

**Australian airport regulation:  
exploring the frontier**

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**Abstract**

In 2002 Australia removed its price freeze on major airports and instituted light-handed regulation including price monitoring. Internationally, this policy is at the frontier. In general it has worked well but there are concerns that it is ineffective in protecting against windfall gains for airports, that investment incentives are a weak link, that Sydney Airport has deferred investment and let service quality fall, and that airlines are still vulnerable to airport market power. These concerns do not justify re-imposition of price control but they require a method for addressing them. Airlines have proposed independent dispute resolution. Experience elsewhere suggests that concerns about this approach are unjustified, and that it would take light-handed regulation forward.

**Keywords:** airport regulation, light-handed regulation, monitoring, dispute resolution

## 1. Introduction

In 1997 and 1998 Australia privatised most of its major airports. Initially there was a five year price control on airport charges, but in 2002 the price controls were removed. The Government encouraged commercial negotiations between airports and airlines, specified certain pricing guidelines, provided for annual monitoring by the Australian Competition and Consumer Commission (ACCC), and left an unspecified threat that price controls could be re-imposed if necessary. There was also a potential but uncertain role for the Part IIIA national access regime. In 2006 the Government refined the guidelines and extended this 'light-handed' regulatory policy to 2012.

The Productivity Commission has been a main proponent of the light-handed regulatory approach, finding benefits in terms of pricing, quality of service and investment, as compared to a 'heavy-handed' regulatory approach involving ex ante investigation and prescription of these parameters. In general, airports have welcomed this. Schuster (2009), describing the Sydney Airport experience, concludes that "contractual relationships in an environment of informal regulation are able to provide sound, and arguably superior, outcomes to formal price regulation". The major Australian airlines have supported it, individually and via the Board of Airline Representatives of Australia (BARA), conditional on there being effective constraints on airport market power, as would be provided by a system of independent dispute resolution. For the most part, there is no pressure to return to the previous price control regime.

Against this are certain reservations and concerns.

- Other airlines in the International Air Transport Association (IATA 2006a,b) have argued that price monitoring is ineffective in preventing airports from realising windfall gains and that incentive-based price controls would be preferable.
- Forsyth (2008) has argued that "the weak link in the regulatory environment ... concerns investment incentives. ... Unless [the] guidelines are clarified and improved, there is a danger that the framework may degenerate into light-handed, cost-plus regulation with adverse implications for efficiency".
- The latest monitoring report by the ACCC (2010) concludes that "Sydney Airport has increased profits by permitting service-quality levels to fall below that which could be expected in a competitive environment over a sustained period". It also finds that "airport car parking prices charged to consumers are consistent with charges reflecting an element of monopoly rent".
- Airlines remain concerned about a variety of aspects of airport behaviour, including terms and conditions, asset valuation and cost of capital, some implications of the dual till approach, and the regulation of smaller airports.

Most airlines (and some others) have argued for strengthening the hand of the airlines in negotiations against airports that have market power. The Productivity Commission (2006b) concluded against the introduction of a more accessible independent dispute resolution mechanism. Instead, it proposed to clarify the threat of re-regulation by introducing a 'show cause' procedure. The Government initially accepted this, but in December 2009 decided against it. This presumably puts the question of independent dispute resolution back on the table.

The Productivity Commission (2002 p. xliv) detected signs of greater interest worldwide in light-handed regulation, citing the Civil Aviation Authority (CAA) in the UK. That interest has continued to develop. The CAA recommended de-designating (i.e. deregulating) two airports where it considered there was sufficient competition. For the remaining designated airports it introduced the concept of 'constructive engagement', whereby the airports and their airlines discuss and seek to agree certain inputs to the price control decisions. (CAA 2009a) In Germany some commentators have argued for introducing independent incentive regulation instead of the present 'cost plus' regulation by the separate federal states, but meanwhile some airports have negotiated 4 year 'framework agreements' with airlines. (2011) The EU Airport Charges Directive 2009, instead of proposing price controls, mandates a consultation process with an independent arbitration mechanism at major airports. New Zealand is developing its own (rather heavy-handed) version of monitoring via default price-quality paths.

In some cases market developments plus ownership restructuring can create sufficient competition between airports that regulation is not needed. (Starkie 2002, 2008) But for major airports that continue to have market power, as may be the case in Australia, is it possible and desirable to regulate them without the use of price controls? If so, what elements of the regulatory framework are conducive to a successful outcome and which are irrelevant or unhelpful? These are questions that potentially apply in all countries, and that face the present Productivity Commission review of the light-handed policy. For the moment, Australian airport regulation is at the frontier. The review will need to explore the neighbouring ground. Will Australian policy go forward, dither, or retreat?

After a brief background, the first part of this paper assesses the Australian light-handed approach against the four concerns just mentioned. The second part examines the case for an independent dispute resolution procedure, including why the Productivity Commission previously rejected this. It suggests, in the light of international experience, that this would now constitute a helpful way forward.

## **2. Background**

Good accounts of the general background to the light-handed approach to Australian airport regulation are given by Productivity Commission (2006b), Schuster (2009), Forsyth (2004, 2008) and other papers referenced therein. There has been much economic analysis of access pricing in general (Armstrong et al 1996) and some modelling of the Australian approach (King and Maddock 1999).

Briefly, Australia privatised Melbourne, Brisbane and Perth airports in 1997, 14 other airports in 1998, and Sydney airport in 2002. 11 of the airports other than Sydney were subjected to CPI-X price caps starting from the prices inherited from the previous Government-owned regime. There was provision for quality of service monitoring by the ACCC. Cost-related price increases were allowed for 'necessary new investment' approved by the ACCC.

The fall in air traffic following the terrorist attacks of 11 September 2001 and the collapse of the major airline Ansett led to the removal of price caps at eight airports

and one-off price increases at Melbourne, Brisbane and Perth. In its review of airport price regulation, the Productivity Commission (2002) noted some severe limitations of the initial price cap arrangements: unduly low prices, lack of clarity, strategic behaviour and possibly inefficient investment. It recommended replacing the price controls by annual price monitoring by the ACCC. It encouraged commercial relationships between airports and airlines, and recommended that the Government specify principles of airport conduct to avoid the re-imposition of price controls. The Government agreed, and implemented the policy for an initial five years.

In its next review, the Productivity Commission (2006b) reported that the policy had delivered some important benefits: easier investment, high productivity, satisfactory to good service quality, not excessive prices, modest compliance costs, and developing commercial relationships. But there had also been some negatives: constraints on market power less strong than expected, non-price terms and conditions less satisfactory than price outcomes, commercial relationships strained, lack of policy guidance on asset (re-)valuation, lack of clarity and process re further investigation of airport conduct, leading to a lack of credibility in the threat of re-regulation.

The Productivity Commission reaffirmed its belief in commercial negotiations and recommended that the policy should be continued with certain modifications. These included that the Government should (1) elaborate on the specified principles of conduct, including to proscribe further asset revaluations as a basis for increasing asset charges<sup>1</sup>; and (2) clarify the threat of re-regulation by introducing an annual procedure whereby the government would ask a problematic airport to ‘show cause’ why it should not be subject to further investigation and possible re-imposition of price control. The Government accepted these recommendations and extended the policy until 2012. In April 2008 the incoming Government directed the ACCC to monitor prices, costs and profits relating to car parking at Australia's five major airports (in addition to the ACCC's existing annual monitoring of the price and quality of aeronautical services).

In response to the ACCC (2010) Airport Monitoring Report, on 9 December 2010 the Government announced a further review by the Productivity Commission, ‘to examine the effectiveness and efficiency of the current economic regulation and quality of service monitoring regime for airports and whether new arrangements are needed’, and to report within twelve months. The Commission published its Issues Paper on 25 January 2011.

### **3. The Part IIIA national access regime**

Running almost in parallel with these developments was the saga of the Part IIIA national access regime. Its application to airports was extensively tested during this period.

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<sup>1</sup> Airlines had become concerned about airports revaluing their assets upwards, and using that as a justification for increasing charges. The Productivity Commission saw some basis for some revaluation but acknowledged the concern. It proposed that the Government's Review Principles should ‘draw a line in the sand’: for price monitoring purposes, the regime should accept revaluations to airports’ monitored asset bases made before 30 June 2005, and exclude revaluations made after that date.

Part IIIA of the Trade Practices Act 1974 provides for a national third party access regime so as to enable competition in industries dependent upon a monopoly infrastructure. A party may apply to the National Competition Council (NCC) for 'declaration' of a service.<sup>2</sup> The NCC makes a recommendation to the Minister as to whether a service should be declared. The provider of a declared service must attempt to negotiate mutually acceptable terms and conditions of access with an access seeker. If negotiations fail, there is provision for arbitration by the ACCC.

