

Australian airport regulation

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1. Introduction

Over the last seven years, Australia has adopted an innovative policy towards the regulation of its privatised airports. It is variously referred to as light-handed regulation, threat of regulation, price monitoring, information disclosure and obligation to negotiate. A survey paper in Ofgem's ongoing RPI-X@20 Review has recently cited it as one of a range of ex post regulatory regimes.¹ In my view it has significant achievements and advantages that merit its consideration for wider application. The purpose of this paper is to summarise the development and nature of Australian airport policy, and to explain why it deserves further consideration elsewhere.

2. The origins of modern Australian airport regulation

Australia privatised its major airports in 1997 and 1998 (Sydney in 2003). It introduced transitional five year price caps on the largest airports, essentially maintaining the prices obtaining hitherto. The caps were complemented by cost pass-through provisions for 'necessary new investment' as well as by quality monitoring. (Some described this as 'heavy-handed regulation'.) There was also provision, if needed, for the ACCC to determine access charges by an arbitration process.² The government announced that subsequent regulation would be determined by a review of the arrangements before the end of the five years, on the premise that price caps would thenceforth no longer apply.

During this initial five year period (1997-2002), the airports made a number of applications (about 16 at 8 airports) for 'necessary new investment', which required approval by the ACCC. These proposals were typically drawn up by the airports, and appraised by the ACCC, using a 'building blocks' approach – that is, using assumptions about operating and capital costs, the cost of capital, depreciation,

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¹ LECG, *The case for ex post regulation of energy networks*, 7 October 2009

<http://www.ofgem.gov.uk/Networks/rpix20/forum/for/Documents1/Final%20report%20ex%20post%200regulation.pdf>

² The Part IIIA national access regime applied (see below). In addition there was an airport-specific access regime whereby certain airport services were automatically "declared" unless the airport had an undertaking approved by the ACCC within a year of privatisation (which in practice none achieved). Access undertakings usually contain provisions relating to prices, quality of service, dispute resolution and negotiation processes. In the event that airlines and airports were unable to reach agreement (under either regime), "declaration" allowed the ACCC to determine airport prices through an arbitration process.

taxation etc. (This was not dissimilar to the approach used in calculating RPI-X price caps in the UK.)

The Productivity Commission (PC) reviewed the sector during 2001.³ It found a high degree of market power at four airports, though it considered that non-aeronautical revenues could constrain the exercise of this power.⁴ It noted some severe limitations of the initial price cap arrangements. These were associated with unduly low prices, lack of clarity, strategic behaviour and possibly inefficient investment. It also noted the advantages of price monitoring.

“The impact of monitoring on firms’ pricing decisions is more indirect, through moral suasion, providing customers with better information, publicity, and the threat of stricter forms of price regulation being re-introduced.... It can achieve the same objectives as stricter forms of regulation but at lower cost and with less distortion of incentives. Perhaps most importantly, as compared with more intrusive regulation, price monitoring can facilitate commercial negotiations between airport operators and users (provided there is no automatic recourse to regulatory determination of prices).” (PC 2002, p. xxxiii)

The PC considered the possibility of continuing the initial price cap regime with modifications to address the limitations, but was not persuaded that there was a strong case for this. There was “the ever-present risk of regulatory failure, given the severe information problems facing any regulator”, and “the ‘problem’ to be addressed does not warrant such a heavy-handed regulatory regime” given the strong commercial incentives pulling against the exercise of market power. (In the UK, the CAA used a similar argument in favour of removing the price control at Stansted airport.)

Instead, the PC was “firmly of the view that the uncertain outlook calls for more, not less, flexibility”. It recommended replacing the price caps by price monitoring by the Australian Competition and Consumer Commission (ACCC) for a period of five years. The ACCC would report annually. The PC emphasised the importance of developing commercial relationships between the airports and airlines. It encouraged this by elaborating some basic principles to give guidance to airports as to what behaviour could provide grounds for reintroducing price controls, and providing guidelines regarding coverage, consultation and dispute-settlement mechanisms. An independent review towards the end of the five years would ascertain whether there should be any future price regulation of these airports.⁵

The Government accepted the PC’s recommendations. Thus, from 2002 onwards the airports were free from price control. The ACCC continued to monitor prices and

³ Productivity Commission, Price Regulation of Airport Services, Inquiry Report No. 19, 23 January 2002 (henceforth PC 2002), p. xix.

