Productivity Commission

Inquiry into Economic Regulation of Airports

Draft Report

Submission on regulatory policy

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1 March 2019

This submission focuses on the main regulatory policy issues associated with aeronautical services at the major airports, and in particular, the areas which require further consideration by the Productivity Commission (PC) following the release of their Draft Report into the Economic Regulation of Airports.

KEY POINTS

The PC maintain that a credible threat of stronger regulatory intervention is important, however, the threat of regulatory intervention is still not 'credible' under the reforms proposed in the Draft report. Given this, there are a number of issues associated with regulatory policy that require deeper consideration by the PC, as summarised below:

- The Draft Report does not reflect an analysis of the prices surveillance provisions contained in Part VIIA of the *Competition and Consumer Act 2010* (CCA) and the experience of the operation of these provisions. These provisions are not 'fit for purpose' regulation for airports.[1]

- The introduction of price regulation would be contrary to the Government's objectives for regulation of airports. Further, there has been an ongoing lack of industry support since the 2002 PC inquiry for price cap regulation as a form of regulation. These factors require consideration in assessing the credibility of the Government adopting price regulation in the future.

- The role of a price inquiry under Part VIIA of the CCA in the current and proposed framework is unclear. A price inquiry under Part VIIA of the CCA in these contexts would impose significant additional costs on industry without an apparent benefit.

[1] Details of the deficiencies were contained in Appendix C of the A4ANZ submission, no. 44, and also in Arblaster, M., 2014. Submission in response to the Draft Report of the Competition Policy Review Available at: http://competitionpolicyreview.gov.au/draft-report/non-confidential-submissions/

- The effect that the costs, timeframes and uncertainty associated with using the recently-revised declaration process under Part IIIA has on future declaration processes has been given little consideration.

- The risks and potential for regulatory error identified by the PC need to be seen in the context of protections against these provided by the legislation governing arbitrations under Part IIIA of the CCA and the ACCC arbitration processes.

- There are costs and harm to the community of not having market power exercised by airport operators remedied in a timely and efficient fashion.

- The costs to Government for ACCC resources under monitoring involving expanded information provision needs to be considered in addition to the potential costs to airport operators. Further, it is not clear how the role of the ACCC as an independent agency fits into the PC's proposed reforms.

- The Draft report portrays the role of regulatory intervention as primarily providing a 'punishment', rather than as providing 'remedies' for issues associated with the exercise of market power .

The importance the PC attaches to a 'credible' threat of regulatory intervention

The PC summarises the characteristics of an effective light-handed regulatory framework for airports:

> **"**Light-handed regulation is intended to achieve outcomes that would be consistent with those found in markets with effective competition, but will only do so if there is:
>
> - transparency as to how an airport operator is performing over time *and*
> - a credible threat of further regulatory intervention if an airport operator is found to be exercising its market power to the detriment of the community." (PC Draft Report, P.5, PC emphasis)

Further, that:

> "The annual monitoring regime, periodic reviews by the Productivity Commission and a credible threat of consequences are essential to encourage airports to engage in genuine commercial negotiations with airlines and other airport users in the future." (PC Draft report, p.13)

And

> "Essential to a light-handed regulatory regime is transparency as to how an airport operator is performing and a credible threat of further regulatory intervention. The regime should be underpinned by a range of supporting data, with a consistent basis for reporting over time." (Draft Report, p.78)

The Draft report concludes that:

> "The pillars of the economic regulation of airports should remain in place, including the annual monitoring administered by the ACCC and periodic reviews by the Productivity Commission — both are critical to the regulatory regime to maintain a credible threat to airports of increased regulation." (PC Draft Report, p.23)

A credible threat of stronger regulatory intervention

While the PC Draft report proposes reforms which will potentially increase the *transparency* of airport performance, the report does not propose any *credible* regulatory interventions that could be applied to airports in the event that airports exercise their market power.

The main regulatory mechanisms currently available for Government intervention in the context of exercise of airport market power are prices surveillance under Part VIIA of the CCA, a price inquiry under Part VIIA of the CCA, a PC inquiry, initiation of a declaration application and action by the Government as lessor of the major airports. The adequacy of these mechanisms as a credible and effective threat of regulatory intervention are discussed below.

