Economic Regulation of Airports

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Introduction

Thank you for inviting me to speak at the AAA National Conference here in Adelaide. Today I would like to reflect on the four Productivity Commission (PC) inquiries that have helped the government to determine airport regulation since the privatisation of Australia's airports in 1994, with a larger focus on the 2019 report.

I would then like to discuss more recent developments, including the pandemic, and the potential future regulatory path of airports.

The Productivity Commission

But first, what is the Productivity Commission? We are a statutory agency of the Australian Government in the Treasury portfolio. We undertake public inquiries and research for the Government on receipt of a terms of reference that describes the time frame for an inquiry and its scope.

We then conduct the inquiries independently and publicly, seeking evidence through submissions, research, and hearings. In conducting an inquiry, we are required to consider the overall community interest, not that of specific groups.

We publish a draft report and, ultimately, a final report that makes recommendations and findings which the Government may choose to act on. For an inquiry, the Government must table the final report in Parliament within 25 sitting days of receipt.

Privatisation by long-term lease

In April 1994, the Australian Government announced the privatisation, by long-term lease, of the airports operated by the Federal Airports Corporation (FAC).

The objective was to improve the efficiency of airport investment and operation in the interests of users and the general community and to facilitate innovative management.

In 1997, the FAC began the sale of 50-year leases for 17 of its 22 airports to privately owned operators. The FAC completed sales in two phases beginning with Melbourne, Brisbane and Perth in 1997, followed by 14 smaller airports in 1998.

The remaining five airports (Sydney, Bankstown, Hoxton Park, Camden and Essendon) were leased to two government-owned corporations in 1998.

In 2001, Essendon Airport was leased to private owners, and in 2002, privatisation was completed with the sale of the other Sydney basin airport leases.

The federally leased airports were subject to price regulation during the initial period of private ownership.

Airports that had significant RPT movements – Sydney, Melbourne, Brisbane, Perth, Adelaide, Gold Coast, Hobart, Launceston, Alice Springs, Canberra, Darwin and Townsville – were designated as ‘core regulated airports’. Price regulation of these 12 airports included price notification, price monitoring, price cap arrangements and special provisions for necessary new investment.

The first PC inquiry

In December 2000, the Government asked the PC to conduct an inquiry into the price regulation of airports, including an examination of the price cap regime. This report, titled *Price Regulation of Airport Services* was led by Gary Banks, Richard Snape and Neil Byron and was provided to the Government in January 2002.

In this report, the Commission found that price caps distorted production and investment decisions due to the inability of regulators to set prices accurately. The Government agreed to the Commission's recommendation to move to a light-handed approach with price monitoring.

The second PC inquiry

In 2006, the Government asked the Commission to conduct a second inquiry which was titled *Review of Price Regulation of Airport Services*. It was handed to the Government in December 2006. This report was led by Gary Potts and Neil Byron. The inquiry found that price monitoring had been successful and recommended its continuation, albeit with a different scope. The Commission recommended that Darwin and Canberra be removed from the monitoring regime because they were relatively small and faced competition from other airports and modes of transport.

The third PC inquiry

In 2011 the Government asked the Commission to conduct a third inquiry which was titled *Economic Regulation of Airport Services*. This was handed to the Government in December 2011 and was led by Wendy Craik and John Sutton. It again recommended the continuation of price monitoring, but that Adelaide airport be excluded from the monitoring regime.

The fourth PC inquiry

The brings me to the fourth report, led by Stephen King and myself, that was handed to the Government on 21 June 2019 and tabled in Parliament on 22 October 2019.

The response to the report was quite varied, as I suppose is likely to be the case when there is a perception by some participants that the current regulatory approach and proposed alternatives are a form of zero-sum game with a fight over rents or profits.

But that's not the right way to view regulation. A good regulatory system encourages efficiency and productivity – factors that provide greater returns to all parties. This is achieved by having sound investments made by airports in infrastructure that comes to benefit customers including airlines and passengers.

In the four inquiries, the Commission came to the view that the negotiation of contracts between airlines and airports on a dual till basis – separating aeronautical services from non-aeronautical services – is likely to lead to efficient investment and that airports would provide the services their customers wanted at a reasonable price.

Our analysis showed that this had been the case, and that there had been substantial investment at airports, but not gold plating.

Gold plating – excessive and inefficient investment – is unlikely to occur in a non-regulated price regime. An airport has no incentive to over-capitalise as it would be unable to recoup the costs of such investment.

By contrast, a regulated price regime – for example the electricity grid in NSW – did provide an incentive to gold plate.

During the mining investment boom, there was a period when Perth airport was straining under the demand, but otherwise our report showed that investment had been flowing well at the airports.

We did a thorough assessment of the regulatory regime. Our benchmarking showed there were no significant problems – airports were not making excessive profits and their costs and charges were reasonable.

