21st August 2006

Mr. Thomas Abe
Commissioner & CEO
Independent Consumer Competition and Commission
P.O Box 6394
BOROKO
National Capital District

Dear Mr Abe

RE: Submission on ICCC Draft Report on the Aviation Industry

I refer to your letters seeking Treasury's comments on the above matters. We have attached herewith a submission outlining our views. The submission is self explanatory and if you need any clarification, do not hesitate to contact Mr. Clement Kote on telephone number **328 8829** or Mr. Winston Rodrigues on telephone number **328 8752**.

Yours sincerely,

SIMON TOSALI
Secretary

Submission to ICCC on its Draft Report on the Aviation Industry in PNG

Introduction
The Independent Consumer and Competition Commission ("ICCC") released a *Draft Report* on its review of the *Aviation Industry in Papua New Guinea* on 18 July 2006 ("draft report") seeking submission thereon by 21 August 2006. This submission is made in response to that invitation.

Background
The draft report covers a range of matters and this submission does not comment on every issue. Comments are made on those issues that Treasury considers appropriate. Other interested parties can be expected to comment on those aspects of the draft report that concern them and for which their experience qualifies them to do so.

Economic significance of air transport
The efficiency and performance of the air transport sector are inextricably interlinked with those of downstream industries such as tourism and hospitality. The handicrafts industry, which is rural-based, relies, in turn, on tourism. The costs, efficiency and pricing policies of the various sectors of the air transport industry, therefore, influence the charges that each successive link of the vertical chain imposes on its customers.

The industries and their customers that depend on the air transport sector include regular passenger air transport services; air charter operators; tourists; passengers travelling for personal or business purposes; and shippers of air cargo e.g. parts for mining and construction machinery and some agricultural products. Hence, such costs flow on to the prices for services such as passenger fares and air freight. Passenger fares, of course, are a cost factor in tourism. Freight is significant for a range of industries including those involved in the import and export of high value industrial and consumer goods. Some agriculture and rural industries may be dependent on air transport for timely delivery of their products (e.g. coffee) and they are likely to be especially sensitive to domestic air freight rates and availability of services.

The issues
The Treasury comments on the following:

(a) Capacity sharing agreements between airlines;
(b) Booking and selling agency arrangements;
(c) The transparency of operations of the Civil Aviation Authority and its commercial strategies.

(a) Capacity sharing agreements between airlines
There is a code-sharing arrangement between Air Niugini and Qantas. The origin of this agreement is said to be related to Air Niugini's financial difficulties at the time it was first entered into.

Whatever the stated reasons, neither the agreement, nor its continued implementation, appears to have been examined either by the ICCC or, as we understand, by the competition authority in Australia, in the context of the authorization provisions of the respective competition laws of the two countries for the purpose of granting immunity for the possible substantial lessening of competition.

The ICCC has indicated its intention to assess whether the code sharing agreement should be allowed to continue when it is due for reconsideration in mid-2007 and such a review is strongly supported by Treasury.

Proposal by Airlines of PNG for capacity tendering on aircraft
The draft report refers to a submission by Airlines of PNG that seats on aircraft flying international routes should be tendered out to increase competition.

Treasury has serious reservations about this approach. The aircraft operator would allocate seats to the bidder offering the highest price and this would do little to reduce costs.

The sunk costs of operating an airline have reduced substantially over time with increased availability of leasing options to suit the particular market strategies of entrants. Scale issues are also much less significant as the range of aircraft sizes and types available to suit the traffic patterns on various routes have been increased. Other economic entry barriers have also been reduced over time. Baggage handling and passenger check-in functions can be contracted out at most airports more easily than before.

Potential entrants, therefore, can be expected to enter markets where viable opportunities exist for an efficient operator and anti-competitive agreements or conduct, or other impediments, do not discourage entry.

In such an environment, the regulatory focus should be concentrated on removing impediments to competition and efficiency, rather than facilitating cooperative arrangements such as code-sharing and other capacity allocation agreements.

Any such proposal for capacity sharing of aircraft, therefore, should be subjected to rigorous examination, preferably under the authorisation provisions of the *Independent Consumer and Competition Commission Act 2002* ("the Act").