Prices Surveillance

Prices surveillance under Part VIIA of the CCA is a general response to systemic problems associated with a broad range of services provided by a company or with a group of specific services. The prices surveillance provisions that have been applied to airports in the past are the primary regulatory intervention currently available in legislation as a measure that could be applied to airports. The PC Draft report states:

> "Also, under Part VIIA, the relevant Minister, or the ACCC with Ministerial approval, may declare goods or services to be subject to price notification. …" (PC Draft Report, p.50)

Prices surveillance (Part VIIA of the CCA) was applied to airports until 2002, including through the application of price caps to newly privatised airports.

There are a number of reasons why it is *not* credible that aeronautical and other airport services would be declared for prices surveillance under Part VIIA of the CCA:

- Applying price regulation would be against one of the Government's key objectives for economic regulation of airports which is "facilitating commercially negotiated outcomes in airport operations" (see Terms of Reference for PC Inquiries 2002, 2007, 2011 and 2018);

- There has been ongoing lack of industry support for price cap regulation as a form of regulation since the 2002 PC price inquiry. In referring to the disagreements between airports and their users, the PC notes:

  > "Despite these disagreements, it is notable that participants in the inquiry have not called for a return to price caps — both airports and airlines have stated that they prefer commercial negotiation to determine price and other terms of access to infrastructure services." (Draft Report, p.7 and p.49)

It is difficult to envisage the Government declaring airport services for prices surveillance given the industry's longstanding lack of support for determination of prices through price regulation, and their preference for commercial negotiations; and

- The prices surveillance provisions in the CCA are *not* suitable for application to privatised airports. The legislation is generally not 'fit-for-purpose', including that the legislative criteria are outmoded with current economic conditions and there are no appeal provisions on merit. Under the legislative provisions the restrictions on prices would relate to future price increases and compliance with an ACCC decision under the provisions is voluntary. Furthermore, there is a precedent of the ACCC's decision on pricing having been ignored in the past with no apparent consequences.

The PC Draft report has not addressed the issues associated with the deficiencies in the legislative provisions for prices surveillance,[2]nor its effectiveness as a form of regulatory intervention and the apparent lack of an alternative regulatory mechanism. Identification that different *views* were expressed in submissions to the Inquiry on whether the potential application of regulation under Part VIIA of the CCA is considered a 'threat' are not sufficient to suggest that the mechanism has any credibility as a threat of stronger regulatory intervention. The recommendations need to reflect an analysis of the actual provisions in the CCA and the experience of their operation.

ACCC Part VIIA Price Inquiries

The PC notes that:

> "Part VIIA of the CCA provides for the ACCC to undertake price inquiries at the behest of either the ACCC itself (with Ministerial approval), or the relevant Minister. The Productivity Commission could recommend that the Minister direct the ACCC to undertake a price inquiry. A price inquiry involves investigation of both prices and price movements of either a business or an industry, and may involve the ACCC investigating factors such as market structure, the level of competition, and potential impediments to efficient pricing. To date the ACCC has not recommended a price inquiry nor has the Minister requested it undertake one into airport services." (PC Draft Report, p.50)

The PC further notes that the ACCC has never recommended to the Minister that it be tasked with undertaking a price inquiry into airport services under Part VIIA of the CCA, and that the ACCC has stated that it does not see much benefit in recommending a price inquiry. The PC is critical of the ACCC for not seeking to use (or test) an additional tool that it has at its disposal to further investigate the concerns that have arisen from its price monitoring function. (Draft Report, p.286)

The only price inquiry under the prices surveillance provisions applied to airports to-date is the Inquiry in the Federal Airports Corporation (FAC) pricing in 1991. This inquiry was conducted when the FAC submitted a price notification for increased prices which could not be adequately assessed within the statutory 21 day price notification period. This was in line with the original rationale for price inquiries in the *Prices Surveillance Act 1983.*

[2] Ibid

Under the regulatory framework which has applied to airports since 2002 there have been scheduled PC reviews of the economic regulation of airports in addition to annual airport monitoring. Given that ACCC price inquiries are typically resource intensive and conducted over time frames similar to those of PC inquiries, an ACCC Part VIIA inquiry would be a significant impost for airports and their users. Further, in addition to findings of fact, the outcome of a Part VIIA Inquiry typically involve policy recommendations to Government which are related to regulation, overlapping and potentially conflicting with the PC's inquiry role. It is therefore difficult to see how the threat of a Part VIIA inquiry by the ACCC would be a credible Government action under the current airport framework.