⁴ Under the dual till principle, airports would have an incentive to reduce aeronautical charges in order to increase sales of other services. Although the PC’s analysis of non-aeronautical revenues has been praised, it was subsequently accepted that this constraint was less significant than initially assumed (see below).

⁵ The PC emphasised that “The Commission ... is not advocating *deregulation* of major airports. It is proposing a probationary regulatory package designed to facilitate the transition to a more commercial environment, while providing credible constraints on the use of market power by these airports.” (PC 2002 p. xlv)

quality of service, and issued annual reports on the basis of information provided by the airports.

3. Productivity Commission Review 2006/7

In general, airlines were critical of some aspects of the regime, airports were more satisfied with developments. There were also differences between airlines and airports. For example, some airlines and airports had signed 5 year agreements but others had not.

In April 2006 the Government asked the PC to carry out the scheduled further five year review of the arrangements for light-handed regulation of the airports, and to advise on any changes to the regime.⁶

The PC reported in December 2006 (released in April 2007).⁷ The PC found that price monitoring, as part of a light handed regulatory approach, had delivered some important benefits.

- i. It has been easier than before for airports and airlines to agree on what new investment is required and the charges necessary to pay for it, so as to sustain and enhance airport services in the face of growing demand for air travel.
- ii. Airports' productivity performance has been high by international standards.
- iii. Service quality has been satisfactory to good.
- iv. Although it is too early to fully judge the effectiveness of the light handed approach in constraining airport charges, price outcomes to date do not appear to have been excessive.
- v. For the larger monitored airports in particular, compliance costs have been quite modest; and
- vi. At most of the monitored airports, commercial relationships between the parties have been developing - though some particular issues have impeded progress in this area.

But there had also been some negatives.

- i. Some of the 'market' constraints on airports' behaviour (such as the countervailing power of airlines) have not been as strong as was initially envisaged.
- ii. Some non-price terms and conditions outcomes (which cover matters such as the allocation of gate and aircraft parking positions, and the right of an airport to vary its conditions of use) have been less satisfactory than price outcomes.
- iii. Commercial relationships between certain airports and their customers have been strained, and some negotiations have been protracted.
- iv. Some 'systemic' shortcomings have detracted from the effectiveness of price monitoring and the light handed approach as a whole. In particular
 - a. Lack of policy guidance on the valuation of airport assets for pricing purposes, which has impeded the development of commercial relationships.

⁶ It was to report on whether the airports had operated consistently with the Government's Review Principles. It was to review two current and controversial issues - aeronautical asset revaluation practices and dispute resolution mechanisms - and advise on improvements. It was also to have regard to the recent (December 2005) decision of the Australian Competition Tribunal (ACT) to 'declare' the airside services at Sydney airport, and subsequent consideration of this matter by the Federal Court.

⁷ Productivity Commission, Review of Price Regulation of Airports Services, Inquiry Report No. 40, 14 December 2006 (released April 2007) (henceforth PC 2006). The following summary reflects the Report's Key Points (p. xii) and the summary in the Government Response (see below).

- b. No clarity on when further investigation of an airport's conduct is required.
- c. No process for initiating such investigation of an airport's conduct. This has led to some perception that the threat of re-regulation is not a credible one.

The PC considered that these systemic shortcomings could be addressed without sacrificing the benefits of a light handed approach. Hence, a further period of price monitoring would be preferable to a reversion to stricter price controls (such as the price capping regime that applied from 1997 to June 2002), with all of its attendant costs and disadvantages.⁸ The PC concluded that price and quality monitoring should be extended for a further six years after the current arrangements ended in 2007, but also simplified and refocused.

The PC also considered that “some augmentation to, and elaboration of, the current principles could enhance their usefulness and thereby the credibility of the light handed approach, without unduly ‘directing’ the outcomes of commercial negotiations. Specifically, there should be three new principles:

- proscribing further asset revaluations as a basis for increasing airport charges;⁹
- 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).” (PC 2006, p. xxiv)

Some parties advocated the introduction of an airport-specific arbitration (or dispute resolution) mechanism to deal with airports’ greater bargaining power. The PC considered that this would be counterproductive. The changes that the PC was recommending should alleviate the situation. But to provide more clarity about further investigation and the threat of re-regulation, the regime should embody a new process for triggering further investigation of an airport’s conduct where there is prima facie evidence of significant misuse of market power. The Government should make an explicit judgement, each year, as to whether or not an airport should be required to ‘show cause’ why it should not be subject to further investigation.

