AURIZON

Airport Regulation Inquiry
Productivity Commission
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Draft Inquiry Report on the Economic Regulation of Airports

25 March 2019

Dear Mr Lindwall

Aurizon Network welcomes the opportunity to respond to the Productivity Commission's (**the Commission**) Draft Report into the Economic Regulation of Airports. Our submission relates primarily to the Commission's assessment of negotiate-arbitrate frameworks.

As outlined in this submission, Aurizon Network largely supports the conclusions made in the Draft Report in respect of the negotiate-arbitrate framework but considers:

- the Draft Report does not consider how the limitations identified by the Commission could be overcome or as to why those limitations are either not present or effectively managed in other transport sectors or monopoly services; and
- there would be wider public benefit in a broader review of commercial negotiation frameworks applicable to access common transport infrastructure services. While many of the aspects to be negotiated are specific to airports the issues identified by the Commission in respect of negotiate arbitrate frameworks are comparable.

Aurizon Network operates a 2,670 kilometre multi-user rail network in Central Queensland. The use of this rail network for the transportation of freight is a deemed[1] declared service under Part 5 of the *Queensland Competition Authority Act (1997)* and access is provided pursuant to a mandatory access undertaking. These regulatory arrangements are highly prescriptive and impose significant direct and indirect economic costs which the Commission has rightly cautioned against due to them requiring substantial efficiency benefits in order to justify this level of regulatory intervention in promoting the public interest.

The Commission should be commended on its approach to assessing whether the circumstances and conditions which support further regulatory intervention are present. In particular, the Commission's focus on whether monitored airports are earning excessive profits and whether that profitability has any adverse efficiency or competition effects is a preferable approach to a

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[1] The Queensland Competition Authority is currently reviewing this service against the access criteria in section 76 of the *Queensland Competition Authority Act 1997 (QLD)*.

presumption that natural monopolies should be subject to prescriptive and onerous regulatory controls.

Aurizon Network's past experience with the latter form of regulation has been less than satisfactory, with increasing levels of regulatory intervention and prescription for continuously reducing marginal benefits. In this regard, increasing levels of regulatory intervention in the provision of transport infrastructure is unlikely to provide the necessary and desired levels of productivity gains relative to those attainable via a commercially negotiated access agreement. The latter has a substantially wider scope to promote innovation and expand the set of feasible negotiated outcomes.

The Draft Report concludes that intervention in commercial negotiations through the application of a negotiate-arbitrate framework would be practically difficult to implement and have adverse effects. This is largely based on concerns regarding:

- information asymmetry for the arbitrator in respect of negotiated outcomes with other airport users;
- the complexity of a negotiation for a multi-product service;
- the risk of shadow price regulation; and
- coordinating airport investment.

Aurizon Network acknowledges these concerns and the risks the Commission has identified from the introduction of a negotiate-arbitrate framework. However, it is possible that some of these concerns could be adequately addressed through effective coordinating mechanisms and facilitating negotiated settlements of unbundled common infrastructure services.

The Commission identifies two forms of negotiate-arbitrate models being the Final Offer Arbitration (**FOA**) and conventional arbitration. Submissions to the Commission have pointed to the use of FOA as applied to railways under section 159 of the *Canada Transport Act (S.C. 1996 c.10)* (**CTA**) as a potential model. Aurizon Network considers there are issues associated with this model that make it unsuitable for the negotiation of a complex access agreement, including:

- Rates established by an FOA are set for one year, after which the carrier may establish a different rate, which in turn could be subject to a FOA. Repeated FOAs are not unknown in Canada rail transport.[2] This approach is not suitable to circumstances which support long term investment decisions;
- There is a requirement for the arbitration to conclude within 60 days, which is unlikely to be sufficient time to address a complex access negotiation involving trade-offs and concessions;
- In a presentation to the Transportation Research Board, Cairns (2014) identified a range of concerns[3], including:

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[2] https://www.stb.gov/stb/docs/IndependentStudy/Final/STB%20Rate%20Regulation%20Final%20Report.pdf. However, recent amendments to the act have seen this period extended to 2 years.

[3] Cairns, M. (2014) Regulation of Freight Rail in Canada, Presentation to the Transportation Research Board, Washington DC, May 29.

- Shippers can use FOA to lever down rates that are not excessive – an FOA rate can be below railway costs;
- Since outcomes are confidential, there is no precedent or predictability of future outcomes;
- While the issue of available and effective competitive alternatives is a matter to be considered, a shipper need not be captive [in the airport context the arbitrator would need not assess the extent of countervailing market power in part services]; and
- There is no requirement for an arbitrator to have any railway business or pricing experience.

- The absence of any railway or pricing experience also requires an additional conventional arbitration process under section 161.31 of the CTA involving the regulator with respect to operational matters and level of service [in the context of airports it may not may feasible to separate levels of service from price].