Under the PC's recommendations for monitoring proposals, the PC envisages that improvements to the data base would increase the threat to airports of a Part VIIA price inquiry conducted by the ACCC. (PC Draft Report, p.279) It is not clear what the PC sees as the purpose of a Part VIIA inquiry conducted by the ACCC is in this circumstance, i.e. whether it would be primarily a punitive measure, an auditing function exercised by the ACCC for the PC or serve another purpose?

Declaration under Part IIIA

Evidence has been provided to the PC Inquiry that declaration processes under Part IIIA have been lengthy, costly and uncertain experiences. The PC Draft report gives relatively little attention to the experiences of using the declaration process under Part IIIA by airport users and by access seekers in other industries, including the very long timeframes that can be involved. The PC is instead fairly dismissive of the costs and uncertainties associated with airport user's use of the declaration process. For example:

> "Airline participants argued that 'declaration under Part IIIA of the CCA has not been effective in constraining airports abuse of market power' (Virgin Australia Group, sub. 54, p. 15). They stated that seeking declaration is costly, time consuming and uncertain (A4ANZ, sub. 44; Virgin Australia Group, sub. 54) and that since changes to the declaration criteria in 2017 there is effectively no prospect of declaration (box 9.5). The revised declaration criteria are as yet untested in Court — any opinion on the likely outcome of an application for declaration is just that, an opinion." (PC Draft report, p.284).

Further, although there are eminent legal opinions that the 2017 amendments to the declaration criteria are likely to increase the threshold for declaration under Part IIIA, the PC Draft report does not take into account the costs of using the declaration process. The Report notes:

> "Inquiry participants have argued that there is uncertainty around how the NCC would apply the declaration criteria, which were amended in 2017, and how they would be interpreted by the Court if there were a review of the Minister's decision." (p.50)

In my view the discussion of access to dispute resolution processes under Part IIIA has a strong emphasis on the potential for regulatory error and risk and on examining hypothetical scenarios without giving sufficient consideration to actual experience, the existing legislative protections and the regulatory procedures and practices used by the ACCC and other relevant institutions. (These issues also apply in the context of arbitrations discussed below.)

Much of the discussion of declaration relates to broad issues on pricing of aeronautical services. The experience of declaration applications[3] in an airport context is that although declaration applications have been few in number they have tended to be narrow, they have not always related to pricing of aeronautical services and they have not always been applications by airline users of airport services. The PC Draft report emphasises the potential errors and risks without addressing the protections in place to avoid these and does not give much consideration to the potential benefits of having access issues resolved through a dispute resolution mechanism.

Action by the Government as lessor of the airports

The PC points to the Governments role of lessor of the airports acting as a constraint on airport market power.

> "The federally-leased airports are required to fulfil their lease terms, which only allow airports to deny access to airlines under limited circumstances (Melbourne Airport, sub. 33; AAA, sub. 50). Lease terms also require airport operators to invest in airport infrastructure to maintain the airport site in 'good and substantial repair' (AAA, sub. 50, p. 76). (PC Draft Report, p.112)"
>
> "Airports stated that conditions in their leases constrain their ability to restrict access or increase charges.
>
> As far as being a 'credible threat', the prospect of lease termination is well down the pecking order. It is unthinkable that the Australian Government would revoke an airport operator's lease because of a pricing dispute. Nevertheless, these lease conditions are a reminder that the Australian Government, as lessor, has substantial powers over airports that it does not have over some other monopoly infrastructure services." (PC Draft Report, p.274)

Airport lease agreements have been confidential or at least not publicly available documents. They would be a very blunt instrument for dealing with the exercise of market power. It is not clear how airport leases could be used effectively in this context and whether this use is likely to have other consequences.

