

## **The Commerce Commission Report on Price Control of Airfield Activities: Submission by Christchurch City Holdings Ltd.**

### **Introduction**

Christchurch City Holdings Ltd (CCHL) is a wholly owned subsidiary of the Christchurch City Council and a major shareholder of Christchurch International Airport Ltd. (CIAL) and other infrastructure companies (Lyttelton Port Co. Ltd., Orion NZ Ltd. and Red Bus Ltd.). Each of these companies operates in a unique market setting. Accordingly CCHL has a strong interest in the report of the Commerce Commission on airfield price control. Inappropriate controls could have major negative effects on their operations, profitability and financing.

There is mutuality of interest between CCHL and the Commerce Commission in economic efficiency and regional and consumer benefits arising from the sustainable use of infra-structural assets entrusted to CCHL's stewardship. However, it is important in analysing the markets for these assets that the facts are correct.

There are a significant number of problems that CIAL has identified in the Draft Report of the Commerce Commission. These are fully discussed in CIAL's submissions. CCHL supports those conclusions and will not repeat them here. However, there are a number of general points CCHL wishes to make because they potentially go beyond current concerns with airfield pricing and CIAL's interest.

Many of the problem areas identified by CIAL and its consultants have common roots in apparent misunderstandings by the Commission of the markets it is dealing with and the range of possible effects price control could have. These general points are discussed below.

### **Maintaining Economies of Scale**

The Commerce Commission characterises airfields like that operated by CIAL as being subject to economies of scale. It is a natural monopoly within the Canterbury region. From a regional development (and from a national perspective) resource use per unit output from airfield activities will be minimised (economic efficiency increased) the higher is the use of CIAL's facilities.

It is important to recognise, however, that for a variety of technical reasons, a considerable amount of (long) forward planning and forward commitments were necessary to ensure these economies of scale exist at present. Furthermore, forward planning and commitments are necessary on an ongoing basis to maintain those economies. CIAL maintains a 20-year planning horizon for this reason.

For example, airline passengers put a high value on ease of access to airports. These demands conflict with housing pressures and other forms of land development close to cities like Christchurch. That is to say, airports need to put high option prices on critical resources for future use. Furthermore, these commitments have to be financed.

In part, this issue is one of appropriate styles of development as perceived by local government. Short-term views on airfield capacity lead to more frequent changes in airfield location than long-term views do. Airfield location changes are extremely costly to a local community as the endless debates over runway extensions and new airport sites around the world attest (e.g. in Sydney and South-eastern England). Local government has to weigh these option values against current benefits of tourism expansion and inter-connectedness with other regions. The important point is that local government is best placed to make these tradeoffs. They are reflected in the policies of CIAL on behalf of its shareholders.

An implication of this view is that price can only equal cost in such situations if option values are included.

### **Demand Side of the Market**

The Draft Report contains very little information on the structure, conduct and performance of the acquirers of airfield services. If we take the analytical part of the Report on face value, the behaviour of acquirers is represented by a standard demand schedule implying that acquirers are atomistic purchasers without market power. This characterisation could be seriously at variance with the facts.

Firstly, the demand for airfield services is strongly influenced by the airlines through the customary scheduling conferences of IATA. Airfield companies have little influence on this process, yet must plan for capacity constraints that may be involved. No contracts are entered into by airlines; demand is reflected in a virtual spot market. This characteristic is in marked contrast to the decade long lead times required on the supply side.

Secondly, over 60 percent of airfield fees at Christchurch are contributed by a single airline. That airline is likely to have market power on most of the air routes that connect with Christchurch.

Thirdly, one of the most profitable airline structures involves hub and spoke operations. An important facet of these operations is that hub airports are more important than airports at the end of any particular spoke. Accordingly, the demand for airfield services at the end of a spoke is likely to be more elastic than the demand for hub airfield services. This might be reflected in the asset beta of such an airport. Airports would be priced accordingly in an unregulated market. This is not a black and white issue. Airports can have varying degrees of hub characteristics and what is more these characteristics are continually changing. In our region of the world Singapore and Los Angeles are the most important hubs followed by Sydney. Auckland is a more regional hub (i.e. it has more spoke characteristics than Sydney) for Australia, Singapore, Los Angeles, South America, the Pacific Islands and virtually all other New Zealand airports. The hub operations of CIAL's largest client are based in Auckland.