On 1 October 2002, the airline Virgin Blue applied to the NCC for declaration of the domestic passenger terminal service and domestic airside service (runways, taxiways, parking aprons etc) at Sydney Airport. This evidently had an impact on negotiations: commercial agreement was reached on terminal access, and on 6 December 2002 Virgin Blue withdrew its application for declaration of the terminal service. However, agreement could not be reached on terms of access for the airside service.

In November 2003 (and reversing its earlier draft recommendation) the NCC recommended that the airside service should not be declared. On 29 January 2004, the Minister accepted the NCC's recommendation.

On 18 February 2004, Virgin Blue (joined by Qantas) applied to the Australian Competition Tribunal (ACT) for review of the Minister's decision. On 9 December 2005, the ACT handed down its decision that the airside service be declared for a period of five years. The ACT found that Sydney Airport had misused its monopoly power and that, unless the airside service was declared, competition in the dependent market would continue to be affected.

On 6 January 2006, Sydney Airport applied for review of the ACT's decision. In October 2006, the Full Federal Court dismissed the appeal. The wording of its decision was perceived to make Part IIIA more accessible to airlines (see below). Sydney Airport applied for leave to appeal to the High Court.

In February 2007, pursuant to the ACT's declaration of Sydney Airport's airside services, Virgin Blue notified the ACCC of an access dispute with Sydney Airport. The ACCC began to arbitrate the dispute. In March 2007 the High Court refused Sydney Airport's leave to appeal. In May 2007 Virgin Blue withdrew the notification, indicating that the parties had resolved the dispute through commercial agreement.

## **PART ONE SOME CONCERNS ABOUT PRESENT POLICY**

### **4. IATA on prices: monitoring versus price control**

IATA (2006a) was particularly critical of airport price increases over the period 2002-2005.

"Price Monitoring does not work and is not effective in preventing airports from

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<sup>2</sup> In order to declare a service, the NCC must be satisfied that: access is needed to promote competition in related markets; it would be uneconomic for anyone to develop another facility; the facility used to provide the service is of national significance; and the service is not already covered by an access regime.

realizing windfall gains. As the reasoning behind the current price monitoring regime seems to be the implicit threat of future price controls, a return to a price controlled regime would enable the Government's objectives to be met directly and efficiently."

The Productivity Commission (2006b) was not convinced that the observed prices reflected the systematic misuse of market power.

- "Airport charges rose substantially immediately prior to, or at the outset of, the light handed regime. But these increases were either formally approved by the ACCC, or closely followed its regulated pricing 'template'. Indeed, at the time, significant increases in the charges inherited from the days of government service provision were widely accepted as necessary to put airport operations on a sustainable longer term footing.
- Since then, increases at most of the monitored airports have been relatively modest. Moreover, some of these subsequent price increases have been to pay for security upgrades, and/or for additional new investments. ...
- Charges at Australia's major airports are, for the most part, mid-range by international standards ...
- The approach used by the ACCC to determine allowable charging levels at Sydney Airport in 2001 had a major influence on the charges resulting from the first round of negotiated agreements at the other monitored airports. Hence, current price levels may not be all that different from those that would have prevailed had stricter controls been retained.
- Strong growth in aeronautical revenues, and generally high airport profitability by international standards, seem to have primarily reflected larger increases in passenger traffic than was anticipated when current charges were struck." (pp. xv – xvi)

The ACCC has issued annual monitoring reports on the major airports. During the period 2000/1 to 2004/5 it reported that operating margin per passenger and return on assets both increased significantly. But from 2004/5 to 2008/9 operating margin increased relatively slowly, and return on assets showed virtually no net increase. (ACCC 2010, Charts 2.2.3, 2.2.4)

In its evidence to the Productivity Commission, the ACCC said that "the existing monitoring regime does not provide any information on the level of efficient costs, which makes it impossible to determine whether an airport has earned monopoly profits. ... The ACCC does not make any judgements in its monitoring reports as to whether levels of prices are 'acceptable' or reflect monopoly profits." (ACCC 2006a pp vi, viii) More recently the ACCC has attempted to interpret the meaning of the monitoring data as far as possible, to make judgements based on the monitoring results over time, and to examine also the airports' incentives and ability to exercise their market power given the structural characteristics of the market. On this basis, and noting that a comprehensive evaluation would be required to make more definitive findings, the ACCC concludes that, with the exception of service quality at Sydney (discussed below), "the monitoring results do not suggest that the [other four] airports have exercised their market power at the expense of users". (ACCC 2010 p. 17)

Forsyth (2008) notes that "while prices are somewhat high at some airports, they are well below monopoly levels, and there are no major efficiency losses resulting from this pricing". (p. 67) A potential problem is that "most of the relevant parties ... see the performance of the system more or less solely in terms of how prices are in relation to costs". (p. 87) This means that prices could be unduly high because costs

(rather than profit margins) are unduly high. However, he concludes that “the system is consistent with good incentives for productive efficiency, and most airports perform well in terms of productivity”. (p 67)

It does not seem to be alleged that the airports have generally priced inconsistently with the Government’s Pricing Principles, including its guidance on ‘the line in the sand’, and with the ACCC’s earlier analyses of prices related to new investment. A precise evaluation of this question would not be straightforward.<sup>3</sup> And it might be argued that the ACCC did not have the opportunity to assess ‘line in the sand’ price increases before 2005 at airports other than Sydney. However, the ACCC’s recent conclusion cited above (albeit qualified) makes it difficult to argue for replacing present policy on the basis of excessive pricing. It is possible that IATA airlines consider that they would get a better deal, relative to other airlines perhaps, if prices were determined by the ACCC rather than by negotiation. But even if relative prices were a cause for concern, which other airlines would no doubt dispute, this would at most call for some modification to the Pricing Principles rather than for a reintroduction of price control. The concern could well be addressed by facilitating the dispute resolution procedures.

## **5. Investment efficiency incentives and light-handed cost-plus regulation**

The Productivity Commission (2006b pp. 32-3) found that “the move to a light handed price monitoring regime has made it much easier to undertake new investment and for airports to reach agreement with airlines on charges for that investment.” Not least this resulted from removing the regulator from investment decision-making.

In a series of papers, Forsyth (2004, 2008) has expressed concern that a light-handed approach could lead to distorted investment incentives, and thereby to the inefficiencies of cost-plus regulation. If the efficiency of the investments is not properly assessed, the regime may be conducive to excessive rather than inadequate investment.

The airports are happy with the investment mechanism, since they can simply raise prices to cover the costs of the investments they make. However, nothing guarantees that the investments they make are warranted. Thus Adelaide airport has just completed construction of a large high-standard terminal (strongly advocated by local politicians). It also now has the highest charges of any major airport other than Sydney. Was this terminal investment excessive? Ideally the Productivity Commission would examine not only whether the price increases covered the costs of investments, but also whether the investments were warranted. However, such a review would require a large amount of data gathering and analysis, and the Commission review did not undertake such a cost benefit analysis. In short, there is a considerable danger that if airports can always pass through the costs of their investments by raising prices, there will be no check on investment programs, which

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<sup>3</sup> “An assessment of whether achieved performance is consistent with the Principles would be a massive undertaking akin to an inquiry or price control determination. The information provided by the monitoring regime is accounting based, historical and about nine months out of date when published, so has only a limited and indirect bearing on the efficiency principles contained in the Principles. The Productive Commission Inquiry was asked to ‘have regard to’ the review Principles and, not surprisingly, did not make a direct evaluation of the performance of the industry against the Principles it had established. Indeed, it could not have done this in the time available.” (Margaret Alabaster, private communication, 10 December 2010)

could lead to a de facto Averch and Johnson world where airports make excessive investments to increase their profitability. (Forsyth 2008 pp. 89-90)

Whether excessive investment is a serious and pervasive feature of the Australian airport sector is unclear. Private sector entities would have an incentive to resist unnecessary investment unless adequately compensated. Adelaide is understood to be exceptional in terms of political intervention. Against this example might be set the ACCC's conjecture (see below) that Sydney Airport might have delayed investment.

If there is further evidence of systematically excessive airport investment, how is this best addressed? There seem to be three main options. One is to require an ex ante regulatory check of proposed major airport investments. But that would mean reinstating many of those aspects of the previous regime that the Productivity Commission and others found so burdensome and inefficient. No doubt improvements could be made.<sup>4</sup> But most of the familiar disadvantages would remain. A second option would be to require an ex post evaluation of major investments, with re-regulation or other sanctions for airports found guilty. We consider this next. A third option would be to strengthen the bargaining hand of airlines, which would include airlines that would have to pay the costs of any excessive investment. We consider that in Part Two.

