Inquiry into Airport Regulation
Productivity Commission
GPO Box 1428
Canberra City ACT 2601

29 September 2011

Economic Regulation of Airport Services:
Some comments on the
Productivity Commission Draft Report of August 2011

Stephen Littlechild
Emeritus Professor, University of Birmingham
Fellow, Judge Business School, University of Cambridge

1. Introduction

The Draft Report, and some of the responses to the Consultation, kindly reference some of my work on negotiated settlements and related approaches to regulation. I have recently suggested that Australian airport regulation has been "exploring the frontier" in terms of international best practice, not least building on some of the Productivity Commission's recommendations in its previous two reports. Unfortunately, it seems to me that the present Draft Report does not take the framework forward, and leaves unresolved the major cause for concern with the present approach. This short paper sets out my reasons for this conclusion, suggests that an arbitration mechanism has been wrongly dismissed, and makes a proposal for a way forward.

This paper is written in a private capacity. It has not been initiated or supported by any of the parties in the Australian airport sector or elsewhere.

2. Achievements and limitations

The Draft Report, like its predecessors, well summarises the achievements and limitations of the Australian approach. To have achieved this performance on investment, pricing and other matters via commercial bargaining between airports and airlines, rather than by regulation that can so often be burdensome, restrictive and distorting, is what puts Australian airport regulation at the best practice frontier.

The main limitation is that the industry is so polarised. Airports are almost unanimous that the present framework is fine, airlines are almost unanimous that it is seriously deficient. Specifically, the airlines say that airports have a take-it-or-leave-it attitude to commercial negotiations, and act unreasonably in other respects. (Draft Report s 9.2)

Such a situation is not conducive to the development of genuine commercial bargaining that the Draft Report rightly supports. Nor is it conducive to the discovery and adoption of more efficient ways of operating and investing, many of which rely on increased cooperation between the parties in the industry.

The Draft Report essentially acknowledges this, and considers how best to address this concern.

3. A credible threat?

The Draft Report's first and main proposal is that there should be a credible threat that action would be taken against an airport found to be abusing its market power. This would be provided by empowering the ACCC to direct that an airport 'show cause' why its conduct should not be scrutinised under a Part VIIA price enquiry.

The Productivity Commission's previous report made a similar proposal, involving the Government rather than the ACCC requiring the airport to 'show cause'. After initially agreeing, the Government said

> Airports have raised concerns that the proposed 'show cause' process might impede their capacity to acquire loan finance because lenders believed that the process introduced uncertainty into the risk environment upon which loans were predicated. Airline representatives considered the 'show cause' process would not necessarily help resolve negotiation disputes with the airports. Both airports and airlines expressed concerns that the 'show cause' assessment would be resource and time intensive to establish and maintain. (National Aviation Policy White Paper, December 2009, p. 180)

In the light of these concerns, the Government decided not to adopt the proposal at that time.

The Draft Report argues that the ACCC is not subject to the same political pressures as the Government. But it is not clear why the proposed process is not subject to precisely the same objections as the previous one. The Draft Report does not address these objections.

Nor does the Draft Report consider what remedial action might be taken in the light of the findings of such an investigation. Suppose, plausibly, that the investigation found essentially the same situation as the Draft Report has found. There is universal agreement that a return to price control is not appropriate: even if it were a credible threat at one time, it no longer is. So, what remedy would be appropriate? Is the proposed 'show cause' procedure doing any more than prolong the uncertainty and polarisation in the industry?

Finally, does this process not introduce the very regulatory influence that the Draft Report is at pains to avoid? If the process has any effect at all, will it not encourage an airport to seek guidance from the ACCC as to what kinds of policies and practices and calculations it would find acceptable? Will it not lead to regulation by the back door?

4. An arbitration mechanism?

The Draft Report recognises (s 11.5) that a show cause procedure would be an ex post mechanism that would not resolve live disputes directly. But the timely, appropriate and effective resolution of live disputes – more precisely, the periodic commercial contractual negotiations that the Draft Report seeks to encourage – is of the essence of the concerns expressed by airlines.