(b) Booking and agency arrangements
Existing arrangements for booking seats through travel agents, as outlined in the draft report appear to give Air Niugini a competitive advantage. Airlines of PNG suggests that a not-for-profit organization be established to handle reservations as part of a one-stop-shop travel service.

This proposal requires considerable further thought before it is pursued for the following reasons:

- it is not clear who would bear the costs of setting up the organisation; how it would be managed; and what commercial incentive would drive its efficiency;

- any vertical or horizontal integration to combine the various service functions of the tourism industry appears to be best served by normal commercial evolution in an expanding market, driven by competition and efficiency;

- clearly, the ICCC supervisory functions in any such industry reorganization assumes particular significance e.g. through its powers of merger control and authorization of arrangements between competitors and parties in a vertical supply relationship;

- arrangements that lead to higher prices and restriction of output have important consequences for the broader tourism industry and, in particular, for elements not party to such arrangements e.g. any players in the accommodation, restaurant and entertainment segments of the hospitality sector, handicrafts industry and domestic travel sector.

If such co-operative arrangements are to be considered, at the very least, those elements of the tourism industry that are not intended to form part of the arrangements should be consulted and their views given due weight. This is best done under the authorisation provisions of the Act.

(c) Transparency of operations of the Civil Aviation Authority and its commercial strategies

The Civil Aviation Authority ("CAA") has a significant safety regulation role and it is emphasized, at the outset, that this submission does not relate to that aspect of its operation, which is generally considered to be largely non-commercial.

CAA controls a number of airports and related facilities and its operations and commercial strategies influence the costs and efficiencies of downstream industries.

It charges fees to commercial users of its facilities. For example, CAA charges landing fees for the use of its runways. Where its real property is occupied by businesses, rental is charged. There are likely to be other such commercial charges that CAA makes on users of its facilities.

Under various programmes, the Government funds capital works to upgrade airports to increase their capacity; improve efficiency and enhance throughput, with the objective of generating benefits to the national economy as well as the local communities in which the airports are located. If the charges and management approaches of CAA do not promote efficiency, those Government objectives would be frustrated. The performance of airport management in relation to particular airports, therefore, provides a feedback loop to inform Government decision-making on funding their development.

For the above reasons, as an operator of infrastructure facilities, the efficiency with which CAA operates is crucial to the air transport and downstream industries.

(i) Lack of transparency of individual airport performance

Aside from certain assets that have not yet been transferred from the State to CAA, it prepares aggregate accounts which do not give an accurate picture of the operational and financial performance of individual airports in relation to their commercial activities.

Consequently, no informed assessment can be made on the efficiency of individual airports. Users of airport services and the communities in which individual airports are located, therefore, are unable to exert market pressure on airport charges or commercial strategies due to information asymmetry.

This gap in performance data reduces the incentive for improvement in performance by the managers of individual airports, as well as CAA, in relation to commercial strategies for each of them.

Proposal – Horizontal Accounting Separation

It is submitted that CAA be requested to publish disaggregated financial information on the commercial operations of individual airports. This will serve a number of purposes.

First, the transparency will act as an incentive for the local managers of individual airports to improve their performance.

Secondly, it will enhance accountability, both of individual airport managers and of CAA in terms of their resource allocation policies and practices – whether the benefits from expenditures on particular facilities are accruing as forecast or intended.

Thirdly, it will:

- increase awareness of the performance of individual airports by CAA and by the communities in which the individual airports are located;
- encourage proposals to increase traffic throughput and enhance performance of the local airport; and
- increase dialogue between the local communities and CAA to optimise the formation of commercial strategies; resource allocation; and efficiency of operation of the particular airport.

Fourthly, the Government's decisions on its own funding allocation for airports will be better informed by the track record of results from earlier expenditures on individual airports.

Finally, such transparency would facilitate identification of those airports which do not recover the costs of their operation. Any future consideration of funding such deficiency as a community service obligation (e.g. after the CAA's financial operations are fully separated from the State) would be facilitated by having it properly quantified.

It is recognised that the airport assets of the State have not been transferred to CAA. Steps are being taken, however, to effect such transfer. It is an opportune time, therefore, for separated accounting to be implemented while CAA's accounting systems are being set up.

