AIRLINES FOR AUSTRALIA & NEW ZEALAND

THE PERFORMANCE & IMPACT OF AUSTRALIA'S AIRPORTS SINCE PRIVATISATION

A preliminary report prepared by Airlines for Australia & New Zealand

MAY 2018

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PREFACE

This preliminary report represents the first stage of a broader piece of work which will comprehensively assess the market power exerted by both Australia and New Zealand's airports and the impacts of this on consumers and the respective economies.

Work undertaken to date identifies that in the absence of a formal threat of imminent regulatory intervention, Australian and New Zealand airports have been exercising market power; to the detriment of airlines, the broader aviation sector, consumers, and the economy.

A4ANZ believes that amendments to the current regulatory environment must be informed by robust evidence and has engaged both Frontier Economics and Johnson Winter & Slattery, to provide expert economic and legal analyses respectively.

"When competition is limited in a market, consumers can end up paying prices that don't reflect the cost of goods or services they receive. When this is the case, regulation can help mimic the effects seen in competitive markets so that consumers benefit in the long term."[1]

In undertaking this work, A4ANZ is advocating for and seeking to create a regulatory and pricing environment for airports that:

- Encourages competition and innovation;
- More accurately reflects cost inputs;
- Accurately reflects a reasonable and fair return on assets;
- Keeps growth at reasonable not exponential rates;
- Supports investment and maintenance of infrastructure that is fit for purpose, efficient and timely; and
- Maintains accessible airfares for consumers across all areas of Australia and New Zealand.

AIRLINES FOR AUSTRALIA & NEW ZEALAND

ABOUT US

Airlines for Australia and New Zealand (A4ANZ) is an industry group, established in 2017 to represent airlines based in Australia and New Zealand. Member-funded and representing international, domestic, regional, full service and low-cost carriers, A4ANZ advocates on key public policy issues relevant to airline operations, including efficient access to domestic airport infrastructure.

The A4ANZ Board identified at the time of the organisation's formation that one of its highest priority issues was the regulatory frameworks for Australia and New Zealand's monopoly airports.

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EXECUTIVE SUMMARY

Australian passengers and our economy are paying the price of airport privatisation in the absence of appropriate constraints on monopoly power. More effective regulatory pressure is required to prevent excessive profits by airports and return more value to consumers and the economy. This preliminary report by Airlines for Australia and New Zealand (A4ANZ) outlines new evidence of the impact of our current system on airfares, passenger numbers and service levels at Australia's monopoly airports.

Airport privatisation has not delivered anticipated benefits

Privatisation of Australia's airports promised to offer many benefits: more efficient management of assets, investment, and downward pressure on prices and airfares. Yet, in the absence of an effective regulatory regime, airport privatisation has ultimately resulted in higher costs for users: both airlines and passengers. This is starkly illustrated in the ACCC's most recent Airports' Monitoring Report.[2]

Increasing charges but quality levels unchanged

In 2016-17, Australia's four monitored airports made a combined $757.6 million in operating profits from aeronautical activity, a 10% increase. **The total combined profit went up by 11%**, to a record $2.1 billion. It is not a recent trend, however, with the **airports now collecting over 25 per cent more revenue for every passenger than they were 10 years ago, in real terms**. Total passenger numbers have also increased by nearly 20%, delivering an even bigger revenue boost for airports. It is important to note that while profits were growing, the ACCC found no commensurate increase in overall quality.

"Monopoly infrastructure operators have the ability to raise prices above a level that would prevail in competitive markets and little incentive to improve services above a minimum standard of service quality, to the detriment of economic efficiency and the living standards of consumers."[4]

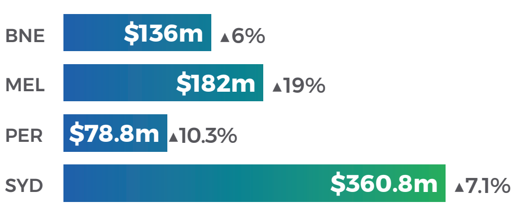
Australia's airports are monopolists

This situation has arisen because Australia's airports are, indisputably, monopoly operators. It is widely accepted that a private monopolist, as the sole producer of a service, is able to "*use its market power to set prices that exceed costs, to the detriment of economic efficiency and social welfare.*"[3] Regulation is intended to ameliorate these effects.

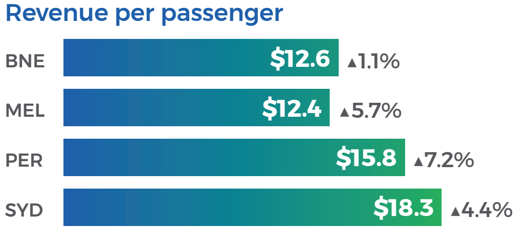
Light-handed regulation has been ineffective

In establishing the current light-handed monitoring regime for Australian airports at the beginning of this century, the Productivity Commission relied on a belief that just because airports have market power does not mean they will use or abuse it.[5] A4ANZ submits that this is a surprising conclusion as in both theory and practice, monopolists have little constraint on their ability to abuse market power to the detriment of

Operating profit



Revenue per passenger



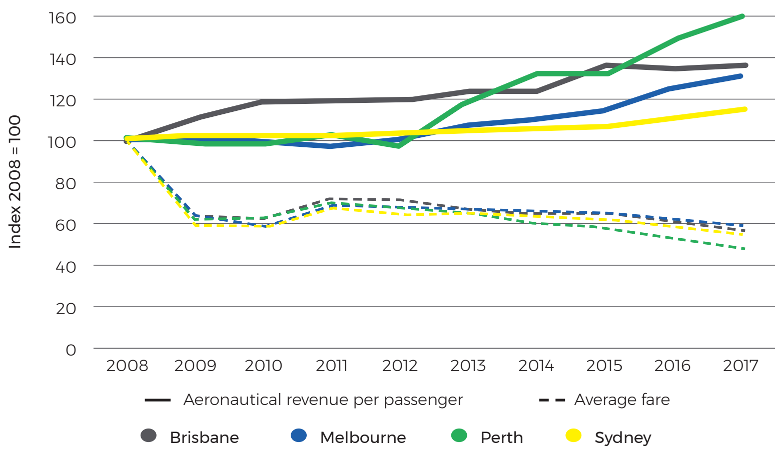
consumers. There is a large and growing body of independent evidence pointing to the fact that there is no real incentive for any of Australia's airports to behave otherwise.