Airport infrastructure is fundamentally different to other ‘monopoly’ infrastructure. It has a large range of services, aeronautical and non-aeronautical.

These include the provision of runways, taxiways, aprons, gates, buses, security, check in, baggage handling, car parks, hotels, business parks, retailing and so on.

It has one customer with 60 per cent of the share of aeronautical services and the airport cannot deny the service even when a bill is unpaid or underpaid.

Overall, we found that the four major airports had significant market power, but it wasn’t being exercised. Airports in the second tier of monitoring did not have significant market power, nor did regional airports.

We think that the evidence for airports not exercising their market power can be seen through benchmarking of their performance (compared to other airports in Australia and overseas) and the fact that negotiations between airports and airlines are robust, complex and can be lengthy based on a building block model.

In terms of benchmarking, the Commission examined the Return on Aeronautical Assets across the monitored airports and did not find evidence that the monitored airports were systematically exercising their market power. If taken in isolation, some financial indicators could be consistent with the exercise of market power. For example, the high international charges at Sydney and Brisbane, Sydney's profitability and the high operating costs at Perth Airport show that there is reason to remain vigilant.

On balance, though, most indicators of operational efficiency, including costs and service quality, aeronautical revenue and charges and profitability were in reasonable bounds. Each monitored airport has generated returns sufficient to enable investment while not earning excessive profits, and passengers at the time considered airports to have good service quality.

There was, however, scope to improve the quality of the monitoring regime to enhance transparency over airports' operations and to more readily detect the exercise of market power.

There is little doubt that an organisation with unconstrained market power would exercise it. But our view is that the present regulatory approach together with the market structure greatly constrains that market power.

And, critically, the lease conditions which form the basis of the airport operations mandate that the services be provided. They cannot be withdrawn to force up the price.

These lease conditions, together with the countervailing power of airlines, make the dynamics of airports substantially different to other regulated monopolies.

Airlines have common cause to the extent that they all want to share in what they perceive to be excessive rents in non-aeronautical services through lower aeronautical charges. But there their common cause ends. Domestic airlines compete against each other and against foreign airlines and their motivations vary. For example, a domestic airline might benefit from restricting airport infrastructure investment to the extent it reduces foreign competition. That would not be in the interests of passengers.

Other airport services

The report also examined other services provided by airports, including car parking, landside access, retail, the market for jet fuel and access arrangements to Sydney airport through the slot system and the regional ring fence.

In respect of car parking and landside access, the Commission found that airports did have market power but were constrained from using it. While car parking prices attract significant public attention, regulatory intervention to lower car parking fees would have significant costs, leading to increased congestion and reduced car parking investment by airports.

The most important constraint to airports exercising their market power in car parking is through robust competition from alternative modes of transport and in this the widespread use of smartphones has added further options for passengers and their families and friends.

In respect of landside access (by taxis etc.) it's true that ground transport operators have less bargaining power than airlines, with no ability to switch to alternative providers and a greater likelihood of being presented with take-it-or-leave it offers.

We were also concerned that some of the data that might help assess the extent of any exercise of market power was not available in the present monitoring reports. Overall, we thought that the combination of technological innovations that increased competition in ground transport and the lack of clear evidence of the exercise of market power by airports meant that the regulatory environment should remain unchanged for the present, noting the improvements in monitoring we recommended.

Sydney airport

Access arrangements at Sydney airport remain problematic. While the regional ring fence, the price cap and price notification regime help access by airlines operating regional flights to Sydney, there is scope for improvements to allow regional services to trial flights during peak periods and to better respond to market demand on different routes.

We thought that the Government should amend the Sydney Airport Slot Management Scheme to allow peak-period slots that are not part of a permanent regional service series to be used for flights servicing NSW. Such slots would, however, not become permanent regional service series (PRSS) slots when used for regional flights.

The Commission also examined the regulatory movement cap and curfew at Sydney that is designed to mitigate aircraft noise. While there is strong resistance to change by Sydney residents, the movement cap does have unintended consequences such as exacerbating delays when there are disruptions such as those due to adverse weather.

These costs can cascade through the aviation network, harming passengers through delays and higher fares.

One reform the Commission proposed was to change the movement cap from a 15 minute rolling hour basis to a once-per-hour cap.

The definition of which aircraft can operate during the curfew period is also excessively narrow and not directly related to aircraft noise.

We also strongly favour a thorough review of the slot management scheme which can be gamed to restrict access by new airline entrants. Again this can harm passengers.

Jet fuel

The market to supply jet fuel is characterised by a small number of vertically integrated suppliers with high barriers to entry and a lack of transparency on pricing.

Greater third-party access to infrastructure services would increase competition and put downward pressure on prices to access those services, as well as on fuel prices.