The Treasury considers that the ICCC should convey to CAA the need for early implementation of separated accounts and the necessity for that initiative to be co-ordinated with the upgrading of the accounting systems now being undertaken by CAA. It is not being suggested that the costs and revenues arising from the navigational safety functions of CAA be separated by individual airport as their scope is national rather than airport based and, in some senses, can be regarded as non-commercial.

(ii) Commercial Strategies and Pro-competitive Initiatives

Currently, it is not clear whether the real property of airports provided to retail operators for their commercial use are recovering an economic return. It is possible that some real property assets are over-recovering while others are under-recovering.

Similarly, aeronautical charges could result in either an over-recovery or under-recovery of the efficient costs of operation.

If that is so, then it leads to a misallocation of resources and the rental "playing field" is likely to be tilted in favour of some and against others.

Furthermore, there may be a single supplier of a particular category of goods or services (e.g. a duty free shop) in an airport while in some other category (e.g cafes and fast food), there may be multiple suppliers. Consequently, some suppliers may possess market power while others do not. Prices, therefore, are likely to be distorted.

Proposal – explore options to remedy such distortions

A number of initiatives are either in place or being considered in various countries to explore ways to address the distortions outlined above.

It is suggested that options be explored to remedy such distortions through the following initiatives:

(i) where possible, setting aeronautical charges to yield an economic return on efficient costs of operation;

(ii) where it is not commercially realistic to recover such costs in particular airports, the deficiency should be quantified;

(iii) setting rents based on an adequate return for the commercial property with retail pricing constraints on monopoly retailers;

(iv) avoiding grant of exclusive rights to particular categories of retailers so that, when demand warrants it, additional retailers of that category could be allowed to lease space;

Constraining the pricing power of monopoly retailers could take a number of forms. At its simplest, it could be to create a role for the ICCC in retail pricing at airports.

Charges for aeronautical or “air-side” services such as landing charges and rents for property used for retailing and other “land side” services should be monitored by the ICCC and, if necessary, regulatory intervention should be considered.

More complex approaches for land-side charges could require tenders for leases at a nominated rental on the basis of the lowest maximum weighted average of prices to be charged for goods or services to be provided by the lessee. While complex, it is considered worth exploring in the case of leases to single provider categories of retailing e.g. where there is a single duty free shop.

Where more than one supplier of the category of goods or services operate at the airport, it may be unnecessary to constrain their prices, on the assumption that they will compete vigorously (although it is possible that if there are only two competitors, competition may not be vigorous).

Overall, if leases are not based on the highest rents bid, that particular cost component of retailers, likely to be their most significant cost, would be realistic and would avoid the necessity for retailers to charge high retail prices to ensure their commercial viability.

Lower prices to travellers (and those farewelling or welcoming them) would enhance throughput with benefits to industries supplying those retailers. It would also have a positive effect on travellers’ attitudes to the country and promote tourism.

Implementation costs and benefits
The implementation costs of horizontal separation of CAA accounts (by individual airport) are not likely to be prohibitive, especially since the business assets are in the process of being transferred to it from the State.

CAA is understood to have separate asset registers for its airports. To the extent other aspects of its accounting (e.g. recurrent income and expenditure) are not currently disaggregated, the upgrade of accounting systems now under way provides a timely opportunity to implement separated accounts.

Similarly, CAA leases real property to retailers at its airports. Changing the basis of leasing involves some additional work and some assessment of the additional costs would be necessary.

While the size and revenue base of small airports raise questions about the cost of implementing leasing policies based on lowest retail prices for a nominated ‘economic’ rent, such airports are the ones most likely to have a single retailer of each category of goods or services.

While the significance of individual airport-related charges to end prices for downstream goods and services would vary, reductions in the former would be likely to flow on to the latter and, cumulatively, could lead to small, but not insignificant, end-price reductions over time, including for air fares.

Recommendation
Reduced air fares resulting from airline competition are likely to increase traffic. Complementary policies are necessary to ensure that the increased passenger traffic leads to flow-on effects for downstream business sectors and the National economy.

The Department of Treasury recommends that the ICCC pursue its consultations with the representatives of parties involved in the chain of aviation functions with a view to exploring options for implementation of these proposals.

Treasury staff are available to discuss these proposals with your staff.