Australian airports the main winners from passenger growth

By shining a light on this situation, A4ANZ is not seeking to start a debate about whether or not airports, or indeed airlines, ought to make a profit. Healthy, profitable businesses are vital to our economy, through job creation and innovation. It is clear, however, that one part of the sector is capturing the majority of the benefits that this growth brings. The contrast is stark between the profitability of airports and that of the competitive Australian airline market, with some airlines only recently returning to profitability. Airfares have been kept low and in fact declined over the same period that the airports have enjoyed uninterrupted growth in revenue per passenger (see Table 1 and Figure 1).

"The benefits of privatisation are realised when governments put in place adequate regulation to ensure competitive access and pricing."

Figure 1: Evolution of Airport Charges and Fares, 2008-17 (Real terms, 2017 AUD)



Source: IATA Economics based on ACCC and PaxIS

Table 1: Evolution of Airport Charges and Fares, 2008-17 (Real terms, 2017 AUD)

	AERONAUTICAL REVENUE / PASSENGER			AVERAGE AIR FARE		
	2008	2017	Change	2008	2017	Change
Brisbane	9.24	12.60	36%	514.14	290.73	-43%
Melbourne	9.47	12.44	31%	548.14	320.31	-42%
Perth	9.95	15.79	59%	801.25	383.83	-52%
Sydney	15.9	18.34	15%	666.11	366.35	-45%

Source: IATA Economics based on ACCC and PaxIS

Sustained monopoly profits

This preliminary report by A4ANZ provides a clear depiction of not only the ability of Australian airports to use their monopoly position to earn excessive profits, but the demonstrable proof that they have been doing so in the absence of a regulatory threat. This is a growth trend that began over a decade ago and which not only shows no sign of stopping, but is increasing.

Independent analysis undertaken by Frontier Economics confirms that earnings at Australian and New Zealand airports are excessive and significantly higher – in some cases more than double – than those of other airports around the world operating in competitive markets or with greater regulation (see Figure 2). Also of note in this figure is the margin at Auckland airport, which similarly operates in a light-handed regulatory environment.

Experts agree that there is a cost to passengers, airport users and the economy as a whole if monopolists are left to earn what ACCC Chairman Rod Sims has termed "*unfettered monopoly profits*"[6] over a long period of time, particularly without quality improvements.

A way forward

A4ANZ is not alone in suggesting that Australians and our economy could benefit from a change in the regulatory settings for airports, to mimic the effects of a competitive market. The Grattan Institute recently suggested greater regulatory controls for airports in its report assessing the costs of market power, and amendments to improve the effectiveness of New Zealand's regulatory regime are currently being considered. Moreover, A4ANZ's proposed solution to address the current situation is not without justification or precedent. It is entirely consistent with previous statements from the ACCC, that the development of commercial relationships between airports and their customers would be encouraged by the existence of a credible ability to seek arbitration.

This goes beyond an attempt to balance the ledger, however. A vibrant aviation sector will drive efficiency and innovation, which in turn is good for consumers and the economy.

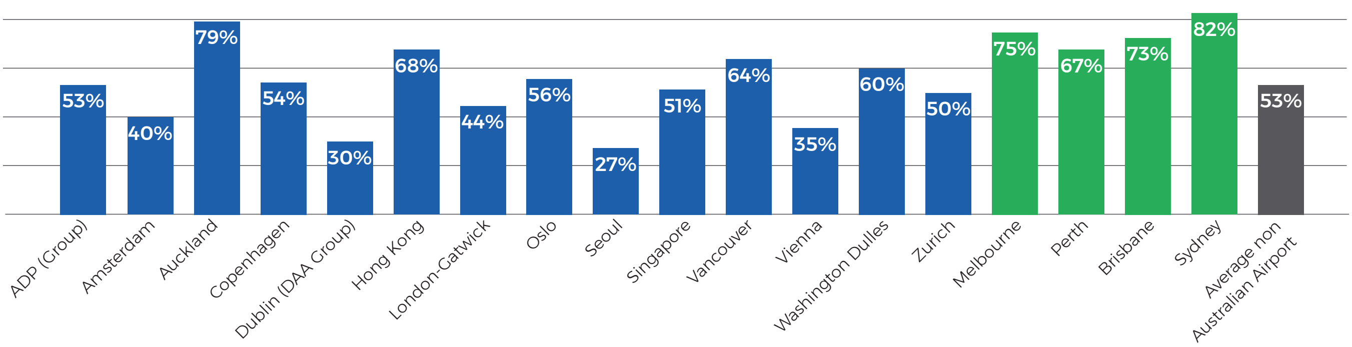
According to IATA Economics, the independent economic consultancy of the International Air Transport Association, if airport passenger charges had remained at their 2008 levels instead of increasing over the past decade, this would have delivered significant benefits at the four airports, estimated to be:

- Savings for passengers of AUD 180 million through lower charges;
- The potential for additional travel, driving an additional 1.23m domestic passengers.