## **6. Ex post evaluation, guidelines and the 'show cause' procedure**

The Productivity Commission (2002) proposed that "an independent public review would be conducted towards the end of the [initial] five-year monitoring period to ascertain whether there should be any future price regulation of those airports". Factors taken into account would include whether the airport had complied with specified criteria to be laid down in advance, relating to efficient prices, rate of return, quality of service, extent of negotiated agreements and of consultation with users, number of complaints etc. The Government adopted the criteria proposed by the Commission. (They are subsequently variously referred to as guidelines, Review Principles or Aeronautical Pricing Principles.) In its next review, the Productivity

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<sup>4</sup> 'Some issues related to the previous price cap regime were directly attributable to design features of the regime: in particular, the 'new investment' provisions allowing pass through of price increases above the cap were poorly defined. It was difficult to distinguish between what was new investment and investment that was already accounted for in the level of the price cap. The initial determination of the level of price caps was not transparent and was undertaken in a very tight timeframe to fit in with the airport privatisation process. Airports and airlines did not know what assets would be covered by the 'new investment' process, leading to substantial gaming on both sides. As a result, it was difficult for the regulator to administer the framework and there was greater intervention than there would otherwise have been. The confusion was compounded by divergent interpretations of the regulatory framework expressed during the sale process. The boundary between what services were or were not covered by the price cap was unclear because of a definition of aeronautical services which depended on contractual arrangements that had applied when the airports were owned by the Federal Airports Corporation (pre-privatisation) and were then a cause of dispute. Further, the regime sat under a general legislative provision, the *Prices Surveillance Act 1983*, which was not designed to administer price caps and made the arrangements more cumbersome and administratively burdensome than equivalent price cap approaches elsewhere. For example, the specific directions (under section 20 of the Act) which were intended to apply the price caps were rewritten three or four times and were still problematic.' (Margaret Arblaster, private communication, 10 December 2010)

Commission recommended three additional principles.<sup>5</sup> The Government again endorsed these.

The Productivity Commission (2006b) went on to explain that “A key element of the light handed approach is the ultimate threat of re-regulation if there is significant misuse of market power by airports.”

“This in turn requires that there is an effective process for initiating further investigation of an airport’s conduct in circumstances where there is prima facie evidence of significant misuse of market power. As noted above, there is no explicit process of this sort in the current arrangements. Accordingly, the Commission is recommending introduction of an arrangement whereby the Minister for Transport and Regional Services — drawing on price monitoring reports and any other relevant information — would be required to publicly indicate each year either that:

- for the period covered by the relevant monitoring reports, no further investigation of any airport’s conduct is warranted; or
- one or more airports will be asked to ‘show cause’ why their conduct should not be subject to more detailed scrutiny through a Part VIIA price inquiry, or other appropriate investigative mechanism.” (p. xxii)

Forsyth (2008) identifies two difficulties with the guidelines approach.

“These guidelines are poorly thought out and are likely to lead to problems in implementation. Requiring that revenues not significantly exceed ‘efficient’ costs presupposes that the problem that has bedevilled regulators for more than a century — that of determining what such costs are in the presence of regulation that affects incentives — has somehow been solved.” (p. 86)

The emphasis on prices reflecting ‘efficient costs’ is certainly evocative of a previous world - of government exhortations to nationalised industries to engage in marginal cost pricing, and other manifestations of static welfare economics where costs are taken as given, as in the UK in the 1960s – rather than a world of commercial bargaining where there is a constant challenge to reduce costs and seek profitable new business. Other commentators too have noted this inherent tension in the guidelines.<sup>6</sup>

The present guidelines are thus “severely flawed” because “they try to be both cost-plus and incentive regulation at the same time”. (Forsyth 2008 p 93) They should be clarified with a view to “finding a balance between keeping prices down and promoting efficiency”.

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<sup>5</sup> “proscribing further asset revaluations as a basis for increasing airport charges; specifying that the parties should negotiate in ‘good faith’ to achieve outcomes consistent with the principles, including through the negotiation of processes for resolving disputes in a commercial manner; and providing for a reasonable sharing of risks and returns between airports and their customers (including those relating to productivity improvements and changes in passenger traffic).” (Productivity Commission 2006b, p. xxiv)

<sup>6</sup> “Under the light-handed regulatory regime, there is still too much baggage from the old approach, too much thinking along old lines, too much hankering for the old regime. The revised Aeronautical Pricing Principles still have an obsession with the underlying costs. In a negotiated commercial relationship, to a large extent costs matter only by constraining the limits of the negotiation; it is often the case that each side knows its own costs but this information is not shared between them. Consequently, in the list of pricing principles I feel there is a contradiction between (a) [setting prices to recover efficient costs] and (c) [letting prices be established through commercial negotiations].” (David Starkie, personal communication, 15 September 2009)

“In particular, guidelines need to be set for the ways in which a review panel or a price inquiry is to determine whether airports are efficient, be this through benchmarking, detailed analysis of costs, or cost-benefit analysis of investments. Without such guidelines, there is a distinct likelihood that the system will degenerate into a light-handed form of cost-plus regulation, with adverse consequences for the efficiency of the airports.” (p. 93)

Unfortunately, Forsyth does not say what revised wording of the guidelines would achieve this better balance. How would they distinguish between those investments that needed to be investigated and those that did not? How would the airports or Minister decide which of the various methods of assessing efficiency are appropriate in a particular case? And how would the Minister use this particular instrument? This raises the other disadvantage identified by Forsyth (2008).

“While the show-cause mechanism will make the regulation threat more effective, it does give considerable discretion to the minister. Pricing inquiries are likely to happen when airport pricing becomes a politically sensitive issue, and the conduct of such inquiries need not stimulate efficiency.” (p. 92)

The ACCC (2006a) had earlier identified similar difficulties.

The two key steps in this process are identification of abuse of monopoly power and a mechanism to re-impose regulation in the event of demonstrable abuse. Unfortunately, this process is intrinsically problematic. Examples of expanded monitoring, such as imposition of pricing principles with monitoring, or establishment of threshold monitoring, appear inadequate and the (limited) experience with them reinforces this. Both examples in effect represent ‘shadow’ forms of heavier regulation, potentially involving a retrospective rate of return approach. They are likely to impose greater compliance costs and regulatory uncertainty and therefore are likely to be less effective in preventing abuses of monopoly power than some direct forms of regulation. It is difficult to escape the conclusion that ‘light-handed regulation’, of which monitoring is the prime example, is either ‘too light’ to be effective for the task—or, if expanded, ‘too heavy’ to be justified.” (ACCC 2006a pp. ix, x)<sup>7</sup>

Even with revised wording of the guidelines, a show-cause procedure would be protracted.<sup>8</sup> This would be uncertain and costly, with many of the attendant disadvantages of the previous regulatory approach. It would reintroduce political

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<sup>7</sup> It has been suggested to me that the New Zealand approach is an example of ‘shadow’ heavy-handed regulation. The Competition Commission, in considering the minimum amount of information that should be disclosed that would be sufficient to assess the airports’ behaviour, has recommended the disclosure of historical financial information (including setting a regulatory asset value), quality measures, statistics, forecast total revenue requirements, pricing methodology, prices, and other key parameters. Setting default price-quality paths seems to be about as information-intensive and constraining as setting price controls, perhaps even more so insofar as they need to be robust to a range of possible future scenarios.

<sup>8</sup> “After a monitoring report is published the Minister could ask an airport to ‘show cause’ why there should not be an inquiry. If the Minister is not satisfied with the airport’s response, he or she instigates an inquiry, which could make recommendations for change, which then have to be considered and implemented by the Government ... by which time the next Productivity Commission inquiry may be about to commence, underway, or even completed.” (Margaret Arblaster, private communication, 10 December 2010)

pressures and Government decision-making that privatisation was intended to remove. And while temporary price cuts or price freezes could be mandated to address excessive profits or inefficient investments, there is a dilemma in that the cure of permanent price control seems likely to be worse than the disease.

In the event, the Government changed its mind. In December 2009 it ruled out the use of a show cause mechanism.<sup>9</sup> How the Government will evaluate and respond to ACCC monitoring reports remains uncertain, though it can in any case instigate an inquiry if it considers there are grounds to do so. If the threat of re-regulation is still a real one, it is no longer clear how that threat might be evaluated and implemented. But if re-regulation as a cure is worse than the disease, the threat would seem to be a hollow one. This brings us to the third option, namely independent dispute resolution, discussed in Part Two below.