Productivity Commission inquiries on economic regulation of airports

The PC Draft report identifies the prospect of a scheduled inquiry carried out by the PC as a constraint on the exercise of market power. There are a number of reasons why the prospect of a PC inquiry is not likely to be considered a serious threat to the exercise of airport market power.

The PC's view of 'community harm'

The PC takes an aggregate, or 'on balance', approach to 'community harm' in relation to the provision of aeronautical services. The approach taken in the Draft report is a weighing up of airport performance across different services. The potential exercise of market power in relation to groups of aeronautical services do not appear to be a particular concern.[4]

[3] The type cases that came under the former declaration process in the Airport Act 1996 are also relevant here.
[4] Other than the inclusion of anticompetitive clauses in airport contracts with users.

For example, in Figure 9 the PC gives a 'red light', which constitutes 'could be consistent with the exercise of market power', to charges for international services at Sydney and Brisbane airports. Given the significance of international air services through Sydney and Melbourne airports to the Australian community, it is surprising that the identified potential for these charges to be too high is not of sufficient concern to the PC to warrant a timely, thorough investigation with the potential for remedial action.

In summary, the 'on balance' approach to community harm in the context of airport performance means that the existence of *important* specific harms do not give rise to recommendations for timely investigation leading to potential remedial action, simply because other aspects of airport performance are shown to exhibit green or amber lights and are therefore deemed to 'balance out' the more concerning aspects.

The timeframes involved to resolve issues through PC inquires

The Draft report recommends the provision of more disaggregated information relating to airport revenues, costs and charges. However, the Draft report is not clear when this information will be adequately assessed, nor when and what credible remedial interventions could be applied to redress any identified problems. For example, the Draft report identifies operational inefficiency that could be associated with Perth airport. The PC does not see this potential use of market power as a significant enough cause of community harm to warrant further exploration prior to the next PC Inquiry. If the next PC inquiry into airport regulation occurs in 2024, any recommended course of action is unlikely to be implemented for at least another five years.

The PC's view of regulation as a 'punishment'

The PC appears to view regulation as primarily 'punitive'. Some examples of where the PC Draft report reflects a view of regulatory intervention as 'punishment' are:

> "The pillars of the economic regulation of airports should remain in place, including the annual monitoring administered by the ACCC and periodic reviews by the Productivity Commission — both are critical to the regulatory regime to maintain a credible threat to airports of increased regulation. The combination of the monitoring report and Commission reviews allows a regular assessment of the performance of airports, whether an airport should be added to the list of monitored airports (or removed from it), and whether a monitored airport should be *subject to more onerous regulation*." (Emphasis added, PC Draft Report, p.23)

> "Airports found to have systematically exercised their market power to the detriment of the community face potentially serious consequences, including an increase in the burden of regulation. The Commission would not hesitate to recommend regulatory changes, including price regulation, for any airport found to have systematically exercised its market power to the detriment of the community. The ongoing *potential for such consequences acts as a deterrent against the exercise of market power*." (Emphasis added, PC Draft Report, p.49.)

While regulatory intervention may have punitive elements, regulatory intervention designed to remedy the exercise of market power is more likely to positively contribute to economic welfare.

Ideally, economic regulation should be designed to be primarily remedial in nature, efficient and effective with the goal of promoting the welfare of all Australians, rather than primarily punitive.

PC Inquiry recommendations relating to a 'credible' threat of further regulatory intervention

The 2007 and 2011 PC Inquiry reports evaluating airport monitoring made specific recommendations to provide a credible threat of stronger regulation in the event that airports exercised their market power.[5] The recommendations involved further processes, procedures and/or inquiries, including a 'show cause' mechanism. The recommendations related to the credible threat of stronger regulation in these reports would have resulted in delays and uncertainty for all parties had they been adopted. They were not accepted by the Government.