Unfortunately, however, the current system of regulation in Australia does not create the right environment for airlines and airports to work in partnership to ensure these gains can be achieved. Instead, they foster the monopoly power of airport owners - a power that enables increasing charges to be extracted from airport users.

A4ANZ members are committed to building, maintaining and improving positive, constructive commercial relationships with airports. They also want to see airports, and the whole aviation sector prosper. It is not only in the airlines' interests, but in their passengers' interests, as well as the interests of Australian tourism and export sectors, and the broader economy for this to occur. We look forward to working with all stakeholders to achieve this outcome.

Figure 2: Comparison of EBITDA margins, 2008-2015



Source: Frontier Economics calculations 2018

BACKGROUND

Airlines, airports and the aviation sector more broadly provide vital services to the Australian community and are key drivers of Australia's economy. To ensure that this vital sector is efficient, sustainable, and continues to foster innovation, there needs to be appropriate airport behaviour and operations, and efficient access to domestic airport infrastructure.

Most major Australian airports are now privately operated. In 1997, the Australian Government began privatising its airports, concluding with the sale of Sydney Airport in 2002.[7] These sales were undertaken with the intention to regulate the privately operated airports as a safeguard against market power misuse. Twelve airports were originally subject to price regulation under the *Prices Surveillance Act 1983*[a], which included price notification, price monitoring, price-cap arrangements and special provisions for necessary new investment at airports.[8]

In 2002, as a result of the Productivity Commission's review of regulatory arrangements for airports, the Government removed price notification and price caps on aeronautical charges. This was in response to broad economic uncertainty, as well as the Productivity Commission's findings which supported lighter-handed regulation, having determined that even though a number of the airports were assessed as having market power, they were not likely to use or abuse that power.[9]

The new system of regulation consisted of price monitoring of charges for aeronautical and related services at Adelaide, Brisbane, Canberra, Darwin, Melbourne, Perth and Sydney airports. This price monitoring was overseen by the Australian Competition and Consumer Commission (ACCC).

The annual monitoring reports have evolved over time such that the ACCC now reports on prices and costs, and well as service quality. In more recent years, the ACCC has also reported on car parking services, but now only reports on four airports which had been assumed to have the strongest degree of market power: Sydney, Perth, Melbourne and Brisbane.

For many years the annual ACCC monitoring report has noted significant increases in aeronautical revenue per passenger (a proxy for airport charges) across the monitored airports.[10] The latest ACCC report shows that Australia's four largest airports are collecting over 25 per cent more revenue for every passenger in real terms today than they were 10 years ago.[11]

These results stand starkly at odds with the claim in a recent report commissioned by the Australian Airports Association, that *"pricing at the four largest airports is implicitly constrained by the potential for the return of explicit price regulation if the airports are found to have misused their market power."*[12] This claim is contradicted by the Grattan Institute's analysis of competition in Australia, which found that *"the [airport monitoring] regime has not done much to constrain market power in some capital city airports"*[13], a concept we consider in more detail in this report.

Furthermore, the ACCC has highlighted the failures of the regime, noting that price monitoring is unable to *"restrict the airports from increasing prices and allowing service quality to decline."*[14], and flagged concerns about the demonstration of market power by the monitored airports.[15]

As the results outlined in this report and the Frontier Economics analysis that follows show, airport pricing and profitability is showing no signs of any constraint. This report explores the implications of this market power, and makes a clear case for change.

a. The 12 airports included: Adelaide, Alice Springs, Brisbane, Canberra, Coolangatta, Darwin, Hobart, Melbourne, Launceston, Perth, Sydney and Townsville

HAS AIRPORT PRIVATISATION COME AT A COST?

Privatisation of infrastructure promises to offer many benefits: more efficient management of assets, investment, and downward pressure on prices. Yet, in the aviation sector internationally, poorly thought-out airport privatisations have meant the anticipated benefits have not always been realised.[16] Instead, airport privatisation has ultimately resulted in higher costs for users: both airlines and their passengers, an outcome that appears to be seen as inevitable by airports.[17]

However, the issue is not one of privatisation per se, but privatisation in the absence of appropriate regulatory controls where the infrastructure is also a monopoly. The Business Council of Australia captured this in stating that *"it would be better to focus on getting privatisation right, which is why appropriate regulation of the privatised asset after the sale to maximise the gains of private ownership is key. The benefits from privatisation are realised when governments put in place adequate regulation to ensure competitive access and pricing."*[18] This position endorsed the earlier directive from the Hilmer Review, that the privatisation of monopolies required safeguarding through regulation.[19]

Australia's current light-handed approach to the economic regulation of airports is based, at least in part, on the implicit assumption that Australian airports do not have significant market power. In the sections that follow, we demonstrate that this is not the case and the current regulatory approach is therefore inadequate.

WHAT MARKET POWER LOOKS LIKE

Market power can be measured in a number of ways. One of these is to examine the performance of the market.

In particular, in assessing whether a particular enterprise (or group of enterprises acting jointly) is enjoying substantial market power, one can examine the extent to which it has been able to generate profits above the level that would be expected in a market characterised by effective competition.

The Grattan Institute noted that monopoly airport operators have been able to earn returns that can be classed as "super-normal profits".[20] The Productivity Commission's (PC's) 2011 report found that Brisbane, Melbourne, Perth and Sydney airports had "sufficient market power to be of policy concern", recognising the efficiency losses that may result if that power is exercised.[21]

To independently assess the extent to which Australian airports have exercised their market power following the removal of formal economic regulation and price control, Frontier Economics applied a rigorous methodology to measure the ability of the airports to earn returns above those that would be earned if the airports were constrained by competition or regulation.[b] Due to the scarcity of reliable and consistent data at non-monitored airports, this analysis covers only the four airports that have been the subject of ongoing price monitoring by the ACCC, which have the most complete data sets available.