Christchurch has some hub characteristics mainly vis a vis Australian destinations, other South Island centres and the Antarctic. However, the Auckland-Christchurch

spoke of the national carrier may be substituted by direct spokes to Queenstown, Dunedin, Nelson, the West Coast and international destinations. These decisions, based on technical and financial considerations are under the control of the national carrier.

Fourthly, the ownership of major users of Christchurch International Airport are fluid, not just in the current environment but over the long term as international strategic alliances develop or do not develop. More generally, airline operations are volatile as reflected in recent airline closures in New Zealand.

Fifthly, CIAL is restricted by the ICAO agreement on price discrimination. This has the likely effect of limiting the possibility of using Ramsey prices and more importantly, it may be limiting the price negotiating powers of CIAL with domestic airlines.

Taking the above factors into account, the question then is, how should the demand and supply side of this market involving the CIAL airfield be characterised? One possibility is that the market at Christchurch is best viewed as a bilateral monopoly.

At the outset of this part of the discussion, it should be kept in mind that no textbook characterisation of a particular market (including bilateral monopoly) will fit the facts exactly. A framework is essential for analysis, however; otherwise an economic evaluation cannot proceed (and won't begin to ask the right questions). Another implication of this state of affairs is that the Draft Report should have taken a much wider, deeper and longer view of CIAL's performance before efficiency and consumer benefit changes were estimated.

### **Bilateral Monopoly**

If a bilateral monopoly is a better characterisation of the airfield market at Christchurch, a number of implications follow. Economic performance outcomes from bilateral monopolies can be quite different from those of a one sided monopoly, such as that adopted in the Draft Report. An acquirer with market power will attempt to exploit the marginal expense of airfield use rather than be dictated to by the cost curves of the monopoly supplier. A demand curve does not, in general, represent the likely reactions of acquirers. Furthermore, strategic behaviour becomes crucial to the outcome and market performance becomes volatile depending upon the balance of economic power. This makes it more important to examine the history of market interactions in the case of the Christchurch airfield.

Infrastructure assets tend to exist in more complex markets of this type. This is why CCHL is concerned with this Draft Report in a general sense.

A workably competitive outcome in a bilateral monopoly is difficult to define but one principle is fairly clear. Balanced economic power between the supplier and acquirer will lead to greater economic efficiency. There are reasons to believe in this particular case that the economic power of the acquirer is greater than that of the supplier in a bilateral monopoly framework.

- ? It may be less expensive for the acquirer to reduce the level of demand (by altering the spoke balances) than it is for the supplier to reduce the level of service.
- ? The customary IATA scheduling system and the ICAO Agreement restricts the power of the supplier.
- ? The acquirer has a large market share in the national, international and regional markets serviced by Christchurch.

### **Regulating Bilateral Monopoly**

Price controls have the capacity to reduce the market power of airfield owners further. In a bilateral monopoly, this re-balancing of economic power may reduce economic efficiency and it may also reduce the likelihood that airline cost savings are passed through to consumers. In short, lower airfield charges may not be simple transfers; they may have efficiency effects.

In other words, airfield price controls could lessen competition in the airline market(s): a more complex outcome than that envisaged in the Draft Report.

There are potential spillover effects from the Draft Report that may go beyond the regulatory environment. In a bilateral monopoly framework the process of determining the need for price controls may also re-balance the bargaining power of CIAL leading to lower prices, lower outputs and lower shareholder returns. CIAL operates a number of joint facilities demanded by acquirers. If the Commerce Commission does not use realistic frameworks to evaluate the performance of airfields, CIAL can be pressured to adopt inappropriate accounting and valuation methods for other facilities.

### **Conclusion**

In revising the Draft Report, the Commerce Commission is encouraged to take a broader and longer view of the markets at issue in airfield pricing at Christchurch. It is also encouraged to adopt the suggestions submitted by CIAL. It is anticipated that a more appropriate framework with sustainable valuation procedures and due allowance for inevitable errors in estimates will produce a more balanced view of the situation.

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