While the 2019 Draft report proposes increased information provision that potentially improves the transparency of airport performance, the measures for potential regulatory intervention do not provide a credible threat (as discussed above). It is to be hoped that the PC's final report is able to recommend credible, efficient and effective regulatory interventions in situations where airports exercise their market power.

Other matters

Increased data provision on airport performance

The PC proposes that airports be required to supply more detailed financial information on their performance to the ACCC on an annual basis through amendments to Part 7 of the Airports Act.

> "The objective of the monitoring regime is to provide evidence on airports' operations, pricing and investment outcomes. The Commission uses that evidence to determine if the monitored airports are exercising their market power to the detriment of the community. There is scope to improve the monitoring regime to enable greater scrutiny of airport performance by the Commission and other parties and to contribute to more effective commercial negotiation.
>
> The combination of the monitoring report and Commission reviews allows a regular assessment of the performance of airports, whether an airport should be added to the list of monitored airports (or removed from it), and whether a monitored airport should be subject to more onerous regulation." (PC Draft Report, p.282)
>
> "It (the ACCC) identified the inherent limitations of using accounting data to analyse economic behaviour. The limitation of the monitoring regime is primarily because it is based on accounting data. For example, to measure profitability, the ACCC is limited to using 'operating profit margin' and 'return on assets'. These are accounting measures which are not well suited to analysing monopoly profits. (sub. 59, p. 31)" (PC Draft Report, p.283)

[5] See Appendix C, p.24 in A4ANZ Submission, no. 44 and Arblaster, M., 2014. The Design of Light-Handed Regulation of Airports: Lessons from Experience in Australia and New Zealand, *Journal of Air Transport Management,* Volume 38, July, pp. 27-35.

The timeliness of resolution of issues

The PC expects that with access to improved data on airport performance the credibility of a threat of further regulation will be associated with future PC inquiries. As the PC recommends that a future PC inquiry on airport regulation occur in 2024, this implies that there is likely to be at least a five year period before any intervention or remedial action can occur to address any identified market power.[6]

The costs and benefits of increased data provision

While the PC Draft report mentions the costs to the airports of its proposal for increased information provision, it does not identify the costs to the Government (and the community). The PC's proposals represent a significant increase in the workload associated with the ACCC's airport monitoring function. If the ACCC's budget was not increased commensurably with the task required, then the opportunity cost of the resources taken from other ACCC functions needs to be recognised. The resource cost to the ACCC in addition to the costs to the airports of expanding monitoring information requirements (already identified) should be assessed against the benefits.

The ACCC's role in airport monitoring

The PC Draft report recommends that ACCC airport monitoring 'audit' airport information and put it on its website with the purpose that the reports be used by the PC for assessment at the next airports inquiry, parties in their negotiations and the public generally. It is not clear what the PC means by the term 'audit' in this context, nor the nature of the monitoring role that the PC envisages that the ACCC will have under its recommendations. Some questions that follow from this and require consideration and explanation by the PC include:

- *If the ACCC's role is restricted to 'auditing' data and putting it on their website, is this a good use of the ACCC's resources and skills?*
- *Given that there is no standardisation of methodologies envisaged, should the ACCC undertake data manipulation to improve comparability between airport reports and over time?*
- *Should the ACCC endeavour to convert financial cost concepts to economic concepts?*

If the ACCC's role is not to make any kind of assessment of the monitoring data it has collected, then this would be a change from the monitoring function the ACCC has had to date and the potential impacts of this would need to be clarified, including the ACCC's role as an independent statutory authority.

Arbitration under Part IIIA

The PC Draft report discussion of arbitrations is very negative and in my view unbalanced. The PC does not appear to give sufficient consideration to the legislative provisions covering an arbitration conducted under Part IIIA, nor to the expertise of the ACCC, the experience to-date of arbitration

[6] Taking into account that an inquiry report will make recommendations which will then require a Government response and implementation.

under Part IIIA including the reluctance to invoke an arbitration[7] and experience of dispute resolution mechanisms in other jurisdictions that apply to airports and industries with similar characteristics.[8] The role of dispute resolution applied to Canadian rail and marine transport could provide insights for the PC on the effectiveness of alternative approaches to regulatory intervention.