Frontier followed standard economic analysis in defining excess returns as a return on funds invested above the costs of those funds. The assessment of returns is not limited to aeronautical activities because to do so would require arbitrary allocations of shared costs between aeronautical and non-aeronautical activities.

Frontier took a conservative approach to their calculations, and as such we might expect that both the excess returns and the margins are even higher than shown here.

Performance of the four monitored airports

Frontier estimated the present dollar value of the excess returns accruing to the owners, suggesting that the dollar value of the overcharging to airport users (including both airlines and other users) is large, even when using the airports' own estimates for cost of capital. Taking into account the time value of money and bringing the value of excess returns to 2017 dollars shows that the likely value of excess return at around $7 billion across all four airports. These figures are considerably higher if one includes the value of the profits accruing to government and captured in the sale prices, with their calculations indicating the value could in fact be over $16 billion in 2017 dollars. Again we note that these estimates are likely extremely conservative.

b. The analysis used a range of methods to produce robust results. These were also compared against results of methods regularly used by competition authorities and regulators, such as the ACCC. A full report of the work undertaken by Frontier Economics on the *Profitability of Australian Price-Monitored Airports* will be made available as part of A4ANZ's submission to the Productivity Commission

Benchmarking Australia's airports

To cross-check the main results and provide a benchmark against which to measure Australian airports' performance, Frontier also considered the returns earned by international airports that are subject to either competition or effective regulation.

The measure used was EBITDA margins,[c] a useful indicator by which to compare airport profitability because it adjusts for airport size (revenues), and is not affected by how airports finance their operations, face different tax regimes, or depreciate their assets. We note that it does not account for the recovery of capital costs, which can distort the results if capital costs vary dramatically. However, this weakness is overcome if the margins are persistent over a long enough time period, which we can see is the case for the Australian airports (Figure 3).

Figure 3: EBITDA margins of Australian airports, 2002-2016

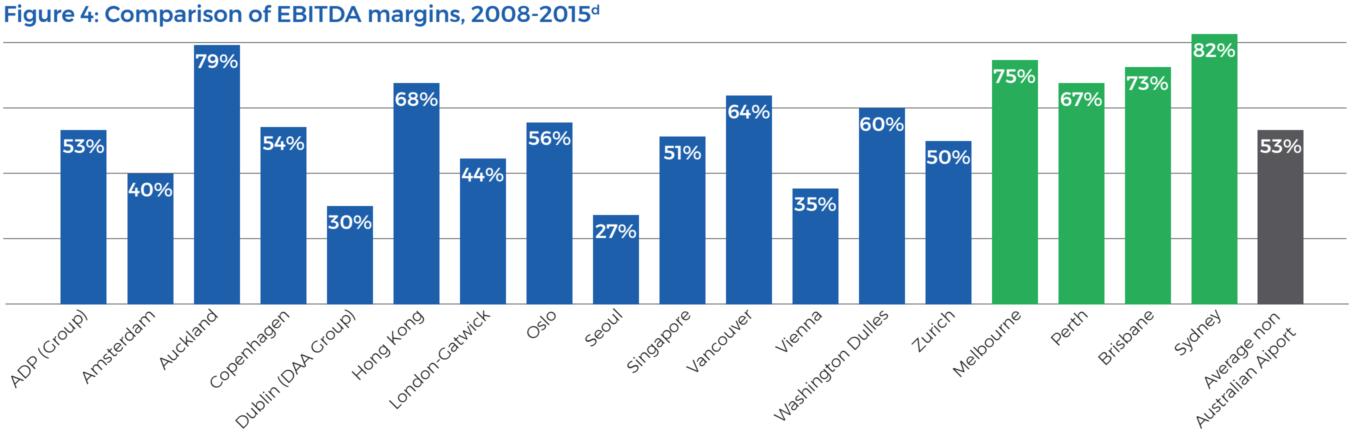
Source: Frontier Economics calculations 2018

Sydney earns the highest margin of any airport in the sample shown (more than 8 of every 10 dollars earned contributes to profits), and the other Australian airports are all in the top 6 in the international comparison.

These returns are naturally much higher than average EBITDA margins for firms in the economy, which reflects in part the capital intensive nature of airports' operations. However, when Frontier then undertook the comparison with international airports, we see that all of the monitored Australian airports also have EBITDA margins well above the average margin calculated across a sample of comparator airports (see Figure 4).

To further assess whether differences in EBITDA margins could be due to different stages of the investment cycle (i.e. high investment leading to high capital charges), Frontier also calculated EBIT margins for the same airports.

Figure 4: Comparison of EBITDA margins, 2008-2015[d]



Source: Frontier Economics calculations 2018

c. Earnings before interest, tax, depreciation and amortisation (EBITDA) margins provide an indication of the cash-earning potential of a business.
d. The time period used is up to 2015 only due to insufficient data across all comparator airports for the 2016 year

It was apparent from those data that average EBIT margins at all the Australian monitored airports, at between 60-64 per cent are extraordinarily high by international standards (average 29 per cent). Only Auckland – another airport subject to price monitoring – had margins comparable to the Australian airports.

