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25 March 2019

Airport Regulation Inquiry

Productivity Commission

Locked Bag 2

Collins Street East

VIC 8003

Dear Mr Lindwall,

**Re: Draft Inquiry Report on the Economic Regulation of Airports**

Australian Rail Track Corporation (ARTC) welcomes the opportunity to comment on the Productivity Commission's (PC's) Draft Report on the Economic Regulation of Airports.

ARTC submitted a response to the Issues Paper published by the Productivity Commission in September 2018 supporting an approach that prefers negotiated outcomes within a light-handed regulatory framework; consistent with the Australian Competition and Consumer Commission's support for a negotiate-arbitrate framework. This support was based on the importance of providing a mechanism to resolve access disputes where there is no contractual mechanism to provide a dispute resolution procedure relevant to those issues.

***Competition Policy Principles***

ARTC believes that the Draft Report provides an important critique of the state of competition policy in Australia, the impact of economic regulation on efficiency and the need to take a considered approach on the impact of related markets of any access price regulation. The analysis reinforces the conclusions of the Hilmer report that underpinned the development of competition policy in Australia that economic regulation should only be imposed where (inter alia) there is an impact on competition in related markets – such that merely being a highly specific asset is not a sufficient reason for economic regulation.

The conclusions of the Productivity Commission to promote the value of negotiated outcomes, to highlight the explicit costs of economic regulation and the need for a demonstratable welfare benefit to compensate for that cost are supported by ARTC. In particular, the confirmation that the allocation of profit between users and owners of infrastructure does not constitute a welfare benefit is a welcome insight. That is, where the pricing decisions made by the Access Seeker result in the absorption of any changes in Access Price within their profit margin with no direct downstream impact, there is no case for regulation.

***Arbitration Principles***

Whilst ARTC understands the issue raised by the PC in respect of the potentially anti-competitive impacts (and consequent outcome of shadow regulation) of arbitrations in access domains underpinned by highly bespoke contracts, there is a need for a dispute resolution process to resolve access disputes in the absence of a contract. In circumstances where there are policies of non-discrimination and transparency of access pricing (to ensure access is pro-competitive), the issues of flow through of results of negotiations between users are largely present regardless. Therefore, arbitration does not change this balance, but it does provide an outlet for dispute resolution in stalled negotiations. This is especially important in industries where Access Seekers are heavily concentrated and therefore have substantial counter vailing negotiating power.

To avoid the issue of shadow regulation and retain the importance of the coverage test in defining the application of regulatory coverage, the clear enunciation of an arbitration framework based on commercial principles would provide sufficient clarity on this issue. This would ensure that the arbitrator would be required to take the value of the service to the Access Seeker into consideration of the determination and would provide a reasonable balance in the provision of information and engagement in the process (as well as costs) which is critical to provide the appropriate incentives to resolve the dispute ahead of arbitration. Finally, such a process would also provide comfort to Users seeking access to infrastructure which recovers less than ceiling due to broader competitive pressures from other industries (e.g. freight rail constrained by competition from road) that the ceiling price was not the implied maximum price of access.

ARTC therefore believes that the presence of an arbitration framework based on commercial principles has the potential to provide benefits to both Users and Owners of infrastructure to resolve access disputes not covered by a contractual framework.

***Efficiency of Commercial Negotiation***

Such a framework is very much consistent with the PC's conclusion that commercial negotiation creates the optimally efficient outcome for investment in the infrastructure. Although the PC does not quote directly from it, this conclusion is embedded in the theoretical foundation of the New Institutional Economics (NIE) and the Nobel Prize winning work of (inter alia) Ronald Coase, Oliver Williamson and Elinor Ostrom. The NIE confirms the efficiency benefits determined by the allocation of property rights arising from bespoke contracting between users and owners of highly specific assets with limited capacity via those that understand the value, the risks and the framework best – the participants – and the need for appropriate dispute resolution procedures to resolve disputes.

The Draft Report is therefore a critical piece of work that provides a critique on the economic regulatory system in Australia. The analysis at page 271 used to conclude that the case for reform was not made out highlights some key issues for Policy makers:

- The test of a successful regulatory regime is not the level of intervention by the regulator, but whether it delivers positive outcomes for the community as a whole;
- Policy frameworks do not have to provide balanced negotiating power and, so long as any disparity is not leveraged to the detriment of the community as a whole, there is no need of reforms to improve one side's bargaining position.
    - Importantly this analysis highlights that information asymmetries are a normal part of bargaining and go both ways. Therefore, focussing on addressing such asymmetries on one side and not the other introduces bias into the process and potentially distort

> investment decisions. Such intervention should only occur where the actions of firms causes wider harm to the community (p 289);