The conditions for competition appeared to be improving, though, and it was encouraging that some airports, such as Melbourne and Darwin, were introducing lease arrangements for the Joint User Hydrant Installation (JUHI) infrastructure that incorporated open access arrangements for third party fuel suppliers.

At the time of our inquiry, other airports including Perth, Sydney and Adelaide were renegotiating their JUHI leases – as we said in the report open access is an important feature of any new agreement.

The PC's recommendations

The Commission made 14 recommendations, but here I would like to highlight a few that we thought important to improve the present regulatory

system while promoting competition between airports and airlines and between airlines.

We had the opportunity to examine a few agreements between airports and airlines. These contained some anti-competitive measures such as clauses that constrain an airline's access to regulatory remedies (such as Part IIIA of the Competition and Consumer Act) and those which reference the terms offered to airlines' competitive rivals. The former clauses tend to benefit airports while the latter benefit airlines. We recommended that the Government amend the Aeronautical Pricing Principles so that agreements between airports and airport users not contain anti-competitive measures.

We recommended the continuation of the five yearly PC inquiry process into airport regulation including whether airports should be added or removed from the monitoring regime, the scope of regional air services in NSW, and competition in jet fuel markets.

We also recommended that the Government make clear that monitored airports should make their agreements with airport users available to the Commission on request and on a commercial-in-confidence basis, to examine potential anti-competitive clauses.

We thought the voluntary self-reporting system for second-tier airports should be discontinued. There is sufficient separate information to ascertain whether such an airport had grown to sufficient size to have market power which would then warrant it being monitored.

We had a detailed recommendation to improve the type of information provided in monitoring reports which would better able the Commission to see if market power was being exercised including in landside access and car parks.

And finally, we recommended that the Australian Competition and Consumer Commission (ACCC) provide advice to the Government on an updated set of quality-of-service indicators in consultation with airports, airlines and other airport users.

Negotiate-arbitrate and Part IIIA

It is no surprise that the Commission's recommendations to continue a relatively light-touch regulatory regime for airports with an improved monitoring regime has been strongly contested by some parties to the inquiry.

While the National Competition Council supported the Commission's views, the ACCC had a different take and there was a push for an airport-specific regulatory structure based on a negotiate-arbitrate scheme.

I would characterise the ACCC's view as the mere possession of market power being a sufficient reason for additional regulation. But that neglects the cost of regulation – direct and indirect – and the impact that it can have on investment and competition.

Both the Productivity Commission and the National Competition Council view the availability of Part IIIA of the Competition and Consumer Act as being an important additional regulatory safeguard and we were not satisfied that proponents of an airport-specific negotiate-arbitrate scheme had demonstrated a failure of the existing regulatory framework.

Indeed, negotiate-arbitrate appears to be a Part IIIA without the safeguards of a net-benefit test. These safeguards, together with opportunities for merits and judicial review, are there to ensure that arbitration is only available when it would encourage competition and promote the public interest.

Indeed, a negotiate-arbitrate regime would upset the current fair balance between airports and airlines and tilt the regulatory regime to favour airlines.

An arbitrator would be able to compel airports to provide services to airlines at the arbitrated price but would not be able to compel airlines to use airport services at that price.

Such an arrangement would be profoundly detrimental to good negotiations between airports and airlines, changing the incentives and behaviours of negotiating parties in ways that would be detrimental, rather than beneficial, to the community. This would result in airport operators reducing the level of investment in airport infrastructure unless they are compensated for this extra risk through higher up-front charges or guaranteed future revenues.

Further, airports invest in common-user facilities to provide services to multiple users. Unrestricted access to arbitration would create opportunities for incumbent airlines to engage in anticompetitive conduct, such as using arbitration over a common-use facility to reduce the ability of other airlines to compete.

Overall, it is hard to see how a negotiate-arbitrate regime would be in the interests of the flying public. To the contrary, it could lead to higher fares, less competition between airlines and restricted services.

Again, I emphasise that there is already an opportunity for airlines that are not satisfied with negotiations they have with airports to seek a declaration under Part IIIA of the CCA. While this can be time consuming, it’s notable that an airline has not sought a declaration in many years. An access declaration could have been sought more than a decade ago and it would have been resolved long ago. But it wasn’t and hasn’t been.

It's like a pilot saying to a co-pilot “these checklists we have to go through before every flight are inconvenient and time consuming. Why don’t we ditch them and declare that we can take off straight away?”

Negotiations between airports and airlines are robust and can be lengthy, but that is because there are two big businesses in negotiations and a complex set of matters to negotiate. Neither party gets exactly what it wants, but airport do offer not take-it-or-leave-it contracts. They use a building block model and make changes to their investment profiles.

If airports were using their market power, they would simply set a price and quality and that's it. They would probably charge peak prices say in Sydney. But they don't. They have even included anti-competitive clauses in contracts that benefit a dominant airline. A monopolist exercising market power wouldn't do that.