These comparisons support the conclusion that the earnings of the Australian airports are consistent with the exercise of market power. Auckland airport is similarly shown to be earning excessive returns. This accords with market analysts' views on the major Australasian airports that EBITDA margins are growing and will continue to do so, at an even higher rate than they have done historically.[22]

Beyond the monitored airports

Market power is not simply an issue for the four major monitored airports. Across Australia, monopoly airports are exerting market power – this includes both Tier Two airports and regional airports.[23]

As noted previously, financial performance is not the only indicator of market power. Furthermore, the absence of excessive profits does not mean market power does not exist. A reported 60% of regional airports are running at a loss, yet they are still able to exercise their market power in other ways.

In the absence of reliable financial data, the market power of Tier Two and regional airports may also be assessed through the analysis of the structure of the market and patterns of airport conduct.

Airline countervailing power has been cited as a factor reducing an airport's ability to exploit its market power, particularly in the case of some Tier Two and regional airports. However, it is unlikely to be a relevant consideration in the Australian context, because it would require airlines to have a credible option to cease or postpone their service, or take up an alternative option. In other words, the risk of an airline switching is only relevant where there is another potentially competitive airport or destination that could be serviced. There are very few circumstances in Australia where this pre-condition would hold, as we discuss further in this report.

Case Study

Airport A is a federally leased airport not subject to monitoring. It is located 300km away from the next closest airport, Airport B. Other major population centres are at least 700km away. These centres also have airports that are neither monitored nor covered by the Airports Act.

Airport B is situated in a major population centre. Airport A services a smaller, yet still significant population centre. While both are important domestic airports, Airport B is a hub airport with significant international connections.

The major mode of land travel between the two population centres surrounding Airport A and B is a road link; there is no high speed rail. The travel time using the road link is approximately 3 hours, outside of peak traffic.

Fewer than 30% of visitor nights spent in the region surrounding Airport A are for the purposes of a holiday. The majority of trips, both daytrips and overnight stays, are for the purpose of business, and visiting friends and relatives.[24]

This airport readily meets the conditions for market power due to the absence of competition between neighbouring airports, the lack of options for modal substitution for all but one route, and the fact that destination substitution is also unlikely, given the major purpose of travel is not discretionary.

This assessment of market power is confirmed with the airport imposing high charges on its users, and anecdotal evidence of behaviours consistent with its monopolist status, such as a lack of transparency and inflexibility in approach to negotiations.

AIRPORTS AS NATURAL MONOPOLIES WITH MARKET POWER

Australian airports are naturally monopolistic. The monopoly characteristics of airports stem from their high sunk costs and from their characteristics as a network.

Furthermore, where a natural monopoly has substantial sunk costs and a location that cannot readily be replicated, its market power is likely to be substantial because it will not face the constraint of competition.

An airport with market power has the ability to sustain prices for its aeronautical services above efficient costs or deliver a poor quality of service. This can prevent people travelling either because the cost of air travel is higher than it needs to be or because airlines can no longer profitably provide some services.

This acts as a drag on the economy. Higher airport charges put pressure on airfares which in turn:

- raises costs for business, hampering their ability to compete in Australia and abroad;
- reduces face to face connections between families, friends and communities; and
- constrains growth in both international and domestic tourism.

Applying Frontier Economics' Airport market power assessment framework opposite, it is clear that there are very few circumstances where an Australian airport may face a significant competitive constraint on its market power.[e]

Options are limited for passengers

The competitive constraints on an airport are driven by the degree to which passengers have alternative ways of satisfying their demand for travel. This could be through alternative airports, using other land based modes or travelling to other destinations. Airports that face more significant substitution possibilities will face more price-sensitive demand (and hence have less market power).

It is important to note that the existence of choice does not equate to effective competition. To understand the extent to which alternative airports, modes and destinations act as a competitive constraint on an airport it is necessary to understand how many passengers would switch in response to rises in airport prices.

Figure 5: Airport market power assessment framework

1 Demand side substitution possibilities?	Other airports	Other modes	Other destinations
2 Passenger switching response?	Taking into account travel purpose: › Visiting friend and relatives › Business › Leisure › Transfer		
3 Airlines ability to respond?	› Capacity and operational constraints at other airports › Airline operational characteristics and switching costs › Route profitability		
4 Supply side substitution?	New entry	Expansion conversion	
5 Materiality to the airport?	› Relative importance of routes where substitution is possible › Degree of airport charge pass through › Passenger mix by travel purpose		

Source: Frontier Economics, 2018

e. A full report of the work undertaken by Frontier Economics on the *Market power of Australian Airports* will be made available as part of A4ANZ's submission to the Productivity Commission

Competition between airports is not relevant in the Australian context

There are very few circumstances in Australia where a major population centre could be argued to be fully serviced by two or more airports. Even where there is the prospect of choice, access time, and the frequency of air services from an airport, drive passenger decision making. For the majority of passengers the additional travel time associated with getting to a more distant airport is high relative to any difference in airfare. This means a passenger's preparedness to switch to a more distant airport in response to a change in air fares is extremely limited. Adding to this, there are likely to be limits on an airlines ability to shift its services. For example, due to capacity or operational constraints at other airports and the high costs associated with switching.

In theory an airport may face competition from more distant hub airports if connecting passengers are able to choose alternative air travel routes between their origin and ultimate destination. However, this is not considered relevant in the Australian context. While connecting passengers represent between 30-60% of passengers using major hubs in Europe they represent only a small fraction of the overall passenger traffic using Australia's major city airports —less than 1%. This is unlikely to pose a material competitive constraint on an airport.

Modal substitution is unlikely to be material

For a select few Australian airports it may be possible for some passengers to use alternative modes of transport on some routes. However, the extent to which this act as a competitive constraint on an airport is limited by a number of factors:

- Modal substitution may only be a relevant consideration for short haul routes— this means only a proportion of passengers serviced by an airport have any capacity to switch which increases the ability of an airport to profitably raise prices.
- For airports servicing a high proportion of business travellers, the demand response to any increase in airport charges may be limited, further enhancing airport market power.