### **7. ACCC monitoring: service quality at Sydney**

The ACCC is required to monitor the price and quality performance of the major airports. Hitherto it has not been unduly critical (see above). But ACCC (2010) concludes that “Sydney Airport has increased profits by permitting service-quality levels to fall below that which could be expected in a competitive environment over a sustained period”. In addition, in view of ongoing price increases and steps taken to affect the availability of alternative services, “the ACCC maintains its view [expressed in ACCC (2009)] that airport car parking prices are consistent with charges reflecting some element of monopoly rent”. (p. xi)

The report contains a rather extensive excursion into economic theory, but the gist of the argument is that monopoly airports have an incentive and ability to exercise their market power by increasing prices and reducing service quality insofar as this reduces costs. The ACCC reports how airlines rated the service quality of the five monitored airports. “Given both Brisbane and Melbourne airports achieved ratings significantly above satisfactory, it is assumed that these airports are not likely to have undersupplied quality relative to what would be expected in a competitive environment.” (p. 34) Ratings at Adelaide had improved significantly with the construction of a new terminal there. Ratings had fallen at Perth, but this seemed to be associated with an unprecedented and unexpected growth of passenger traffic. Moreover, that airport acknowledged that the service quality had become unsatisfactory, and was acting decisively to improve it with significant investments.

The ACCC was more critical of Sydney Airport:

“From 2002–03 to 2008–09, airlines rated Sydney Airport’s international terminal at below satisfactory on average. This suggests that Sydney Airport has potentially undersupplied quality relative to a competitive-market benchmark. ... Sydney Airport possesses a high degree of market power in domestic markets and, as the main international gateway airport in Australia, it is likely to have a more significant degree of market power for international traffic....In their survey responses, airlines

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<sup>9</sup> It reported that airports were concerned that the resulting uncertainty might impede their capacity to raise finance, airlines said that the procedure would not necessarily help resolve negotiation disputes with the airports, and both sets of parties expressed concerns that the procedure would be resource and time intensive. (Australian Government 2009 p. 180)

identified Sydney Airport as the least responsive of the monitored airports with respect to committing to service delivery and quality. ... Profitability measures have increased significantly since the ACCC's determination of allowable revenue for Sydney Airport in 2001-02.... Although Sydney Airport has recently commenced significant capital works at the terminal, it seems that the timing of this investment might have been inefficiently delayed by the airport, and there has been inadequate maintenance." (p. 40)

The ACCC acknowledged that a more detailed evaluation of the Airport's performance would be required to confirm its finding. For example, it seems that the profitability comparison with 2001/02 may be harsh insofar as profitability significantly increased for all airports over that period. From 2004/05 to 2008/09 Sydney Airport's operating margin was the highest of all five airports, but it increased only slightly and by less than the margins at other airports. Its return on assets was at the median level initially, and was actually lower by the end of the period while returns at the other airports increased. The ACCC may have refrained from making such comparisons because of its less recent examinations of the costs of other airports.

It has been said that the recent deferral of capital expenditure at Sydney was due to slower than expected growth in passenger numbers, and that the deferrals were made in consultation with airlines.<sup>10</sup> One of the new guidelines provided for a reasonable sharing of risks and returns between airports and their customers, including those relating to changes in passenger traffic. It will be relevant to consider whether this principle has been appropriately applied here.

Sydney Airport suggested that the report was already out of date, insofar as the "recently commenced significant capital works" in fact commenced construction more than two years earlier, this construction work may have impacted on customer experience during the period of the report, and several of the new facilities were now open. The Airport also noted that it had earlier expressed concern about the ACCC methodology. Reportedly, the recent terminal investment had now led to a significant improvement in service quality. But with the publication of the next monitoring report the debate continues.<sup>11</sup>

It would be surprising if any monitoring report found nothing to criticise. But the situation is evidently quite complex. To the extent that there is a consistent problem over time, what alternative arrangements would have best ensured that Sydney Airport invested more promptly or improved service quality in other ways, or responded to unexpected changes in passenger volumes in a more appropriate way?

It is not clear that an ex ante price control would address concerns related to a deferral of expenditure in response to an unexpected change in passenger volumes. The threat of reimposing price control following an ex post review would be a heavy-handed and not necessarily effective sledgehammer to crack this nut.

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<sup>10</sup> "The deferrals related mainly to apron parking spaces and the expansion of the baggage handling system. Parking at the Airport is very tight during the morning and afternoon peaks, so airlines weren't pleased with that aspect of the matter. We're getting by, but only just. The baggage system is being developed via a plan to make smaller scale add-ons over time, rather than a big bang expansion all at once. There's no real drama there." Warren Bennett (BARA), personal communication 19 July 2010.

<sup>11</sup> ACCC (2011) and Media Centre press releases of 11 March 2010, 3 and 7 February 2011 at [www.sydneyairport.com.au](http://www.sydneyairport.com.au).

Again, it seems that airlines might be best placed to evaluate the situation and take action. The ACCC's assessment relied critically on the views of airlines: their ratings, their detailed commentary on the deficiencies at Sydney (p. 38) and their observations on Sydney Airport's lack of responsiveness on quality issues. Airlines are thus aware of the problem earlier than the ACCC, and at first hand. Moreover, different airlines have different views on quality, which is difficult for a regulator to accommodate. The challenge is to make airports more responsive to airline concerns on an ongoing basis.<sup>12</sup>

## **8. Basic assumptions and other concerns**

The Productivity Commission's second report noted a number of negatives with respect to the experience of light-handed monitoring. The Commission will need to assess how these issues have developed, and whether other concerns have arisen.

For example, airlines were concerned at airports using asset revaluation as a basis for increasing charges. The Government adopted the Productivity Commission's recommendation to 'draw a line in the sand'. This was a simple and timely measure to address a particular and urgent aspect of valuation: it did not seek to assess in detail the range of concerns about asset valuation and rates of return. As anticipated, some considered it 'rough justice'. Some airlines felt aggrieved at the extent of the revaluations before 2005, some airports felt aggrieved that they had not revalued sufficiently by then, or that others had stolen a march on them.

How does this issue look today? Reportedly, there is now less negotiation on charges between airports and airlines because airports tend to use a variant of the building block financial model previously used by the ACCC, with asset values and cost of capital based on those calculations. This may seem unobjectionable or even commendable. But a closer inspection warns against complacency.

Airport economists would suggest that, over time, there may be a case for reflecting increased locational value in airline charges, but that higher charges are not required to efficiently allocate limited capacity where there is not congestion. Airlines argue that in present circumstances of excess capacity some of the assets are overvalued and should be written down, that the cost of capital claimed by the airports is too high, and that the airports are effectively seeking pre-funding of excess capacity.<sup>13</sup> They are also concerned that airports are upwardly revaluing assets in their books

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<sup>12</sup> C.f. "In commentary to the airline surveys it was noted that, while Sydney Airport management is available to talk to, concerns are often not addressed. Several airlines commented that retail operations at the airport appeared to be getting significant attention from Sydney Airport management while concerns by airlines were not being appropriately addressed." ACCC (2011) p. 288.

<sup>13</sup> "BARA's view is that that airport operators are seeking to transfer greater levels of risk back to international airlines by applying higher weighted average cost of capital (WACC) values and lower passenger forecasts than are warranted. Another tactic that is being used by airport operators where there is excess capacity in aeronautical assets at the airport is a pricing outcome where the airlines effectively fully fund the current and future excess capacity. ... When firms operating in more competitive markets are faced with a significant decline in demand for their services, together with substantial excess capacity, they simply have to accept the fact that they made (in hindsight) a poor investment decision. The consequence is that the value of the assets must be written down to more closely reflect their actual income earning potential." (BARA 2010a)

inconsistently with the ‘line in the sand’ (BARA 2010b). Airports argue that their risk of stranded assets is relatively high and that price should reflect commercial and contractual risk positions, not just quality and capacity. All these issues about basic assumptions in calculating reasonable prices, and other more subtle aspects of valuation, now need consideration.

Airlines were concerned that non-price terms and conditions were less satisfactory than price outcomes.<sup>14</sup> Quality of service provisions were a particular concern.<sup>15</sup> The Productivity Commission found that commercial relationships were strained. Is the situation better now? One of the new guidelines specified that the parties should act in good faith, including through the negotiation of processes for resolving disputes in a commercial manner. Has there been progress on that front?