4. Revised Aeronautical Principles and a National Aviation Policy Statement

The Government again accepted all the PC’s recommendations.¹⁰ The five major airports would continue to be subject to price monitoring for the six year period from 1 July 2007. Another review would take place in 2012.

⁸ In fact, the PC was concerned about the extent to which the mindset of airlines and airports still reflected a hankering for regulation. It thought that the solution was a more credible process for investigating suspected misuse of airport market power, whereupon “airlines might be more willing to move beyond seeking outcomes closely linked to what the previous regulatory regime might have delivered.” (PC 2006, pp 62,3)

⁹ Airlines had become concerned about airports revaluing their assets, and using that as a justification for increasing charges. The PC 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.

In line with the PC recommendations, the Government revised its Review Principles so as to “provide better guidance on expected pricing negotiation outcomes”. The revised Aeronautical Pricing Principles are as follows:

The pricing principles relating to prices for aeronautical services and facilities (as defined in Part 7 of the *Airports Regulations 1997*) provided by airports are:

- a) that prices should:
 - (i) be set so as to generate expected revenue for a service or services that is at least sufficient to meet the efficient costs¹¹ of providing the service or services; and
 - (ii) include a return on investment in tangible (non-current) aeronautical assets, commensurate with the regulatory and commercial risks involved and in accordance with these Pricing Principles;
- b) that pricing regimes should provide incentives to reduce costs or otherwise improve productivity;
- c) that prices (including service level specifications and any associated terms and conditions of access to aeronautical services) should:
 - (i) be established through commercial negotiations undertaken in good faith, with open and transparent information exchange between the airports and their customers and utilising processes for resolving disputes in a commercial manner (for example, independent commercial mediation/binding arbitration); and
 - (ii) reflect a reasonable sharing of risks and returns, as agreed between airports and their customers (including risks and returns relating to changes in passenger traffic or productivity improvements resulting in over or under recovery of agreed allowable aeronautical revenue);
- d) that price structures should:
 - (i) allow multi-part pricing and price discrimination when it aids efficiency (including the efficient development of aeronautical services); and
 - (ii) notwithstanding the cross-ownership restrictions in the *Airports Act 1996*, not allow a vertically integrated service provider to set terms and conditions that discriminate in favour of its downstream operations, except to the extent that the cost of providing access to other operators is higher;
- e) that service-level outcomes for aeronautical services provided by the airport operators should be consistent with users’ reasonable expectations;
- f) that aeronautical asset revaluations by airports should not generally provide a basis for higher aeronautical prices, unless customers agree; and
- g) that at airports with significant capacity constraints, peak period pricing is allowed where necessary to efficiently manage demand and promote efficient investment in and use of airport infrastructure, consistent with all of the above Principles.

The new Government elected in October 2007 committed to issuing a National Aviation Policy Statement (White Paper) in mid-2009, which is not yet published. Its Issues Paper in April 2008 covered a wide range of topics. On pricing, it commented that “There continues to be some debate as to whether the right balance is struck between airports and airlines when they settle commercial arrangements for access to

¹⁰ Government Response to the Productivity Commission Inquiry Report – Review of Price Regulation of Airport Services, attached to Peter Costello, Treasurer, Media release of 30/04/2007.

¹¹ For the purpose of determining aeronautical prices through commercial negotiations, these should be long-run costs unless another basis is acceptable to the airports and their customers.

services.”¹² Submissions to the consultation showed a familiar pattern: airports generally supportive of present arrangements, airlines generally critical of their lack of effectiveness.¹³ A Green Paper in December 2008 committed the Government to implementing the ‘show cause’ process, and proposed to release a guideline soon.¹⁴ It noted that the PC had not supported an airport-specific dispute resolution mechanism, and gave no indication that it took a different view. It then indicated that it was considering a (separate) reform of the Part IIIA access mechanism.

To summarise, airports express more satisfaction than airlines with the present state of the Australian airport sector and its light-handed regulation. But with some justification the PC has presented a broadly positive picture and proposed relatively minor modifications to address the ‘systemic shortcomings’ that it finds. The present Government has accepted these and continued the light-handed approach.