Destination substitution may be relevant, but only in specific circumstances

For passengers travelling for leisure a viable travel alternative maybe another destination —for example, a holiday maker may regard Port Douglas and Cairns as substitutes for the Sunshine Coast.

This will only constrain an airport's market power if it predominantly services the inbound discretionary tourism market.

Airline countervailing power will not protect against airport market power

Countervailing power is a term used to describe the ability of large buyers in concentrated downstream markets to obtain price discounts or counteract the ability of a supplier to exercise its market power.

We do not consider airline countervailing power to be a relevant consideration. This is because a necessary condition for countervailing power is that airlines have a credible option to cease or postpone their purchase, or take up other 'outside alternatives'. In other words the risk of an airline switching is only relevant where there is another potentially competitive airport or destination that could be serviced. There are very few circumstances in Australia where this pre-condition would hold.

For an airline the cost of withdrawing or reducing its services would be high. Airlines suffer significant brand damage when they attempt to reduce services; this can also affect the configuration and reach of their network and ultimately their profitability.

The Frontier framework outlined in Figure 5 can be applied to numerous examples of airports in Australia, most obviously the monitored airports. As the case study outlined earlier shows, however, there are many examples of airports across Australia which satisfy the above conditions for market power. It is important to note too, that these conditions can apply regardless of the level or status of profitability of the airport. As we have shown, while excessive profits are one demonstration of market power, there are other elements. A consistent theme, however, is the high - and increasing – charges.

AIRPORT CHARGES REFLECT THEIR MARKET POWER

There appears to be a commonly held view – including by the Productivity Commission in 2011 - that airports and airlines ought to be left to undertake "commercial negotiations" as would occur in other business settings. However, this approach completely ignores airports' monopoly status and the fact that they enjoy a natural bargaining advantage over airlines.

This is due to:

- **Market power:** As outlined above, airlines typically have few (or no) alternatives. Even where there is competition from other airports, it may be difficult to feasibly relocate services.
- **Informational advantages:** Airports are likely to know more about their own asset (e.g. the costs, utilisation and capacity) than airlines. This may give an airport an advantage during negotiations.

Clearly, an airport has an incentive to exploit these advantages in any negotiations, and to display any or all of the following behaviours (not exhaustive):

- Adopting a 'take it or leave it' position;
- Delaying or refusing to disclose necessary background information or material facts, thus delaying settlement;
- In other ways protracting negotiations;
- Developing agreements that fail to provide contractual certainty or lack clarity and transparency;
- Using media to put pressure on airlines to accept deals; and
- Withdrawing unrelated services during negotiations and disputes.

A4ANZ members' experiences with many airports reflect this imbalance in the bargaining power between airlines and airports, with commercial negotiations between the parties often not conducted in accordance with the Government's Aeronautical Pricing Principles, which include, for example, sharing of risks when there are changes in passenger traffic.[25] This is not to say, however, that all airports display these behaviours in negotiations; our members have also shared some examples of airports working collaboratively and constructively with them in the process of coming to an agreement, and at an operational level. That said, airports are commercial entities beholden to shareholders and as such have been described as perfectly *"entitled to exploit legislative short-comings with a profit maximisation objective"*.[26] It is therefore no surprise that high charges result, and continue to increase each year.

Against this background, the extent to which the engagement between airports and airlines represents "negotiations" is questionable. The fact that an outcome is produced does not have any inherent value and it is likely to be the case that superior outcomes could be achieved from a framework that is more conducive to genuine negotiations.

While the Australian Airports Association (AAA) contend that the current regulatory environment *"promotes private investment… and ensures airports remain focused on delivering the best possible outcomes for passengers and their airline partners"*[27], it is clear from what has been outlined above, that there is in fact a disincentive for airports to focus their attention this way.

Frontier Economics' summary of the evidence on monopolists shows that firstly, high prices (and/or low quality) can result in inefficient under-utilisation of airport infrastructure and services, including by airlines, passengers and related markets such as those that rely on goods transported by air. Secondly, firms with market power may invest inefficiently or under-invest, so that demand for their services will exceed supply, leading to further potential for monopoly prices. This can also lead to underinvestment in related markets. Thirdly, an airport exercising its market power could operate inefficiently by allowing its costs to rise or by it not adopting cost-saving or innovative technologies. Finally, monopoly pricing is of concern to the community and

Figure 6: Evolution of Airport Charges and Fares, 2008-17 (Real terms, 2017 AUD)

Source: IATA Economics based on ACCC and PaxIS

consumers, especially as they will ultimately pay for any monopoly rents.

Consumers have largely been shielded from the impact of increasing charges as airlines have kept airfares low through driving efficiencies in their own businesses. Taking inflation into account, **air fares actually fell between 42% and 52% in real terms over the same period as airport passenger charges paid on the average air fare to fly from Australia's airports increased by 15-59%** (Figure 6).[28]

The above appears very stark when presented in the format shown in Figure 6 and Table 2, from IATA Economics.[29]

As highlighted above, the fact Australian airports are now collecting more revenue per passenger and generating significantly higher profits than their international benchmarks stands in stark contrast to the flat or declining airfares offered by domestic airlines.[30] These charges are one of the biggest roadblocks to the airlines' ability to introduce new and grow existing routes and to reinvest in product and fleet.

The role of infrastructure investment

With airports reportedly about to embark on a *"capital spending spree"*[31], the impact of this planned investment on charges, which are often locked in ahead of time, is of great concern to A4ANZ's members, given the environment in which they negotiate their agreements (see earlier).