An increasingly important issue at Sydney Airport, and indeed at other airports too, is the increased importance given to retail/commercial development relative to airline operations and passenger facilitation. This is a concomitant of the dual till system, which provides greater incentive to develop retail/commercial facilities because the profits are not put into a single till. Future arrangements will need to balance the expansion of commercial activities with the protection of passenger service quality, which might have implications for the attribution of costs and revenues to each activity.

The car parking issue examined by the ACCC might be a manifestation of this. The ACCC finds an element of monopoly rent. The airports might argue that this is a relatively competitive activity and in that context the returns are not unreasonable. To the extent that the concern is upheld, it might suffice to proscribe potentially anti-competitive practices by the airport. Alternatively, although car parking is not presently covered some reference to car parking charges might be included in the pricing guidelines. Some airlines would want to explore the extension of monitoring to staff car-parking rates and also to property rents.

Issues around price control or pricing guidelines for regional and smaller airports will be on the table. The ACCC recently objected to Sydney Airport’s proposed increase in charges for regional airlines, and the Airport indicated that it would be raising this issue in the forthcoming review.<sup>16</sup>

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<sup>14</sup> Non-price terms and conditions cover such matters as allocation of gate and aircraft parking positions, and rights to vary terms and conditions, and the way that airports conduct negotiations. (Productivity Commission 2002)

<sup>15</sup> “Qantas referred to airports denying or frustrating access to force acceptance of unreasonable terms and conditions. It said that, as a result, some airport users have entered into agreements that contain terms which: (a) provide operators with the unilateral right to increase charges for services, including aeronautical services; (b) have minimal (if any) service levels; (c) even where some service levels are included, have no penalty for the airport operator if it fails to meet those service level obligations; (d) contain no binding dispute resolution procedures; and (e) exclude the airport operator from liability for loss suffered in connection with the use of the airport or as a result of closure of the airport, even if that loss or damage is the result of the airport operator’s own negligence or recklessness.” (reprinted in Productivity Commission 2006b Box 2.4 p. 34)

<sup>16</sup> <http://www.accc.gov.au/content/index.phtml/itemId/947582> and <http://www.sydneyairport.com.au/SACL/SPContent.aspx?PageID=63&ItemID=220&count=1>

Airport economists are perennially concerned about protecting and promoting competition. They want to be reassured that agreements negotiated between airports and airlines do not increase market entry barriers for newcomers, reduce airline competition and imply greater airfares at the expense of passengers. My impression is that airports are keen to attract new business, that agreements do not present barriers to entry and that, if anything, the concern is about unduly favourable conditions for new entry. But from time to time potential entrants may have problems with particular airports that need resolution.

## **9. A process for addressing the concerns**

All these and no doubt many other issues will need consideration, and arrangements may need to be modified to take appropriate account of them. But it is important to stress that none of them are signs that the present light-handed regulatory framework is not fit for purpose. They are precisely the kinds of issues that arise in any price control review process too. Moreover, they are not one-off issues that can be resolved in 2011 once-and-for-all. Issues of this kind will continue to arise as market conditions and other factors continue to change over time. As each price control or negotiated agreement or contract comes to an end, the next control or agreement or contract needs to take cognizance of the changing situation.

Thus, these issues do not constitute a case for replacing the present framework by a return to price control. Rather, they require the development, within that framework, of an appropriate process for identifying, discussing and resolving issues of conflict between the parties involved, taking account of the legitimate interests of all parties, with minimum cost and uncertainty. Simply threatening the re-imposition of price control avoids the problem rather than addresses it.

On the assumption of no return to formal price control processes, what are the options for such a mechanism? One is to crystallise the present process, whereby the Productivity Commission assesses the situation every five years and makes recommendations to the Minister, who then considers whether to implement them. This has addressed a number of issues, like initial asset revaluations and the investigation of car parking charges. But it has significant limitations as an ongoing method of resolving conflict between the parties. It is not easily tailored to the particular circumstances of each airport and airline, and it seems unsuitable for the detail of (e.g.) assessing the changing cost of capital over time. It also introduces political considerations, delays and uncertainties, as illustrated by the changing stance on the 'show-cause' procedure.

The alternative option is an independent dispute resolution mechanism or procedure. Part Two considers the issues involved with that approach.

## **PART TWO INDEPENDENT DISPUTE RESOLUTION**

### **10. Independent dispute resolution**

The airlines (including BARA and IATA), and other parties including some airports and the ACCC, have argued for an independent dispute resolution (or binding arbitration) mechanism. Disputes between airports and airlines about the level of

charges and other terms and conditions would be referred to a third party (whether the ACCC or an independent agency) and the outcome would be legally binding.. This dispute-arbitrate approach is used under Part IIIA, but the applicability of Part IIIA to airports was in doubt for many years, and the cost of using the courts for the process is relatively high. Hence there has been interest in an airport-specific arbitration scheme, which would presumably avoid the need to establish that access to a particular facility would promote competition as a prerequisite for invoking arbitration.

Forsyth (2008) notes that, in such a system, many disputes are resolved before arbitration. He suggests that, with this framework, issues would be resolved more quickly than in a review-sanction system. There could be better ex ante scrutiny of investment, since airlines would take costly proposed investments to arbitration if they felt the attendant price rises would be excessive.

“In those cases the arbitrator would submit investment proposals to more scrutiny than currently takes place. It is probably easier to discourage excessive investment before it is made than to punish it after it has been undertaken, which is what happens under the current review-sanction approach.” (p. 92)

This approach would have two further advantages. It would remove, or at least diminish, the political element inherent in a minister deciding whether to require further justification or investigation. Instead, appeal would be a primarily commercial decision, capable of being avoided by negotiation and agreement between airlines and airports. Indeed, it would address precisely the concern expressed by the Productivity Commission (2006b): “There is currently no clarity as to when further investigation of an airport’s conduct should be undertaken, and no process for initiating it.” (p. xviii) Further investigation would be undertaken when an airport was unable to persuade its airlines to sign contracts accepting its charges, and the process for initiating it would be a reference by the airlines (and/or airport) to the independent arbitration process.

Second, the approach would not unduly limit the commercial responsibility, risk-taking and initiative of the airport. It would not enable the airport to shift responsibility for decision-making to the regulator or minister. It would also leave open the possibility of the airport deciding to proceed with an investment, even without getting the desired up front contribution in charges. The airport could attempt to secure airline agreement at a later date, when the investment had proved its worth, or when the appeal body might take a more favourable view.

The possibility of independent dispute resolution would strengthen the airlines’ hand in negotiating terms and conditions with airports. The contracts would presumably include such conditions as to investment or maintenance as airlines considered necessary or appropriate to address service quality concerns. This might include penalty payments (or compensating adjustments to their charges) if adequate service quality was not maintained. Arbitration, or the threat of it, could be expected to stimulate both greater and earlier responsiveness, and at lower cost, than, for example, the threatened re-imposition of price controls.

Various arrangements for conducting the arbitration are possible. Under Part IIIA a dispute is referred to the ACCC. That organisation has experience and expertise

relevant to setting regulated prices. Forsyth (2008) suggests that “the principles that the arbitrator uses, and the ways in which they are interpreted, are crucial to the outcome. The ACCC takes a rather cost-based approach to Part IIIA disputes and could be expected to take a similar approach with airports.” (p. 91) Some may argue for a more commercial approach. There are indeed independent arbitration bodies that settle commercial disputes. Airlines and airports provided a range of suggestions to the Productivity Commission’s second review.<sup>17</sup>

The question of which organisation resolves a dispute are second order compared to the question whether there should be a more effective independent dispute resolution procedure. Given the prospective advantages of such a procedure, what are the objections that have been raised to it?

### **11. An early sceptical view from the ACCC**

At the time of the Productivity Commission’s first review, the then-chairman of the ACCC suggested various reasons why Part IIIA arbitration would not meet the principles of good regulation. (Fels 2001 pp. 10-11) These reasons and my comments are as follows.

