



AIRPORTS & AVIATION OUTLOOK '99

Melbourne
Monday 9 August, 1999

“Privatisation Review”

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Introduction

The aviation industry is one of the larger and more important industries in Australia. It facilitates our tourism industry and provides the necessary infrastructure to make Australia one of the leading tourist destinations in the world. With approximately sixty million plus passengers utilising the privatised airports and more than six hundred million dollars in direct revenue generated each year, the airport industry is vital to Australia's growth and prosperity.

Due to the importance of the airport industry in Australia and its natural monopoly characteristics, the government created a strong regulatory regime for airports, prior to privatisation. The regulatory regime covers the phase I airports sold in June 1997, and the phase II airports which were sold in May 1998.

The Australian Competition and Consumer Commission has primary responsibility for implementing and administering the economic regulatory arrangements that apply to these airports. The Commission also has an economic regulatory role for Sydney Airport, which has some similarities to its role for the privatised airports.

The regulatory regime comprises a package of measures under the *Trade Practices Act 1974*, the *Prices Surveillance Act 1983*, and the *Airports Act 1986*.

The Commission has been administering the economic regulatory arrangements that apply to the privatised phase I airports (Melbourne, Brisbane and Perth) since July 1997 (two years). The Commission has also been administering similar arrangements for the phase II airports since June 1998.¹ In this time, the Commission has dealt with a number of important issues and gained valuable practical experience in administering the legislative framework.

This paper reviews the Commission's experiences over the past two years. It focuses on:

- price cap compliance and quality of service issues;
- fuel throughput charges;
- the issue of new investment and cost pass through; and
- airport access provisions and their implications for airport operators.

Airport Regulatory Arrangements

The regulatory regime comprises a package of measures with a price cap on aeronautical services and access arrangements. The package also includes a number of complementary measures including formal prices monitoring, quality of service monitoring, new investment provisions and a review of the regulatory arrangements after five years.

¹ Phase II airports are Adelaide, Alice Springs, Canberra, Coolangatta, Darwin, Hobart, Launceston and Townsville.

In many respects the airport regulatory arrangements closely resemble those that apply in other industries. The access arrangements are based on general provisions of the *Trade Practices Act*, which form the basis for the regulatory arrangements in the gas, electricity and telecommunications industries. Aspects of the prices oversight arrangements are also similar to regulatory arrangements in place for other industries. For example, the price cap is similar to that applied to a range of services provided by Telstra, and quality monitoring is used in the regulation of both the telecommunications (by the Australian Communications Authority) and electricity industries under their respective codes.

Indeed airport operators with international experience may be familiar with the regulatory framework imposed on privatised airports in Australia. The arrangements are similar in many ways to the regulatory framework that applies to privatised airports in the United Kingdom. For example, both regulatory frameworks have a price cap on aeronautical services and the price caps are of the CPI-X form.

In today's converging markets, airport privatisation and hence regulation has become the major focus of many of the world's governments. New Zealand, and many South American countries, for example, are moving towards privatisation and regulation and are looking to the experiences of other regimes, such as that of Australia, for guidance in developing their own forms of regulation.

In light of this, I thought it timely to discuss some of our experiences to date.

Privatisation two years on

In general, the experience over the past two years has been positive for airport users.

- The pricing outcomes have generally been good, with the recent price cap reconciliation at the phase I airports indicating that prices have been reduced in line with the CPI-X values.
- Similarly, good quality of service results have been recorded at the phase I airports. This indicates 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 investment. The Commission has received applications from Perth Airport and Adelaide Airport to pass through the price cap the cost of new investment. The Perth application has been approved and the Commission has released a draft decision on Adelaide Airport's application.

In general, the Commission considers that it has developed a constructive working relationship with airport users and airport operators over the past two years.

There are, however, some concerns that have arisen over this time.

- The gains for users, in terms of the lower price capped aeronautical charges, may be eroded. The Commission and airport users are concerned about increases in

prices for aeronautically related services such as fuel throughput. The Commission has made recommendations to government on the fuel throughput issue and is awaiting a response. I will discuss this issue in more detail shortly.

At this point I would like to detail some of the positive results derived from the regulation of airports.

Aeronautical Charges

In administering the legislation, the Commission assesses the price cap compliance of each airport at the end of the financial year. This allows the Commission to determine if airport operators have reduced charges for declared services by the required CPI-X amount.

As reported in the Commissions 1997/98 regulatory reports, the results of the price cap reconciliation shows that prices for aeronautical services are being reduced in line with the relevant price caps at each of the phase I airports.

Melbourne and Brisbane airports more than complied with their CPI-X price cap. Both airports reduced landing charges by approximately double CPI-X half way through the financial year. In this way they sought to meet the requirements of the price cap over the full financial year.

Perth Airport reduced charges by 3.15% instead of the required 3.4% (the relevant value adjusted for inflation). While charges were lowered by twice the CPI-X amount six months into the year, traffic outcomes resulted in the over recovery of revenue at Perth Airport. Perth Airport has two years to pass back the respective revenue to the appropriate group of users.