It is evident that airport charges are directly affected by these infrastructure investment decisions, and while investment is necessary given growth, A4ANZ believes that it must be fit-for-purpose, aligned with the needs of passengers using the facilities and demand for air services. Australia has numerous examples of what the International Air Transport Association (IATA) and Airports Council International (ACI) guidelines would rate as "overdesign"[32], such as creating international airports or additional capacity for larger planes where there is little current or predicted demand, or simply not ensuring that the existing asset is being used most effectively, which may be achieved through more modest increases in operational expenditure.

Prioritising efficient operations would ensure that consumers are not the ones ultimately paying for the infrastructure through high charges. The best way to reduce overcapitalisation, determine requirements and ensure an optimal design is through industry consultation. International experts regard the Australian regulatory environment as *"not conducive to the development of genuine commercial bargaining…nor to the discovery and adoption of more efficient ways of operating and investing, many of which rely on increased cooperation between the parties in the industry."*[33]

Indeed, the concept of genuine, open consultation and co-design represents exceptional, rather than usual behaviour in Australia's airports. A recent survey by the AAA confirmed this, with fewer than half of regional airports (~ 45%) reporting that they consult with airlines prior to *"major capital works entailing increased airport charges"*.[34] Given the financial situation of many regional airports as noted earlier, this presents an extremely strong argument for improvements in the level of consultation with these airports' customers, to assist in ensuring efficient, targeted investment and reducing unnecessary expenditure.

Airlines would welcome a shift into what one Australian airport CEO termed the *"new transparent modern world"*[35] and a recent AAA claim that the rising charges and investments outlined in the ACCC report, were determined by negotiation between airports and airlines,[36] but the reality is far from this, as others have acknowledged. Further illustrating the lack of transparency and consultation, increased charges are often levied with little forewarning, with an overwhelming majority (86%) of regional airports admitting that they only give airlines three to six months' notice of changes to airport charges[37], often after tickets have already been sold.

In addition to airlines being impacted by airports exerting market power, other airport users, including the travelling public are also directly impacted. Not only have services at Australian airports not generally improved beyond "satisfactory" in line with the increased costs and charges, but there is an opportunity cost to this as well.

IATA Economics estimate that if airport passenger charges had remained at their 2008 levels instead of increasing over the past decade, this would have delivered significant benefits at the four monitored airports, including:

- Savings for passengers of AUD 180 million through lower charges;
- The potential for additional travel, driving an additional 1.23m domestic passengers.[f]

These lost opportunities should come as no surprise given that, at the time of airport privatisation, the ACCC were advised that *"A firm that is able to maintain significant monopoly rents for, say, more than five to ten years… is able to inflict substantial damage on the economy. The misallocation of resources associated with monopoly pricing means that an extended period of high prices is socially costly"*.[38]

A4ANZ's concern is that if this situation is replicated into the future, the opportunity for even more benefits will be lost. Australia's airports are monopoly assets originally built as common user assets, and as such, the public needs protection from their exercising of market power.

Table 2: Evolution of Airport Charges and Fares, 2008-17 (Real terms, 2017 AUD)

	AERONAUTICAL REVENUE / PASSENGER			AVERAGE AIR FARE		
	2008	2017	Change	2008	2017	Change
Brisbane	9.24	12.60	36%	514.14	290.73	-43%
Melbourne	9.47	12.44	31%	548.14	320.31	-42%
Perth	9.95	15.79	59%	801.25	383.83	-52%
Sydney	15.9	18.34	15%	666.11	366.35	-45%

Source: IATA Economics based on ACCC and PaxIS

f. Excluding taxes

HOW MARKET POWER CAN BE CURTAILED

Australia's approach to regulation of its major airports is absolutely a factor in the overall costs borne by travellers and airlines overall. As highlighted earlier, the current method of regulating airports in Australia is light-handed and *intended* to be a deterrent regime.

However, to act as an adequate deterrent, such a regime relies on the following:

1. An ability to identify, demonstrate and measure misconduct i.e.
   - An ability to adequately monitor outcomes / behaviour
   - Clarity around what outcomes represent evidence of misconduct
2. A credible threat of effective punishment / penalties:
   - Penalties that are suitably high and certain to act as a discouragement
   - Penalties are not perceived as avoidable i.e. firms must not be judgement proof – for example, too big to fail; OR
3. Regulatory constraint on the exercise of market power

The current regulatory model under which the major airports operate is, by the ACCC's own words, ***"limited in its ability to address behaviour that is detrimental to consumers. In particular, it does not provide the ACCC with a general power to intervene in the airports' setting of terms and conditions of access to the airports' infrastructure."***[39]

The deterrent, in the current regime, is intended to be derived from:

- the threat of airlines taking legal action under the *Competition and Consumer Act (CCA) 2010*[40]; and
- an apparent threat of re-regulation on the basis of ACCC monitoring and regular reviews by the PC.

The risk of an airport being restrained via these channels has clearly not been suitably high to act as a deterrent. The first channel set a high regulatory hurdle and entailed extremely costly, lengthy processes.

Furthermore, following amendments to the *CCA*[41], the regime is now entirely missing a credible threat. Legal advice sought by A4ANZ confirms that there is now effectively no regulatory provision in Australian competition law that constrains a monopolist from exerting its power to extract monopolist rents, fees and charges for deficient services.

In practice, this means that there are limited (if any) incentives for airport operators to engage in good faith negotiations with users and provide access on reasonable terms and conditions in order to avoid the prospect of declaration.

The negative consequences of this were highlighted in the Grattan Institute report into competition which clearly stated that ***"where profits are high because firms face little competition, they are earned at the expense of customers or suppliers. They are also associated with inefficiencies."***[42]

Australia is clearly lagging behind in this regard. Greater oversight by regulators to encourage and, where required, force constructive, commercial engagement is needed to minimise the negative impact of the airports' monopoly powers.