- “It would make it difficult to achieve efficient pricing outcomes since the negotiate arbitrate model results in consideration of disputes on an ad hoc basis as they arise rather than considering regulated airport services as a whole.” But for many purposes it is not necessary – or desirable or even feasible - to attempt “to achieve efficient pricing outcomes ... for regulated airport services as a whole”. In general, the ability to deal with particular disputes as and where they arise seems a merit rather than a defect. Where issues arise that have implications for other airports, this can be taken into account over time.
- “It imposes a high regulatory burden on all parties, both in terms of the administrative costs and the delays involved.” This proved to be true for Sydney Airport because the eligibility for Part IIIA arbitration was unclear and challenged. If eligibility were established then the costs and delays for future cases would be much less. In practice the norm is that the ability to go to arbitration enables the parties to settle relatively quickly. Even so, a lower cost and more flexible procedure than the courts would be desirable.
- “It could involve “micro-management” of airports. The complexity of the issue in the dispute between Delta Car Rentals and Melbourne Airport provides an example of this. The dispute involved issues about location of car parks and traffic management as well as pricing.” In the event, once the ACCC established (in 1999) that this service was covered by Part IIIA, Delta

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<sup>17</sup> Virgin Blue (2006a p. 73) suggested the ACCC. Melbourne Airport (2006 pp. 70-1) argued for separating regulatory policy from regulatory decision-making and suggested that the ACCC be required to appoint another body to carry out the inquiry. Qantas (2006a pp. 22-3) suggested three options: declaration under Part IIIA; ‘deemed’ declaration with removal upon receipt of satisfactory access undertakings embodying commitment to binding dispute resolution; and an industry-wide access code with provision for binding dispute resolution.

Car Rentals and Melbourne Airport negotiated an acceptable solution themselves. The ACCC was not called upon to micro-manage the airport.

- “It is not transparent since arbitrations are not public processes.” But this is equally true of the commercial negotiations that the Productivity Commission and the Government seek to encourage. It is also true of the negotiated settlements in the US and Canada. The latter do not preclude parties with a legitimate interest participating in the process and having access to the information distributed therein. The outcome of the arbitration could be made public if that were desirable.
- “It could deter investment because of the lack of certainty.” So far there seems to be no evidence of this. It does not seem plausible that provision for arbitration whose incidence is at least partly within the control of the airport would introduce any more uncertainty about future revenues than a periodically scheduled price control review whose outcome would be comparably unpredictable.
- “Importantly the approach fails where regulation is most needed. The time frames involved make the process virtually irrelevant for new entrants. Similarly the costs involved may make the process inaccessible for small users such as new entrants and regional airlines.” The interests of new entrants and small users are indeed important, and it is important to ensure that the time and cost involved do not render the process inaccessible to them. The time and cost would be much reduced if this were a standard and simplified procedure separate from the courts. Under these conditions, the ability of a potential entrant or small user to refer an airport to arbitration would enhance its bargaining power. And, as elsewhere, the ability to make such a reference will reduce the probability that the process will need to be called upon.
- “The negotiate-arbitrate model makes most sense where flexibility is required. In the case of telecommunications, for example, Telstra is vertically integrated so has incentives to deny access. It could use non-price as well as price methods to do this. Arbitrations have the flexibility to deal with such matters. In the case of airports the service providers are vertically separated. In general the operators should have every incentive to encourage access. The question then becomes one solely of price. This is best addressed through a price cap or other price controls *not* through Part IIIA.” But the evidence to the Productivity Commission was that in practice airlines, as well as telecommunications users, are much concerned about non-price as well as price issues. The flexibility offered by the negotiate-arbitrate model is precisely what they require.

## **12. The Productivity Commission’s draft report September 2006**

With the benefit of further experience, views evolved. In August 2006 the ACCC submitted its views to the second Productivity Commission review.

“there appear to be two broad options for future regulatory arrangements for airports:

option A—rely on Part IIIA of the Trade Practices Act, while either removing the existing airports-specific monitoring arrangements or retaining them as a complement to Part IIIA

option B—attempt to improve the existing airports-specific monitoring arrangements, in order to address the identified deficiencies and enable them to act as a direct constraint on the use of airport market power.

The ACCC noted that Option B would need to address the crucial weakness of lack of a clear and credible threat of re-regulation if market power is abused, and explained why this was effectively impracticable (see excerpt above). It now favoured Option A.

“Reliance on Part IIIA ... is likely to be reasonably effective in constraining monopoly power, but its effectiveness may be limited by the cost and delay involved in seeking redress through these provisions. ... There is also an issue of the imbalance in bargaining power and asymmetry of information ... Therefore, there may be a case for continuing some monitoring as a complement to Part IIIA.” (ACCC 2006a, p ix)

In its draft Report in September 2006, the Productivity Commission sought to counter the limitations of the monitoring arrangements with respect to the threat of re-regulation by proposing that airports should only be subject to further investigation if there were strong evidence of market power.

“... the monitoring process should be reoriented to put much greater emphasis on seeking and reporting the views of the stakeholders. Those at the ‘coalface’ are in the best position to put the numerical outcomes of the process in proper context. ... In turn, making such commentary available to the Government would render more credible the threat of stricter price control if there is costly misuse of market power. As such, this approach would avoid the need to employ more mechanistic, and potentially counterproductive, price and rate of return triggers to signal when more detailed scrutiny of outcomes may be warranted.” (p. xx)

Notwithstanding potential improvements to the Part IIIA national access regime, it was likely to remain a costly and time-consuming mechanism for resolving disputes. (Nine months earlier, the ACT had decided in favour of Virgin Blue, Sydney Airport had appealed, and the Part IIIA action had been running for nearly four years.) Moreover, the case for an airport-specific arbitration regime was “far from compelling”.

“... it is not clear that it is possible to devise a mechanism that would retain strong incentives for all of the parties to negotiate outcomes, rather than viewing arbitration as the default option. ..., [T]he most likely outcome of implementing the suggested arbitration mechanisms would be a return to heavy-handed determination of charges, with all of its attendant costs. (p. xxvi)

Nonetheless the Productivity Commission indicated that it was “seeking further input on whether it would be possible to configure such a regime to provide strong incentives for negotiated outcomes”. It said that the role of Part IIIA in constraining monopoly pricing at airports should be kept under review.

In October 2006, commenting on the Productivity Commission’s draft report, the ACCC (2006b) said that, “in effect, the Productivity Commission has recommended a

regime ... which is consistent with 'option A' proposed by the ACCC". (p. 2) It is not clear how it drew this conclusion.

### **13. The Productivity Commission's final report December 2006**

In October 2006 the Federal Court dismissed Sydney Airport's appeal against the ACT's decision that the airside service be declared. The Productivity Commission completed its final report in December 2006. It expressed strong concern that the Federal Court's decision, "that potentially makes the Part IIIA national access regime a more intrusive regulatory instrument, has raised questions about the sustainability of the light handed approach for airports". (Productivity Commission 2006b, p. xii) The Productivity Commission's report was released in April 2007, before the resolution of the dispute in May 2007.

The concern about intrusiveness was that the Federal Court's decision had 'lowered the bar' to the Part IIIA access regime.<sup>18</sup> The Productivity Commission feared that, instead of being a mechanism of last resort,

"a more readily accessible Part IIIA regime could conceivably come to supplant price monitoring (and the underlying threat of re-regulation) as the operative regulatory instrument governing [charges and] terms and conditions at the monitored airports. This might in practice be much the same as a reversion to explicit price regulation, meaning that there would be little point in continuing with monitoring as the information collected would be of no particular policy relevance." (p. xix)<sup>19</sup>

The Productivity Commission was also concerned that such access regulation could deter investment. It therefore recommended that the Government should consider amending Part IIIA to restore the prevailing interpretation prior to the Federal Court decision. The Government agreed to do so.

The Productivity Commission acknowledged that "some of the 'market' constraints on airports' behaviour — such as the countervailing power of airlines — have not been as strong as was envisaged". (p. xii) Being now critical of the application of the Part IIIA approach, the Productivity Commission seems to have needed a stronger threat of re-regulation with which to discipline the airports. The show-cause procedure - introduced only in the final report - was intended to clarify and make real that threat.

### **14. Support for independent dispute resolution**

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<sup>18</sup> Part IIIA requires that access to a nationally significant infrastructure service must 'promote competition' in a related market. The ACT and others had assumed that this necessitated consideration of conduct 'with and without' declaration, which could necessitate a detailed evaluation of hypothetical alternative outcomes. The Federal Court found that such a comparison was not necessary. It sufficed to hold that access (or increased access) would promote competition.

<sup>19</sup> The words [charges and] appear in the same quotation on p. 56. The Productivity Commission continues "It seems likely that arbitration would come to be viewed by airlines as the default option, with negotiations increasingly centred in a narrow band around previously arbitrated outcomes. The net effect would therefore be a return to 'institutionalised' determination of charges and conditions for airport services, with its attendant costs." (Productivity Commission 2006b, p. xxv)

The ACCC and the Productivity Commission and others were concerned that use of Part IIIA would be costly and time-consuming. This was certainly Sydney Airport's experience. But the right to declaration having been established, it would presumably be quicker and less costly to use Part IIIA in future. And an airport-specific mechanism could further reduce both time and cost.