We consider now the concerns that have been expressed about market power, excessive prices and economic efficiency. Then we explore the process of reaching commercial agreements and outstanding concerns about non-price terms and conditions. We then look at the ‘show cause’ proposal. Finally we examine the Part IIIA issue and the possibility of binding dispute resolution.

5. Market power, excessive prices and economic efficiency

The PC’s initial recommendation to remove the price caps was based in part on an assumption that there were strong commercial incentives pulling against the exercise of market power. It later accepted that the extent of this was limited. The long distances between most Australian airports mean that these airports have a significant element of market power.¹⁵ (It is perhaps worth emphasising that the Australian approach has worked in a market with less competition than in the UK and European airport market, for example.) Unchecked, this market power would allow them to charge excessive prices and act inefficiently. A major purpose of the monitoring regime was to assess and curb such outcomes.

¹² Department of Infrastructure, Transport, Regional Development and Local Government, Towards a National Aviation Policy Statement, Issues paper, April 2008, p. 13, at <http://www.infrastructure.gov.au/aviation/nap/files/AviationIPApril2008.pdf>

¹³ See summary of submissions at

http://www.infrastructure.gov.au/aviation/nap/files/Submission_Register-NAPS_website_version2.xls

¹⁴ National Aviation Policy Green Paper, Flight Path to the Future, December 2008, p. 173. For submissions on the Green Paper in the period ending 27 February 2009, see

<http://www.infrastructure.gov.au/aviation/nap/submissions.aspx>

¹⁵ The point was debated extensively in the Australian Competition Tribunal hearing which reviewed (on appeal) the decision not to declare services at Sydney Airport (SACL) under Part IIIA (see below). The Tribunal in summary did “not consider that the airlines have any significant countervailing power, or that the threat of re-regulation by the Commonwealth Government is an effective constraint upon SACL, or that SACL’s ability to derive non-aeronautical revenues operates as a sufficient constraint on SACL’s ability to derive non-aeronautical revenues operates as a sufficient constraint on SACL’s monopoly power.” [Australian Competition Tribunal, Virgin Blue Airlines Pty Limited [2005] ACompT5, 9 December 2005, para 18] Also “There was general agreement among the economic experts that the answer to the question was that the constraining effect of non-aeronautical revenues was not significant.” [para 511]

However, the ACCC said that its monitoring did not enable it to judge these issues.¹⁶ Nor was the ACCC able to say whether airport investment programmes were efficient. It considered whether there was scope to improve the existing monitoring arrangements, but concluded that more detailed monitoring would be worse.¹⁷

The PC shared the view that more regulation would not improve investment.¹⁸ Forsyth (2006) attempted to assess efficiency and saw improvements but was similarly unable to come to a definite conclusion.¹⁹ He was also concerned about the tension between promoting incentives to efficiency and keeping prices close to cost. To the extent that the guidelines emphasised the latter they were likely to weaken the incentive to efficiency. “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. 31)

The Aeronautical Pricing Principles are couched in generalities and rather vague as to the meaning of critical terms (not least the clarification of ‘efficient costs’). This emphasis on prices reflecting ‘efficient costs’ is itself a reflection of a previous world.²⁰ There have been no systematic studies (by the PC, the ACCC or the

¹⁶ “Critically, 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.” ACCC, Submission to the Productivity Commission’s inquiry into price regulation of airport services, August 2006 (henceforth ACCC Aug 2006), p. vi. “The ACCC does not make any judgements in its monitoring reports as to whether levels of prices are ‘acceptable’ or reflect monopoly profits. The ACCC considers that such judgements are not possible under the existing monitoring arrangements. ... It is very difficult to interpret higher or lower prices, costs and profits disclosed through a monitoring exercise in terms of whether prices are generating revenue consistent with the long-run costs of efficiently providing aeronautical services.” ACCC Aug 2006, p. viii.