The aviation sector in Australia is growing, but it is quite clear that at the moment, the airports are capturing a disproportionate share of this growth. Reducing their market power does not mean making airports unprofitable. A4ANZ believes that Australia needs a regulatory framework that drives airport-airline negotiations to produce better outcomes for consumers, through improved efficiency in the allocation of resources, and targeted investment.

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POTENTIAL REGULATORY REMEDY

There are a number of potential approaches to solving the problems identified with the current regulatory environment. Following consultation on both legal and economic implications, A4ANZ has formed the view that regulatory remedies based on minor modifications to the existing regime are unlikely to be effective as there would still not be any credible threat to, or consequence for, monopoly airports exerting market power in airline-airport negotiations.

However, we are not advocating for the re-imposition of price control, as we agree with the expert view that the present situation provides no justification for that.[43]

To address the issues outlined above, A4ANZ believes that the most effective regulatory solution and the one that is most likely to result in genuine commercial negotiations between airlines and airports to effect fair outcomes for airport users, is a negotiate-arbitrate model.

International experience suggests that concerns about invoking a system of independent dispute resolution are unfounded, and in fact would take the current light-handed regulatory model forward.[44]

A way forward

Consideration could be given amending the *Airports Act 1996*[45] such that the range of services provided by airports which have a substantial degree of market power would be deemed as declared and the existing provisions in the CCA relating to negotiation, followed by the default process of arbitration by the ACCC, would apply accordingly. This would avoid further changes to Part IIIA of the CCA which would apply to all infrastructure, not just airports, and would be cumbersome to introduce, given the complexity of the legislation.

This approach would provide a mechanism to bring to life the remedy suggested by the ACCC in its response to the 2011 Productivity Commission's draft report. Then, the ACCC opined that *"An effective solution would be one that encouraged bona fide market-based commercial outcomes; that is, normal commercial agreements arrived at absent the exercise of the airports' market power. Such agreements will promote efficiency and better outcomes for consumers and for businesses in related markets. Such an effective permanent solution could be achieved by addressing the imbalance in bargaining power of the parties, so that the exercise of market power could be constrained."*[46]

While this potential remedy would see the ACCC potentially acting as an arbitrator, the *form* this arbitration takes is an important consideration. Traditional arbitration leads the arbitrator to generally award its own determination which may or may not be a compromise between the parties' final positions. However, this process has the potential to incentivise "gaming" of the negotiate/arbitrate process with little incentive for either party to negotiate a reasonable outcome.

A4ANZ is proposing instead that the ACCC give consideration to "final offer arbitration", a method commonly used in various sectors in Canada and the United States. Using this method, a dispute between two parties is resolved by an arbitrator choosing between final offers of settlement made by each party to the dispute.

> *"The final offer chosen by the arbitrator binds the parties to the dispute and in most applications, forms the basis of an agreement between them for the provision of services."*[47]

The use of final offer arbitration in Canada is acknowledged to have been effective in fostering a more competitive negotiating environment.[48] In Australia, the adoption of final offer arbitration would be unlikely to require legislative direction but could be adopted by the ACCC through an amendment to its Guidelines, providing an indication to the parties as to its approach to arbitrations.

With the arbitrator selecting one party's final position (or parts of each party's final position) without the possibility of compromise or variation, the risk of arbitration is raised and therefore, increases the incentives for the parties to bargain and negotiate on reasonable terms prior to the regulator's involvement. In other words, creating a highly credible threat of intervention.

Importantly, international evidence has shown that the existence of final offer arbitration as a method used by a regulator has the effect of obviating the arbitration process altogether.[49] As the ACCC have previously noted, *"Practical experience – including in the airport industry itself when Sydney Airport domestic services were declared – has shown that parties greatly prefer to reach commercial agreements rather than fall back on ACCC or any other arbitration."*[50]

The benefits of stronger regulatory controls were raised clearly in the 2011 Productivity Commission Draft Report, with limited dissent (largely from airport operators), and, as outlined earlier, the calls for change have only amplified since. This approach would bring Australia into line with what is regarded as a best-practice approach.[51]

CONCLUSION

This preliminary report provides a clear depiction of not only the ability of Australian airports to use their monopoly position to earn excessive profits, but the demonstrable proof that they have been doing so in the absence of a regulatory threat. A growth trend that began over a decade ago and which not only shows no sign of stopping, but is increasing.

By contrast, the competitive Australian airline market has had to work to keep airfares low - and declining over the same period - with profitability returning only recently for some airlines.

A4ANZ is not a lone voice in suggesting that Australians and our economy could benefit from a change in the regulatory settings for airports, to mimic the effects of a competitive market. The Grattan Institute recently suggested greater regulatory controls for airports in its report assessing the costs of market power.[52]

Moreover, A4ANZ's proposed solution to address the current situation is not without justification or precedent. It is entirely consistent with previous statements by the ACCC, that *"For aeronautical services, the existence of a credible ability to seek arbitration would balance the bargaining power of the parties. It would encourage, not inhibit the development of commercial relationships between the airports and their customers."*[53]

"Aligning the incentives of private infrastructure operators and their customers is a goal that governments can actively pursue."[54]

A4ANZ members are committed to building, maintaining and improving positive, constructive commercial relationships with airports. They also want to see airports, and the whole aviation sector prosper. It is not only in the airlines' interests, but in their passengers' interests, as well as the interests of the Australian tourism and export sectors and the broader economy for this to occur. We look forward to working with all stakeholders to achieve this outcome.

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