The ACCC was also concerned about asymmetric information. It considered that monitoring reports could help, although they would not supply all the relevant information, and were not sufficient to establish the exercise of market power. The major airlines and BARA have not indicated concern about such asymmetry, or a need to rely on the monitoring reports.

The Productivity Commission's strongly held view was that an airport-specific independent dispute resolution procedure could come to supplant monitoring, and in effect revert to price regulation, thereby losing the benefits of commercial negotiation and possibly leading to a less efficient outcome. Most airports shared this view. The NCC, in its earlier judgement on the Sydney Airport dispute, had taken a similar position.

However, in the same dispute, the ACT had explicitly disagreed with the NCC. It argued that a binding dispute resolution process (such as would be provided by the Part IIIA access regime) would in fact enhance the prospects for commercial negotiation and would not lead to a less efficient outcome. (ACT 2005 paras 603-4)

The Department of Transport and Regional Services (DOTARS) endorsed the ACT's position.<sup>20</sup> The airlines noted that "a diverse range of stakeholders including large and small airlines, other airport users, DOTARS and Melbourne Airport" supported the concept of binding independent dispute resolution. (Qantas 2006b p. 4) This was partly because "Part IIIA is a very slow, costly, inefficient and difficult process by which to constrain the exercise of market power by airports." (Virgin Blue 2006a p. 59) It took up valuable management time and effort, when the airlines preferred to negotiate and work with the airports.<sup>21</sup> Melbourne Airport (2006 p. 67) admitted that the resolution of the Sydney Airport dispute "has taken absurdly long" and "has to some extent poisoned airport-airline relationships more generally".

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<sup>20</sup> "In competitive market situations binding arbitration provisions are commonly written into commercial agreements. In a light-handed regulatory environment which seeks to emulate competitive market conditions, a more efficient commercial arbitration process for aeronautical pricing matters could reinforce the commercial negotiating process by negating a 'take it or leave it' position by either party. DOTARS believes that serious consideration needs to be given to implementing a commercial arbitration model where the parties are required to proceed to an independent commercial negotiator/arbitrator (agreed between the parties) for a binding decision when they can't agree on terms and conditions (including non-price terms and conditions) in their commercial negotiations." (DOTARS 2006 p. 11)

<sup>21</sup> "We're all just a bit tired and I don't want to do it again. ... It is costly, it is time-consuming. Four years and we still don't have a resolution. ... We're in the business of business. We've got far too many things on the drawing board at the moment to be worried about declaration lawyers and sitting in courts. That's the last thing that we'd want to do. ... our fundamental approach is we would still prefer and [sic] negotiate, then the ability to fall back to arbitration if we have to. But we operate with airports at many, many levels, through the day, through the week, through the month, through the year, and we need those to be healthy relationships. We need to work together." Virgin Blue in Productivity Commission Hearings, Sydney, 31 October 2006, pp. 139-140.

Airlines explained the role of arbitration, and more precisely the threat of arbitration.<sup>22</sup> They argued that it was in the interests of parties to settle rather than use Part IIIA or go to arbitration.

“Terms and conditions of access negotiated on a commercial basis have some clear benefits over an outcome determined by arbitration, including:  
(a) certainty of outcome, as terms are agreed by the parties. This also gives the parties the potential to negotiate flexible terms and conditions;  
(b) speed of outcome, as even the most efficient arbitration processes take time; and  
(c) cost savings, as costs associated with arbitration are avoided.”<sup>23</sup>

In addition, the airlines drew attention to the evidence from experience.

“There is no evidence to suggest that binding dispute resolution will become the 'default' position and prevent the development of more constructive negotiations between airports and airport users. Indeed, all the available evidence is to the contrary:

- For the periods between 1998 to 2002 (for Phase I Airports) and 1999 to 2003 (for Phase II airports), during which 'airport services' were effectively declared pursuant to the deeming provision under s192 of the *Airports Act 1996*, there were no arbitrations. Put another way, that is a total of 43 years for which airport services were declared at various Australian airports without arbitration becoming the 'default'.
- During the period for which cargo handling services (from 2000 to 2005) and airside services (since 9 December 2005) at Sydney Airport have been declared there have been no arbitrations – commercial negotiations have continued and there has been no ‘race’ to the ACCC. (Qantas 2006, p. 5)

Virgin Blue (2006b p. 52) gave examples from the rail and gas pipeline sectors to show that availability of binding arbitration does not mean that arbitration would become the default. (Though it has been said that these examples also involved ex ante price or revenue regulation, which would reduce the scope for disputes to arise.)

## 15. Further evidence on dispute resolution

The above evidence was put to the Productivity Commission. Yet other Australian examples could have been mentioned.<sup>24</sup> But perhaps the most telling example

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<sup>22</sup> “The aim of arbitration is to act as a “circuit breaker” in the event that commercial negotiations fail (and it may be necessary on rare occasions to resort to such a circuit breaker). However, the conduct of arbitrations is not the only valuable element of such a regime. It is the *threat* of arbitration that would provide parties with an incentive to negotiate on a reasonable, commercial basis.” (Virgin Blue 2006b p. 51)

<sup>23</sup> *Ibid.* See also Qantas (2006) “[t]he Productivity Commission's purely theoretical concern that resort to binding dispute resolution will become the default ignores commercial reality. Qantas and (presumably) other airport users and owners will use the binding dispute resolution mechanism only as a last resort. ... more issues will be resolved [between the parties] as both parties will need to assess whether their conduct would be considered reasonable in the event the other party invoked its right to refer the issue to independent binding arbitration.” (p. 5)

<sup>24</sup> For example, there was a dispute between Melbourne Airport and Delta Car Rentals relating to the location of drop off and pick up sites. This resulted in Delta seeking confirmation from the ACCC that the service it was purchasing from Melbourne Airport was covered by declaration under the Airports Act. In April 1999 the ACCC determined that the service was covered. Melbourne Airport and Delta then negotiated a resolution of their dispute. Or again, Australian Rail Track Corporation's access undertakings under Part IIIA incorporate an arbitration framework which has not been invoked in

occurred at Sydney Airport just after the Productivity Commission's final report. The confirmed *possibility* of arbitration sufficed to enable the parties to reach agreement without *actual* arbitration. The ACCC chairman welcomed this. "The outcome of this arbitration illustrates that Part IIIA is working as intended, and that the regulatory framework provides a useful backdrop that supports effective commercial negotiations."<sup>25</sup> Nor were any other disputes referred to arbitration during the five year period that Sydney Airport's service was declared.

Elsewhere in the world, evidence continues to accumulate that parties in a regulatory framework are willing and able to negotiate settlements to the extent that they are allowed to do so. These parties effectively have the ability to trigger regulatory arbitration simply by declining to reach agreement. Nonetheless, they have not in general found it necessary or advantageous to do this. For example

- In the US, the Federal Energy Regulatory Commission (FERC) encourages parties to settle. In 1994-2000, out of 41 gas pipeline cases, 34 settled in full, 5 in part, only 2 were litigated. (Wang 2004) At present, some 90% of rate cases are settled. (Littlechild 2010)
- In the Florida electricity sector, settlements gradually took over from litigated cases. In the decade 1976-1985 there were a total of 20 base rate cases involving the four major electricity companies; all of them were litigated in the traditional way. In the next decade 1986-1995 there were a further 20 base rate cases, of which 17 were litigated and 3 were settlements. In the subsequent decade 1996-2005 there were only 10 base rate cases, of which all but one were settlements. (Littlechild 2009a,b)
- In Canada, almost all pipeline toll cases at the National Energy Board (NEB) before 1997 were litigated; since then almost all have been settled. (Doucet and Littlechild 2009)
- In the UK, the Civil Aviation Authority (CAA) instituted a process of constructive engagement (as noted with approval by the Productivity Commission). It invited the airlines and regulated airports to agree certain elements of the price control (primarily baseline traffic forecasts, service standards and future capex programmes). With some hiccups, they were able to do so at Heathrow and Gatwick and, later, at Stansted. (CAA 2009a)
- Subsequently, the CAA has successfully applied the same concept to the determination of charges for National Air Traffic Control Services (NATS). With the benefit of previous experience, a more structured customer consultation process was put in place. The CAA's mid-term review found broad consensus that the process to date had worked well. (CAA 2009b para 2.10) The process subsequently concluded satisfactorily.

