the Minister's Direction - is an example of the Commission applying its due and proper function of interpreting the legal framework.

One recent example, where the Commission considered it was operating within the bounds of the framework, was in its recent assessment of aeronautical charges at Sydney Airport. In its draft assessment of the proposed charges, the Commission adopted an approach to pricing that took into account some revenues from aeronautical-related services. Following the release of the draft decision the Government issued a new direction stating that the Commission must give special consideration to *not* taking into account costs or revenues of services other than aeronautical.

Submission to the Productivity Commission

It will soon be five years since the privatisation of the Phase I airports in Australia. The Productivity Commission is currently conducting an inquiry into future regulation of airport services in Australia. The inquiry covers Sydney Airport as well as the airports already privatised. It is likely to have important implications for regulation of Sydney Airport as, over time, the regulatory provisions at major airports are harmonised.

Last week the Commission released its submission to that inquiry. The submission concludes that Australia's large airports should continue to be price regulated. The reason is that these airports are regional monopolies. Except for smaller regional services there are no alternatives for travellers flying into cities such as Sydney, Melbourne or Brisbane. Furthermore planning restrictions and economies of scale effectively prevent new entry.

The submission's conclusion follows a detailed assessment of the issues drawing on the Commission's experience in regulating airports to date as well as input from a number of leading independent experts.

One of the arguments advanced in favour or deregulating airports is that airport operators are not in a position 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.

This argument has been rejected by two of Australia's leading economists. Professor Forsyth describes countervailing power as a "mirage". 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 in relation to larger airports. He points out that if an airline carried out a threat to reduce or cease services this would undermine its own profitability and lead to significant gains to rival carriers.

The potential for market failure in the provision of airport services has been widely recognised overseas. In every developed country governments have regulating prices at privatised airports – except in New Zealand. There the outcomes of the so called 'light handed' approach (the threat of price controls) 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.

In its submission the Commission concludes that deregulation would result in substantial price increases. These would be borne by airport users and could result in significant efficiency losses the Australian economy, particularly the tourism industry.

Such increases in charges are not warranted. Advice from KPMG shows that pre-tax operating returns on net tangible assets at the large privatised airports (Melbourne, Brisbane and Perth airports) averaged a respectable 13.5% over the period 1997-98 to 1999-2000. Similarly the recent price increases at Sydney Airport are likely to deliver reasonable returns at that airport over the next few years. At the same time profit performance at the airports already privatised seems in line with expectations. Melbourne Airport, for example, announced that it "continues to perform ahead of the shareholders' bid business plan".

Currently CPI-X price caps apply to all of Australia's larger privatised airports. The Commission's submission recommends continued price cap regulation, but with a number of changes. The main proposals are as follows:

- Price cap major airports but not some of the smaller airports currently regulated such as Alice Springs, Coolangatta and Launceston airports. Monitor prices at these airports as a transitional measure.
- Introduce new provisions to encourage airport operators to undertake investment.
- Continue to include taxi charges in the price cap.

The Commission also proposes broadening the services covered by the price cap to include aircraft refuelling services. The arrangements in place now only cover 'aeronautical' services. No price restraints apply to the other services.

The Commission considers that the definition of 'aeronautical' is too narrow. The risk is that the regulatory measures will be ineffective with 'regulatory bypass'. There is already evidence of this. The current price cap aims to reduce airport landing charges over time. The introduction of fuel throughput levies at some of the airports has offset a substantial part of those reductions.

The submission is available on the Commission's web site.

CONCLUSION

In summary, there are a few key messages that I would like to emphasise in relation to the regulation of airports.

- Regulation is important to protect the interests of users.
- At the same time, the regulator must strike a balance between commercial and consumer interests.
- We have all now had the benefit of considerable experience with regulation.
- Potential bidders for Sydney Airport can learn from this experience also.
- Interested parties are welcome to talk to the Commission to understand their rights and obligations under the framework.