In this regard while the Commission has not assessed the performance of the Canadian FOA model it has reasonably concluded the FOA model has serious weaknesses that diminish its application to complex access negotiations.

The Draft Report concludes that conventional arbitration could also lead to shadow price regulation as *"the arbitrator would need to do most of the work that would be necessary for a price determination for a regulated infrastructure asset"*[4]. The Commission's concerns are evident in the Australian Competition and Consumer Commission's (**ACCC**) submission to the National Competition Council's (**NCC**) preliminary views on revocation of the declared shipping channel services at the Port of Newcastle[5]:

> *The NCC points to the fact that the arbitrated terms were specific to Glencore and PNO at a particular point in time. However, as the ACCC submitted to the NCC after the arbitration, these determined conditions are of broader relevance to the market more generally. The ACCC continues to consider that the arbitration outcome is the best and most recent independent assessment of what constitutes reasonable terms and conditions for the service as a result of declaration.*

The inference from this statement is that the arbitrated outcome should form the benchmark for all future negotiations with other users of the service. It is also apparent that under a negotiate-arbitrate model the expectations of an arbitration outcome would either default to, or be conditioned by, a building blocks approach which places little focus on the value of the service or whether price reflects the relative scarcity and provides the right incentives. In addition, where the negotiation is a repeat game, the user's incentives become one of trying to secure lower prices or obtain increasing levels of service than prior arbitrations.

Notwithstanding these issues, Aurizon Network cannot fully reconcile the Commission's reasoning in respect of the problems associated with issues involving the interests of other users regarding;

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[4] Productivity Commission (2019) Economic Regulation of Airports, Draft Report, Canberra p. 315

[5] Australian Competition and Consumer Commission (2019) NCC preliminary view to recommend to revoke declaration at the Port of Newcastle, Submission to the National Competition Council, February, p. 3

- 'arbitration over a complex bundle of matters with the potential for effects on other airport users'[6]; and

- the resolution of differences of opinions over investment in airports in respect of scope, timing and cost/risk allocation.

Aurizon Network assumes that in the absence of workable collective negotiation and coordinating planning frameworks these issues would prevail under the current light-handed monitoring regime. This suggests there is some scope for augmentation of the current light-handed monitoring regime to promote the collective negotiation of unbundled common services rather than the full suite of aeronautical services.

Aurizon Network recognises that there are difficulties regarding achieving a negotiated settlement in respect of common services. These include:

- A negotiated settlement depends on the customer group acting as a collective rather than as competitors. This can lead to difficulties in coordinating a common view or position where individual members hold differing preferences and biases;

- The ability for customers to collectively agree to a solution which maximises the total surplus from a negotiation may be adversely affected where the benefits of the increase in the surplus are not evenly distributed between them;

- Individual customers may engage in strategic competitive behaviours such as frustrating expansions which facilitate competitor entry or dilution of market share; and

- There may be deficiencies in the design of the negotiation process which preclude the parties reaching a workable settlement.

As discussed in the submission made by the Australian Rail Track Corporation there are a range of infrastructure services involving direct negotiation between the provider and users of the service which necessarily address the problems of coordinating negotiation for common services across multiple users as identified by the Commission in the Draft Report. In this regard a properly and narrowly defined bundle of common airport services would appear to share common issues when negotiating access that are present with other transport infrastructure assets.

The unbundling of the complex services would facilitate collective negotiation on a narrow range of services applicable to all airport users and preserve bilateral commercial negotiation on services and needs that are specific or bespoke to the individual airport user. The Board of Airline Representatives authorisation to collectively negotiate provides a partial example of this model. However, authorisation alone places no obligation on the provider or users of monopoly services to engage in collective negotiation of common services.

The experience of North American gas pipelines, where stakeholders have recourse to cost of service (building block) regulation, has resulted in negotiated settlements becoming the predominant practice. This suggests that well designed negotiation and governance frameworks can address some of the concerns identified by the Commission in respect of negotiate-arbitrate frameworks more broadly. However, this remains premised on a clear demonstration that this level of regulatory intervention promotes the public interest.

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[6] Productivity Commission (2019) Economic Regulation of Airports, Draft Report, Canberra p. 313

In summary, a range of effective well-designed fit for purpose regulatory controls could provide an intermediate level of regulatory intervention between the extremes of price monitoring and price cap regulation. Aurizon Network considers that there is both opportunity and a clear need for a broader review of negotiating frameworks for access to infrastructure involving common services as an alternative to welfare reducing and productivity constraining economic regulation. Aurizon Network recommends the Commission consider this broader context in evaluating alternate models for the scope of economic regulation of airports.

Should you have any questions in relation to this submission please contact Dean Gannaway

Yours sincerely

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