The Productivity Commission (2006b) expressed a concern that arbitration would lead to "negotiations increasingly centred in a narrow band around previously arbitrated outcomes. The net effect would therefore be a return to 'institutionalised' determination of charges and conditions for airport services, with its attendant costs." (p. xxv) However, the actual outcomes of settlements in North America seem to have been the opposite of this feared trend. Far from being limited to the 'previously

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the seven year period of experience because any disputes that have arisen have been resolved through negotiation.

<sup>25</sup> ACCC press release #MR 130/07, issued 24 May 2007.

arbitrated outcomes’, they have been more rather than less innovative than the ‘institutionalised’ determination would have delivered.

Settlements in the US and Canada have typically been the vehicle for introducing innovative forms of regulation – notably fixed price multi-year incentive schemes – that the regulatory bodies could not or would not have otherwise determined. In Canada, settlements have also been used to specify and improve service quality, to revise information and publication requirements, and to agree investments and risk-sharing arrangements for new facilities.<sup>26</sup> In Alberta, a settlement was the means of implementing the innovative Regulated Rate Option in the electricity sector. This was a form of retail price control based on a risk-sharing approach to energy procurement contracts, which is unlikely to have been possible under traditional litigation.

Admittedly one benchmark for the parties will be their expectation of what the regulator or regulatory process would otherwise decide, but this does not invalidate the process. FERC explicitly indicates its initial thinking in the form of a draft settlement, which the parties use as a basis for negotiating against the pipeline’s requested price increase. In Canada the NEB at one time instituted a ‘generic cost of capital’ formula that updated annually the cost of capital it would allow for each category of pipeline in the event of litigation. (Doucet and Littlechild 2009) This seems to have been found helpful rather than unhelpful in enabling the parties to reach settlement. It did not stop the parties from agreeing slightly higher rates on occasion in return for exceptional service.

There is not yet experience with the latest EU Airport Charges Directive (EU 2009), and its applicability to smaller airports subject to competition may be questioned, but its approach is noteworthy. (Littlechild 2011) Rather than specifying price controls it establishes a procedure for regular consultation between an airport and its users about the structure and level of airport charges, and the quality of service provided. Wherever possible, changes to these parameters should be by agreement between the airport and its users. In the event of disagreement, either party may seek the intervention of an independent supervisory authority that must be established.

## **16. Other issues**

Biggar (2011) has questioned the basic rationale for airport regulation. He suggests that it is not, as conventionally argued, to control deadweight loss, but rather to protect and promote sunk complementary investments by airport users. From that perspective, he has (separately) questioned whether an alternative approach such as dispute resolution would adequately discharge the aims of regulation. The present paper would see a broader aim for policy (which would include the above rationale) – essentially, to facilitate the competitive market process, including by providing incentives to discover and provide the services preferred by customers and by ensuring that, over time, the rewards of greater efficiency and innovation are shared with customers via prices tending towards costs. By either criterion, however, there

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<sup>26</sup> One particularly innovative settlement provided for the transition of a pipeline’s gas gathering and processing services to a specially designed scheme of light-handed regulation. This provided for negotiated settlements with individual shippers, information provision to facilitate price discovery, interconnection terms to reduce barriers to entry, and a complaint-handling procedure that envisaged the NEB as the last resort rather than the first resort. (Schultz 1999)

seems no basis for arguing that a dispute resolution procedure would be inferior to the present policy.

Biggar also raises other questions.<sup>27</sup> How could the procedure set price for one service to one airline without knowing (or setting) the prices for all other services to all other airlines at all other periods of time? In the unregulated world, of course, this is the norm: it is only a regulator that can contemplate setting all prices at once. In practice, some airlines are content to negotiate their own fees and other terms and conditions; others are more concerned about their relative positions. It would be open to the latter airlines to bring their cases jointly to an arbitrator if they wished to do so, and for the arbitrator to take such account of the terms offered to other airlines as seemed appropriate.

Even if an airline and an airport agree a deal that is in their own best interests, is that deal in the interests of the community as a whole? What about present and future passengers and potential new entrants not at the negotiating table?

Regulators that have encouraged negotiated settlements and constructive engagement have been alert to such issues. In the UK, the Competition Commission did not see a need to intervene.<sup>28</sup> The CAA has consistently emphasised that it would be minded to adopt agreed outcomes “subject to the CAA’s consideration of the extent to which the results from any customer consultation reflected the interests of passengers, cargo shippers and airlines not directly represented in such consultation”.<sup>29</sup> On this basis, the CAA introduced a positive incentive for BAA to improve quality of service, beyond what the airlines considered necessary for their own purposes.

In the Australian context, if the Government considered that commercial negotiations and agreements between airports and airlines had led to outcomes that did not adequately reflect the interests of customers, or that there was a serious risk of this happening, it would be open to the Government to modify the Pricing Principles accordingly. In the event that (e.g.) an airline was reluctant to pay the additional cost of a social provision, the regulatory framework could require that any dispute resolution procedure should take account of the Principles or of other specific requirements.

The question of whether individual passengers or passenger groups or other interested parties should be able to engage in negotiations with the airport, and appeal to a dispute resolution procedure, is no doubt for consideration. At this point, it suffices to note that negotiations at FERC have not been paralysed or impeded by the involvement of such parties. FERC itself has developed criteria for dealing with the concerns of non-consenting parties.

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<sup>27</sup> Daryl Biggar, personal communication 24 November 2010.

<sup>28</sup> “We took the view that the airport’s airline customers are generally in a much better position than the regulator, the CAA, to suggest what development is needed at the airport, even recognising that these interests might, on occasion, diverge from the interests of future airlines and passengers, whose interests should also be represented.... We considered whether the interests of potential new airlines at the airport or passengers might deviate from the interests of current airlines in these decisions, but we found no reason to believe that they did.” (Competition Commission 2008 paras 23, 24)

<sup>29</sup> CAA, “CP3 Price control review for NERL – CAA consultation”, October 2008, paras 5.48, 5.49.

## 17. Conclusions

Some countries have abolished price controls on airports subject to effective competition. Australia is at the frontier of light-handed regulation of airports with market power. This policy has been broadly successful. Measures have been taken to address early concerns. More recent concerns - about prices, investment incentives, quality of service, assumptions used in setting prices etc. - do not indicate a failure of light-handed regulation, or justify reverting to price control. They are typical of the issues that arise over time in regulating any utility. They do, however, raise the question of how best to ensure that airports respond to these concerns in an appropriate way.

The present process is effectively for the Productivity Commission to review the situation every five years or so. It then recommends measures such as changes in the Pricing Principles (guidelines) laid down by the Government, or the adoption of a 'show-cause' procedure for re-imposing price control. This increased reliance on Government direction does not sit well with the intended emphasis on commercial negotiation. It is uncertain in impact and subject to political considerations. It depends on a threat to re-impose a cure (price control) that is scarcely credible since it is widely agreed to be worse than the disease (the present approach). It is not well suited to the increasingly fine tuning that is appropriate in this sector, to deal with ever-changing market conditions and the particular circumstances of each airport and airline.

The obvious alternative, which has been debated over many years, is a provision for independent and binding dispute resolution (compulsory arbitration) in the event of unresolved disagreement between airport and airline. This would strengthen the hand of airlines negotiating with those airports with market power. It would act as a filter to focus further examination on questionable airport proposals. This ex ante examination would be more effective than the ex post investigation and retribution implied by the present approach. There would be earlier and more effective resolution of concerns about prices, investment, quality of service, basic assumptions, and other issues.

Independent dispute resolution has been supported by airlines, some airports and the ACCC. The Productivity Commission's resistance may have been unduly influenced by the then-controversial but incomplete Sydney Airport case. The Commission's main - perhaps only - reservation was that arbitration would become the norm, thereby undermining and replacing commercial negotiation. Airlines gave evidence that this was not in their interest, would not happen, and had not happened elsewhere in Australia. Since the last Productivity Commission report, there is increasing international evidence - from other sectors in the US, Canada, and the UK - that access to dispute resolution tends to facilitate commercial negotiations rather than undermine them. With an adequate dispute resolution procedure, there is no longer a need for a threat of re-regulation and a show-cause procedure, nor for elaborate Government-specified pricing principles or perhaps even for monitoring itself.<sup>30</sup>

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<sup>30</sup> The ACCC monitoring arrangements "could go the way of the dodo if an effective (and timely) dispute resolution process existed". Warren Bennett (BARA), personal communication, 28 August 2009.

EU policy on airport charges is now explicitly based on commercial bargaining plus independent dispute resolution. However, as yet, EU experience is limited, and national regulatory frameworks are generally more heavy-handed. In terms of light-handed regulation aimed at facilitating rather than replacing the market process for those airports held to have market power, Australia is still at the frontier. It can still lead the way forward.

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