The ACCC's arbitration function under Part IIIA is governed by the CCA legislative framework and based on sound principles of economic efficiency. In this regard s.44AA the Objects of Part IIIA and s. 44X relating to the final decision in an arbitration decision conducted under Part IIIA are also relevant (see extracts of the relevant sections from the CCA below). The CCA also contains legislative time limits for decisions. The relevant provisions of the CCA do not appear to have been carefully considered in the PC Draft report. Similarly protections, such as independent review through appeal processes and guidelines on arbitration processes, are not addressed in the report.

Summary and conclusions

The PC's Draft report has not recommended credible, efficient and effective regulatory intervention in situations where airports exercise their market power. The 2007 and 2011 airport inquiry reports were also unable to do this. This situation seems to have arisen because of the reliance on the use of regulatory mechanisms under Part VIIA of the CCA, and PC and other inquiry processes. Insufficient consideration is given to the characteristics of these processes and the potential remedial actions available from these processes.

Insufficient consideration has also been given to experience under the declaration processes, the protections provided by the legislative provisions and administrative processes associated with arbitrations. Review of experience with dispute resolution in infrastructure industries in Australia and in other jurisdictions, such as in Canada could be insightful.

[7] There is a general reluctance to invoke an arbitration, and dispute resolution mechanisms more generally. There have been only two completed arbitrations since Part IIIA was enacted in 1995.

[8] See Arblaster, M., 2017. Light handed regulation of airports services: an alternative approach to direct regulation? Chapter 2 in James Peoples Jrn. and John Bitzan (Eds.), *The Economics of Airport Operations*, sixth volume in Advances in Airline Economics series. Emerald Publishing

Attachment A

Extracts from Part IIIA of the *Competition and Consumer Act 2010* relevant to access arbitrations.

https://www.legislation.gov.au/Details/C2017C00375

"44AA Objects of Part

The objects of this Part are to:

(a) promote the economically efficient operation of, use of and investment in the infrastructure by which services are provided, thereby promoting effective competition in upstream and downstream markets; and

(b) provide a framework and guiding principles to encourage a consistent approach to access regulation in each industry."

"**44X Matters that the Commission must take into account**

Final determinations

(1) The Commission must take the following matters into account in making a final determination:

(aa) the objects of this Part;

(a) the legitimate business interests of the provider, and the provider's investment in the facility;

(b) the public interest, including the public interest in having competition in markets (whether or not in Australia);

(c) the interests of all persons who have rights to use the service;

(d) the direct costs of providing access to the service;

(e) the value to the provider of extensions (including expansions of capacity and expansions of geographical reach) whose cost is borne by someone else;

(ea) the value to the provider of interconnections to the facility whose cost is borne by someone else;

(f) the operational and technical requirements necessary for the safe and reliable operation of the facility;

(g) the economically efficient operation of the facility;

(h) the pricing principles specified in section 44ZZCA.

(2) The Commission may take into account any other matters that it thinks are relevant.

Interim determinations

(3) The Commission may take the following matters into account in making an interim determination:

(a) a matter referred to in subsection (1);

(b) any other matter it considers relevant.

(4) In making an interim determination, the Commission does not have a duty to consider whether to take into account a matter referred to in subsection (1)."

"**44ZZCA Pricing principles for access disputes and access undertakings or codes**

The pricing principles relating to the price of access to a service are:

(a) that regulated access prices should:

(i) be set so as to generate expected revenue for a regulated service or services that is at least sufficient to meet the efficient costs of providing access to the regulated service or services; and

(ii) include a return on investment commensurate with the regulatory and commercial risks involved; and

(b) that the access price structures should:

(i) allow multi-part pricing and price discrimination when it aids efficiency; and

(ii) not allow a vertically integrated access provider to set terms and conditions that discriminate in favour of its downstream operations, except to the extent that the cost of providing access to other operators is higher; and

(c) that access pricing regimes should provide incentives to reduce costs or otherwise improve productivity.

Note: The Commission must have regard to the principles in making a final determination under Division 3 and in deciding whether or not to accept an access undertaking or access code under Division 6."