Prices at the phase II airport have also been reduced in line with the CPI-X requirements. Most airport operators have provided data to the Commission indicating that prices were reduced on July 1 to bring charges in line with the price cap.

The Commission considers this to be a positive result and a good indication of airport operator's willingness to comply with the regulatory framework.

Quality of Service

The price reductions for aeronautical services at the phase I airports have not resulted in quality reductions so far even though, under the regulatory framework, there may be incentives for airport operators to cut costs by reducing quality for certain services.

Commission monitoring shows good quality results at the phase I airports.

Under the regulations to the Airports Act, airport operators are required to provide information to the Commission on a range of quality indicators. These indicators cover various aspects of an airport's service quality performance and focus on services covered by the price cap.

The results indicated that:

- Brisbane Airport achieved high scores in each category surveyed. As an example, over 70% of passengers surveyed at Brisbane Airport were satisfied or very

satisfied with the waiting time for Government inspection. Gate lounges rated similarly.

- Melbourne Airport also performed well in terms of customer perceptions of quality. Government inspection waiting time and airport access were rated as good to excellent, with most other indicators rated similarly. Baggage was the only category surveyed which rated below good. It achieved a score of 3.9 indicating that customers rated the facilities from average to good.
- The customer perception survey at Perth airport also indicated high quality of service levels. In most instances, 70% of customers rated the quality of facilities at Perth airport as very good to excellent.

Customer perception surveys were not the only source of information used by the Commission to rate the quality of service at the airports. Surveys of airlines were conducted by the Commission on the quality of aprons, runways, taxiways, gates, aerobridges, check in-facilities and baggage processing facilities to name a few. For example, at all three airports gates and runways were rated from satisfactory to excellent.

Fuel Throughput

The Commission is, however, concerned that the good results achieved in the price cap reconciliation and quality of service monitoring may be off-set by price hikes in some areas which are not covered by the price cap but where the airport operator may have a substantial degree of market power.

The Commission would not like to see price decreases for aeronautical services eroded by unjustified price increases in such areas. In fact, the economic regulatory framework directs the Commission to be wary of attempts by airport operators to exploit market power situations.

The Commission has been directed by the Treasurer to undertake formal prices monitoring of aeronautical related services, which may be subject to substantial degrees of market power. The Commission may make recommendations to government for stronger forms of price control if it is found that airport operators have misused their market power in setting prices for such services. Aircraft refuelling is one of the services the Commission is required to monitor.

In July 1998, Brisbane Airport introduced a new charge for aircraft refuelling services in the form of a fuel throughput levy of 0.4 cents per litre. Perth Airport has proposed a levy of 0.5 cents per litre at its international terminal. In line with the requirement that the Commission formally monitor aircraft refuelling charges, and following concerns expressed by airlines and oil companies about the introduction of fuel throughput levies, the Commission released a report on fuel throughput levies at privatised airports in December 1998.

The report is structured around section 17(3) of *Prices Surveillance Act* which requires the Commission to consider “the need to discourage a person who is in a position to substantially influence a market for goods or services from taking advantage of that power in setting prices”.

Based on its assessment of the relevant criteria, including extensive consultation with industry members, the report reached the following conclusions:

- The introduction of the fuel throughput levies at Brisbane and Perth Airports would significantly increase the price of refuelling services.
- The price increases were not justified in terms of increases in costs.

- There was a strong case that airport operators had market power in the provision of refuelling services.
- When considered in light of the lack of cost related justification for the levies, or offsetting reduction in charges, there was a strong case that by introducing fuel throughput levy's the airport operators would be taking advantage of market power.

In light of the report's conclusions the Commission recommended that stricter forms of prices oversight should be considered in relation to aircraft refuelling services.

The Commission considers this issue to be particularly important due to its broader implications. The potential impact of a fuel throughput levy goes beyond Brisbane and Perth Airports, and if implemented nationwide, could have a significant impact on the industry.

This issue is now before the government.

New Investment

The regulatory framework provides for the pass through of charges to fund 'necessary new investment'. The provisions allow an airport operator to apply for increases in charges beyond those allowed under the CPI-X price cap. The Commission has the role of assessing applications for such increases.

The new investment provisions are included as part of the regulatory framework to provide incentives for airport operators to invest in appropriate commercial ventures. At the same time, the legislation is directed towards protecting users by ensuring justified price increases.

In assessing a new investment cost pass through, the Commission is guided by nine criteria, set out in the Direction. The criteria focus on the efficiency and quality outcomes of investment for the airport's operations and the relationship of the proposed charges to costs and support from users for the proposals.

Adelaide Airport Limited (Adelaide Airport) has applied to pass the costs of a new Multi-User Integrated Terminal (MUIT) through the price cap. The MUIT would comprise a new passenger terminal and associated infrastructure to service domestic and international operations. Adelaide Airport proposed to recover the 'aeronautical' component of the costs of the MUIT through a charge on passengers (a Passenger Facility Charge or PFC). The PFC proposal would provide for:

- recovery of the 'aeronautical' component of construction costs (around \$150 million);
- a return on the investment; and
- a contribution to additional operating costs associated with the new facility.