Ultimately the most telling conclusion is that whilst market power is prima facie evidence for the need for regulation, it is not a per se requirement and there must be evidence of a loss of community welfare to justify the imposition of the (significant) regulatory costs on the industry. Importantly, the concentration of the Users is a critical factor for determining counter vailing power and the finding that it can be exerted where those Users possess a significant market share is telling. This critically rebuts a presumption that exists in other Regulatory decisions that a monopoly possesses and will exert its market power to the detriment of economic welfare and, further, that the mere presence of that monopoly power is sufficient to remove any possible counter vailing power from the Users, no matter the concentration (coordination) that may exist within them. These conclusions reflect the text book definition of monopoly acting as a profit maximizing firm reducing supply to maximize profit and creating a deadweight loss. No additional analysis is provided or required because this is assumed as a theoretical fact and results in a per se requirement for regulation.

The Productivity Commission rejects this approach and usefully provides an outline of the key evidence required for the exercize of market power:

- Under investment in the network to constrain capacity and lift profits (or over investment if it was guaranteed the recovery of capital);
- The setting of prices above the efficient level;
- Systematic and persistent evidence of lack of good faith in negotiations (where failure to agree another parties offer is not sch evidence); and
- Take or it leave it negotiation tactics.

Evidence of the above is still not a per se need for regulation as it then requires a further test to assess the overall welfare loss caused by the exercize of market power. Only upon satisfaction of both the exercizing of market power and an associated economic welfare loss is the case for regulation made out. That is, whilst the potential for market power is a prima facie case for an assessment of the need for economic regulation; it is not a per se justification for mandatory regulation of the infrastructure. Restatement of this critical principle at the heart of the Hilmer Report and Australia's Competition policy framework is therefore most welcome and needed.

***Public Interest Test for Regulation***

Further to the above discussion, the Draft Report at p310 reproduces a quote from the National Competition Council which is reproduced below in full given its importance:

> *Deemed declaration side-steps the checks and balances of the declaration process envisaged by the Hilmer Committee and enacted by Parliament. As the Council previously stated in its submissions to the earlier airport inquiries by the PC, if a service would not satisfy the declaration criteria, then it is difficult to see how imposing regulation by other means would not amount to the promotion of particular private interests rather than the promotion of effective competition in the public interest. (NCC, sub. 79, p. 20)*

This approach reaffirms the NCC as the arbiter of the declaration criteria as enacted by Parliament and defined in the CCA and highlights how, if the service would not satisfy the declaration criteria, the imposition of regulation amounts to the promotion of private interests (ie via rent allocation) rather than

the promotion of effective competition in the public interest. Pursuing a regulatory agenda that bypasses the CCA, including the voluntary provisions for non-declared assets, therefore represents an overriding of Parliament's express wishes on the conduct of competition policy in Australia. This is a crucial point given the state of play of competition policy in Australia.

In respect of Australian rail networks, users, like airports, are highly concentrated and generally large (sophisticated) counter parties (either by individual companies or coordination through User Group negotiation). These Users are adept at utilizing the regulatory process to aid their commercial position given its sole focus on the transparency of the infrastructure owner and their efficient cost. In this context, calls for the mandatory regulation of specific assets and the need for economic regulators to undertake price negotiations on behalf of Users, can be seen for what they are – regulation in the private interest and not the public interest. The PC and NCC position above clearly highlights this.

The balanced assessment of the PC and the NCC on this issue therefore gives some assurity that the principles of Australian competition policy are being adhered to by the economic agencies of the Commonwealth Government. Given the issues arising across the broader transport sector, and the lack of a consistent and national approach to its regulation of the transport industry, a similar review by the PC could provide benefits across the entire industry.

***Conclusion***

In conclusion, ARTC strongly supports the conclusions of the PC assessment in respect of:

- Its reaffirmation of the principles of Australian competition policy and the case for regulation of assets;
- the ability for parties to use regulation to pursue private interests and the inconsistency of this approach with the principles of national competition policy
- the need to impose the costs of regulatory burden only where it is in the public interest to do so based on a detailed assessment of the entire industry (and not just because a highly specific asset is deemed a natural monopoly); and
- the value of negotiated outcomes in determining access to specific assets; although ARTC would reaffirm its position that commercial arbitration frameworks benefit this process where contractual mechanisms are not available to resolve access disputes.

Given the lack of a consistent and national approach to the regulation of the transport industry, a similar review by the PC of the Transport industry, and recommendations on necessary changes to the regulatory structure to provide national consistency, could provide benefits across the entire industry.

If you have any questions in respect of this submission, please don't hesitate to contact me

Yours sincerely

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