The ACCC has proposed that this be addressed by the deemed declaration of relevant airports under Part IIIA. The Draft Report argues against this.

> "… expedited access to arbitration at the contract formation stage could fundamentally undermine light-handed regulation. It is difficult to conceive how provision for ACCC arbitration would provide both airports and airlines with strong incentives to engage in genuine commercial negotiations."(s 11.5)

The Draft Report then cites the Productivity Commission's 2006 Report to the effect that arbitration would come to be viewed as the default option, with a return to 'institutionalised' determination of charges and conditions.

It is disappointing that the Draft Report is unwilling to acknowledge the clear explanations, provided by the ACCC and the airlines, why ACCC arbitration would indeed provide strong incentives to engage in genuine commercial negotiations. And while it was perhaps understandable that the Productivity Commission had pessimistic expectations five years ago, it is equally disappointing that the Draft Report is unwilling to acknowledge the overwhelming evidence that has been presented to it, as to how access to arbitration or its equivalent has actually worked in practice.

Examples of how parties prefer to negotiate their own agreements, even when they have access to regulatory arbitration, continue to emerge. For example, the Australian Rail Track Corporation (ARTC) was in process of submitting an access undertaking to the ACCC in relation to the Hunter Valley rail network. Rather than await an ACCC decision, ARTC and the coal producers that used the line negotiated and agreed a revised undertaking that better met the coal producers' needs and provided the slightly higher return that ARTC needed. The ACCC was not "predisposed to intervene": it accepted the agreement on 29 June 2011.

The Draft Report presents no new empirical evidence to counter this record. Only two notes of dissent are mentioned.

The first is a quibble by Sydney Airport as to whether UK airport experience is relevant. This is based on the erroneous claim that "There is no opportunity for negotiation or arbitration, because the CAA must set prices." (Box 11.4, p 250) The ACCC (sub 76) has explained why this is incorrect. Although the CAA ultimately sets prices, this does not preclude it setting the prices that an airport and airline negotiate and agree. This did not happen in the last price control review, because the CAA did not invite the parties to negotiate price as an element of the constructive engagement. But it did happen more recently, when the CAA invited the parties at Heathrow and Gatwick to negotiate and agree an extension of the price control by a year. And the possibility of the parties negotiating charges is envisaged for the forthcoming review. In addition, in this respect the regulatory framework is the same in the UK as in the US. FERC too must set prices, but that has not precluded 90% of the rate cases being negotiated between the parties.

The second cited dissent with reference to actual experience is by MAp, owner of Sydney Airport. It says that "Once the regulator has become involved, overseas experience is that the level of regulatory involvement increases over time." (s 11.5 p. 249) Certainly regulatory involvement has increased in certain countries over certain time periods. But in the UK and some German states, as well as Australia, regulatory involvement has decreased in recent years. And the recent EU Airport Directive 2009 very much puts the emphasis on commercial negotiation and says nothing about conventional price regulation.

MAp goes on to say that regulation involves "progressively narrowing the scope for innovative and flexible agreements". But the commercial negotiations and agreements that are beginning to supplant conventional regulation in the UK and parts of Germany exhibit the opposite tendency. For example, in the ongoing discussion about the adoption of negotiated settlements in the CAA's next airport price control review, one proposal is that the airlines and airport set up joint working groups on operating cost and the design of incentives, with a gain-share basis for operating savings found by joint action.

In the same piece of evidence to the Commission (sub 22 p. 12), MAp then refers to "the tendency for regulatory determinations to become more complicated". It cites the increasing number of capex triggers at Heathrow, the need to revise some triggers over time, and the regulatory involvement in interpreting trigger events. However, the CAA documents cited by MAp make it clear that the airlines were broadly very supportive of the CAA proposals, with some arguing for the CAA to go further. The revision of the triggers seems to have been straightforward, with the CAA seeing no reason to object to the revisions agreed by the airport and airlines. And while the CAA was required to interpret a condition that it had put in place, in Australia this would be handled by a non-regulatory dispute resolution process agreed by the parties themselves.