In May of this year, the Commission released its Draft Decision on Adelaide Airport's proposal. The Commission is in the process of receiving submissions from interested parties and will draw on the comments received in making its final decision.

The Draft Decision was to allow a PFC of \$3.45 per arriving and departing passenger at Adelaide Airport. This compares to Adelaide Airports request for a charge of \$3.66. The difference arises from the rate of return methodology used and the allocation of costs between aeronautical and non-aeronautical functions of the MUIT. Adelaide

Airport proposed a pre tax nominal weighted average cost of capital of 8.89%. The Draft Decision was for 8.25%.

At this point, I would like to comment on two of issues relevant to the Commissions assessment on a new investment proposal.

Cost allocation

Since the framework only applies to ‘aeronautical services’, costs need to be separated into aeronautical and non-aeronautical functions.

The allocation of costs is complicated by the presence of costs that are common to both aeronautical and non-aeronautical functions. For example, certain landside roads, such as those that allow the operation of car parking, car rental and valet parking businesses, as well as the pick up and drop off of passengers, are likely to fall into this category of ‘common costs’. This raises the question of how common costs should be allocated. The full allocation of these common costs to the aeronautical side is not likely to be acceptable to the Commission. Instead the Commission will seek to allocate the costs between aeronautical and non-aeronautical functions on a fair and reasonable basis.

Rate of Return

A significant proportion of the costs of most airport infrastructure investments is capital costs. The required rate of return on the capital invested is thus an important component of the total costs of an investment. I would like to make a few brief points on this issue.

- Firstly, the approach used in the regulation of airports is consistent with decisions made by the Commission in other industries.
- Secondly, the rates of return and relevant risks are estimated using the Capital Asset Pricing Model.
- Finally, the Commission understands the necessity for commercially driven ventures at airports and is confident that the legislation is designed to encourage such investment at all privatised airports.

For detailed guidance on the Commission’s approach to rate of return issues see the Commission’s publication ‘Principles for Regulation of Transmission Assets’. Although these principles were designed with the electricity industry in mind many of the issues are common to all regulated entities, including airports.

Access Arrangements

Another area of the framework that has recently been tested is the access provisions. Under Part IIIA of the *Trade Practices Act 1974* (TPA), declared services are subject to access by third parties.

Airport services at all privatised regulated airports, except Townsville will soon be declared. Declaration gives current and prospective airport users the right to negotiate terms and conditions of access with the airport operator. Furthermore, if the initial

negotiations prove unsuccessful, parties can request the Commission to arbitrate terms and conditions in relation to an access dispute.

Declaration is by reference to a number of criteria, not a list of services. Under the framework the Commission has the role of determining whether a particular service is declared. In other words, the Commission has the role of assessing the service in question against the relevant criteria to determine if it is an 'airport service' and thus declared for the purposes of Part IIIA of the TPA.

In October 1998, the Commission received its first request for a determination of an 'airport service' under section 192 of the Airports Act. Delta Car Rentals (Delta) requested a determination to clarify whether certain 'landside drive' services it used were declared. In April 1999, the Commission released its determination. The determination was that the *provision of landside roads and associated vehicle facilities for dropping off and picking up passengers at Melbourne Airport* is an 'airport service' for the purposes of section 192 of the Airports Act:

As a result of the determination the service is in effect declared for the purposes of Part IIIA of the *Trade Practices Act 1974*. This determination not only effects Melbourne Airport, but also has implications for other airports. The same test and processes are likely to be followed if a request for determination is received regarding services at another privatised airport. The Commission does not consider that determination or requests for arbitration should be the first point of call for users or operators, if a dispute arises. The Commission encourages the development of access arrangements with reasonable terms and conditions and considers it important for airport operators and users to develop working relationships with each other in the negotiating of contracts.

Conclusion

In conclusion then, the first two years of the Commission's role in regulating the privatised airports has seen some good results emerge in terms of price cap compliance and quality of service monitoring. The last two years have also given the Commission and the industry useful experience in terms of the new investment and access provisions.

It would, however, be disappointing to see these good results eroded by unjustifiable price increases implemented in areas where the airport operators have substantial market power.

Looking ahead, the Commission's review of prices oversight arrangements in the fifth year of operation of the cap is approaching. The Commission is required to table its recommendations before government early in 2002. It will draw on the experiences from privatisation in formulating its recommendations.

The Commission is beginning to consider the many issues associated with the review. The Commission intends to provide guidance on the review process, and the matters that it is required to consider, later this year.

Considering the importance of review to the industry, the Commission will consult extensively and will seek the views of all sectors in the industry. The Commission will seek views through submissions and through public hearings. I encourage you to contribute to this process so that an appropriate outcome can be achieved.