Moreover, these negotiations lead to tailored agreements which can have sophisticated performance metrics to judge achievement of contracted terms. Additionally, both the AAA and the Board of Airline Representatives of Australia have been examining the scope for standardised 'boilerplate' clauses and other aspects to guide the negotiation of future agreements. As we noted in the report (p. 137) the Australian Government could facilitate this process if airlines and airports consider that helpful.

The pandemic

The less I say about the pandemic the better. It had a profound impact on the aviation sector. I recall being in Brisbane International Airport on a flight to Pakistan on 22 November 2020. It was deserted and I had to have a special exit permit. According to the 2021-22 MYEFO, total government support for the aviation sector during COVID-19 was over $5.1 billion.

But in the aftermath – and we continue to see the impacts of the pandemic on aviation – does it affect the Commission's calculus that the present regulatory system remains optimal?

I don't think it affects that calculus. Airlines were able to park aircraft, something airports were unable to do. And airports offered relief to airlines including rent relief, landing fee relief for international airlines, relief from terminal tenancies and so forth.

Both airlines and airports have been profoundly affected. But I cannot see that the post-covid environment provides any additional incentives for airports to exercise market power which they have previously eschewed. This would remain a matter for any future PC inquiry of course.

WA Supreme Court decision

Let me now turn to the recent decision by the WA Supreme Court in the matter of Perth Airport Pty Ltd v Qantas Airways Ltd, handed down on 18 February 2022 and I understand pending appeal to the Court of Appeal.

In this case, Perth Airport took Qantas to the court over unpaid or underpaid accounts. Qantas continued to use Perth airport services while in dispute over the pricing.

This is a very complex case, as reading the judgement shows. His Honour, assisted by expert witnesses, carefully assessed the case, using a building block methodology in what is clearly a robust assessment and came with an outcome that he considered was 'fair and reasonable'.

Perth airport sought a weighted average cost of capital (WACC) of 9.7%, Qantas asked for something in between 5 and 5.5% and the Court awarded 9.6%. And each of the building block details had to be resolved, for example including the effective life of an asset.

As mentioned, I understand that the decision is being appealed. But here is an example of where an independent and rigorous assessment using a building block methodology of airport charges was undertaken by the Court.

And the case may have the side benefit of providing some precedent as well as transparency over airport charges.

But coming back to the main question of my talk – does it affect in any substantial way the calculus the Commission reached on the balance of airport regulation?

I think not. It shows that an airport cannot just set a price and have it unchallenged. It gives credibility to the methodology used by airports and airlines in their negotiations. It shows that an airport cannot deny a service to force a customer to pay.

It's probably too early to speculate more, especially as an appeal is on the cards. But if anything, the WA Supreme Court case gives additional weight to the Commission's view that the present regulatory system is fit for purpose. Beyond that, any future PC inquiry would clearly consider in detail the outcomes of this case.

Aviation White Paper

Finally, let me touch on the Government's announced Aviation White Paper. It is principally designed to improve the passenger – airline and passenger – airport experience.

The White Paper will set the long-term policies to guide the next generation of growth and innovation in the aviation sector.

If the Commission is asked, we would be happy to contribute to the White Paper process.

As for future PC inquiries on airport regulation, that's entirely up to the Government. We have been very happy conducting the past four inquiries and have recommended that this continues on a five-yearly basis. Should

there be a fifth inquiry, perhaps in 2024-25, there would be a different two commissioners undertaking it. It would start from scratch, and the Commission would reassess the evidence and recommend heavier handed regulation if the Commission found airports were abusing their market power.

Conclusion

Let me briefly conclude by saying how much Stephen King and I enjoyed working on the 2019 inquiry. It was a challenging topic, highly contested, with a lot of detailed material to get across. But we found the participants from the airlines, the airports, other airport users such as car rental companies, retailers and so on were very helpful and friendly. It was a thoroughly enjoyable experience. For me, it was one of the most memorable inquiries, along with public infrastructure and immigration.

I'm sorry that we were unable to predict the catastrophe of COVID-19 that shook the aviation sector and the world so profoundly. It's a feeling of humility which I'm sure would be similar to the authors of recommendations of a report provided in early 1914 that made no allowance for a world war.

That said, I think the recommendations of the 2019 report remain valid and the genius of our airport regulatory system dates back to the person who wrote the lease clause which doesn't allow a leased airport to deny services to an airline even if a bill is contested, unpaid or underpaid. That, in combination with strong countervailing powers by incumbent airlines, renders moot any ability of an airport to exercise its market power.

Circumstances can change, of course, which is why five yearly reviews are important, which can always recommend more stringent regulation if there becomes evidence of the exercise of market power.

But airport regulation is pretty good, and with the adoption of some of the recommendations in our report, it could be better still.

Thanks for taking the time to listen.