In sum, MAp's evidence on airport regulation in general, and its experience of capex triggers in the UK, provides every reason to encourage a process of commercial bargaining between the parties rather than a reversion to regulation. But it provides no basis for opposing the introduction of an arbitration mechanism in Australia involving the ACCC.

5. What would arbitration involve?

The ACCC's proposed arbitration mechanism is demonised as a return to heavy-handed regulation. But what exactly would it involve?

Deemed declaration under Part IIIA would mean that either an airline or an airport could refer a dispute to the ACCC. It is for the referring party, not the ACCC, to specify the nature of the dispute. And although the ACCC's determination "may deal with any matter relating to access by the third party to the service, including matters that were not the basis for notification of the dispute", nonetheless the ACCC's scope is more limited than with a normal price control review. The referring party may withdraw the dispute at any time, which is not the case with a price control review. The rules of procedure are quite different, and more flexible than with a price control review. And the ACCC must give its determination within 180 days, about six months, whereas a price control review can last for a couple of years.

In short, arbitration by the ACCC under Part IIIA would not be – and could not be - the heavy handed regulation experienced a decade ago.

The Draft Report suggests that arbitration "would provide scope for airlines to get a 'second opinion'". (s 11.5 p. 249) This is not the case. A 'second opinion' is one that the commissioner of the opinion can unilaterally take or leave, conceal or use as it sees fit. In contrast, arbitration, once commissioned, leads to a determination that is known to both parties, and binding upon them unless they both agree otherwise. The determination may be favourable to the airline, but it may not be: it may therefore worsen the airline's bargaining position, which a 'second opinion' would not do.

The Draft Report sees "a risk that airlines might see it in their interests to have building block parameters examined by regulatory decisions – an arrangement that might, through precedent, lead to a default form of revenue capping, antithetical to commercial negotiation". (s 11.5 p. 251) The use of a building block approach is not in itself objectionable, and indeed is reportedly commonly used and helpful. (s 9.2 p. 204) Since the elements of the building block are constantly changing, it would not be surprising if the parties disagreed on some of them. Airlines might therefore refer a dispute on particular parameters. The ACCC's determination of that dispute would inform all the industry parties and remove or reduce the need to seek arbitration on those parameters in future. This would be entirely consistent with commercial negotiation. Why it "might, through precedent, lead to a default form of revenue capping" is unexplained and implausible.

6. A proposal

This paper has agreed with the Draft Report that the currently bad relations between airports and airlines, and the airlines' resentment of the airports' bargaining stance, is a serious failing that needs to be remedied. However, this paper argues that a show cause mechanism would have serious defects as a credible threat. It further argues that an arbitration mechanism such as deemed declaration under Part IIIA would have significant benefits and would not have the adverse effects feared by the Draft Report.

Is there a compromise policy that would provide a useful way forward without risking the outcomes feared by the Draft Report? Suppose just one airport were deemed declared under Part IIIA. Other airports would remain undeclared for the present. Logically, the airport to be declared would be the airport causing most present concern. Evidence in the Draft Report provides a basis for treating airports differentially in this way.

This would make it possible to observe, from experience, the effect of such a declaration in the Australian airport context. How far would it lead to the positive or negative outcomes predicted by the different parties? How far would it solve the main problem to be addressed? Would commercial relationships improve, deteriorate or remain unaffected at this airport?

In addition, this policy would also provide evidence as to the credible threat provided by such deemed declaration. This would be a real and immediate threat. Do the other airports ignore it? Or do they respond by negotiating more flexibly? Again, do commercial relations improve as a result?

Future policy could be evaluated in the light of this evidence. It might suggest that deemed declaration be extended to other airports, left in place for just one airport, or withdrawn. Importantly, policy would be based on better evidence than is available today. In this way, the Productivity Commission could enable the Australian airport sector to continue to lead at the frontier in terms of regulatory practice.