¹⁷ “Attempting to improve the existing monitoring arrangements in order to make them effective in constraining monopoly power involves establishing a regime which is able to identify whether market power is abused and a mechanism to re-impose regulation in the event of abuse. This approach is intrinsically problematic. Monitoring is likely to be either ‘too light’ to be effective for this task—or, if expanded, represent ‘shadow’ retrospective rate of return regulation which is ‘too heavy’ to be justified and associated with inefficiencies.” (ACCC Aug 2006, p. vi)

¹⁸ “Basically, the reason the current regime has improved the investment climate is because the regulator is no longer directly involved in decision making. Given the pivotal role of capital in enhancing and sustaining airport services, the improved investment environment delivered by the light handed approach is a very important benefit.” (PC 2006, p. 33)

¹⁹ “Overall, if efficiency is the objective, it can be maintained that the current system has performed fairly well in some aspects (productive efficiency) and more questionably in others (investment), though time and more rigorous assessment is needed to make a more conclusive assessment.” (p. 28) P Forsyth, “Airport Policy in Australia and New Zealand: Privatisation, Light Handed Regulation and Performance”, Rafael del Pino Foundation and Brookings Institution Conference, “*Comparative Political Economy and Infrastructure Performance: the Case of Airports*”, Madrid, September, 2006. See also Peter Forsyth, Monash University, “Key Policy Issue: Light-handed regulation of airports: The Australian experience”, April 2007, IATA Economics: economics@iata.org.

²⁰ That is, the world of government exhortations to nationalised industries to engage in marginal cost pricing, and other manifestations of static welfare economics, as in the UK in the 1960s. David Starkie comments “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, I feel there is a contradiction between (a) and (c) in the list of pricing principles.”

Government) to appraise the performance of the airports. The information provided to the ACCC for monitoring purposes is the basis of an annual report. The reports are factual and substantial (the 2007-08 report is nearly 350 pages). They focus on comparisons between airports and performance over time. They are of general interest, and useful in several respects, including to inform bargaining between the parties. But the information is acknowledged not to be sufficient for the ACCC or others to form definitive views on airport efficiency and pricing.

Nonetheless, having said all this, the users of the airports, namely the airlines, have in a sense approved airport performance in most (but not all) of these respects. Despite – or perhaps because of - the absence of price controls, it seems that most (but not all) airlines and major airports have negotiated commercial agreements covering investment programmes, operating costs, pricing and quality of service. These agreements have often been for five years over the course of the period 2002-2007, then renewed for a further five year period.

Admittedly these agreements do not embody the rigorous and detailed emphasis on efficiency incentives found in UK regulation. However, in reaching these agreements, the parties have debated the airport's capex proposals, removing those that the airlines do not support and introducing others that they want to see. Each capex proposal is accompanied by a business case explaining what improvements in opex it will generate. The airlines have challenged and where appropriate agreed modifications to the airport's projected operating costs. They have then monitored these opex and capex costs over time. They have agreed a depreciation profile and (ultimately) a cost of capital (or allowed rate of return) to apply to these investments. On the basis of these factors they have agreed airport charges for the period of the agreement. The arrangements have provided assurances for the airlines and airports. The parties have also signed up to quality of service provisions in these agreements, albeit the provisions may be less precise and demanding than some airlines would like.

Whether all this constitutes what the ACCC would describe as "efficient" is unknown. Nonetheless, the airlines seem to have been broadly satisfied on the efficiency front. Investment planning is better than it used to be.²¹ And given the difficulty of knowing and coordinating the preferences of users and the productive capabilities of service providers, and the potential problems introduced by regulation, the ACCC and the PC each considered that more frequent investigations or more detailed involvement by the ACCC would not provide any greater assurance.

6. Reaching commercial agreements and outstanding concerns

Outcomes that are agreed upon by a provider of services and its users would usually be regarded as satisfactory in other unregulated markets. How have airports and airlines managed to come to these agreements? Several factors seem to be important.

- First, airports and airlines are conscious of the cost and time and stressful confrontational relations in the earlier price control reviews. They are all keen to avoid a return to such a regulatory regime. In that sense, as well as others,

²¹ As Warren Bennett of BARA remarked, "It is only since privatisation that airlines have had an effective input into determining the scale and timing of airport developments."

the threat of re-regulation is a real one, albeit one that perhaps weighs more heavily with some airports than others.

- Second, both sets of parties have interpreted the Aeronautical Pricing Principles in terms of the ACCC investment appraisals during the era of price control. The building block approach used in that period is acceptable to them. And they know what decisions the ACCC took last time and might be expected to take in future, if regulation were to be imposed once more.
- Third, the PC's 'line in the sand' may have taken some of the sting out of the earlier disputes about asset valuation. It has enabled negotiations to continue. Whether the parties like the line or not, asset revaluation seems to be off the table at the moment.
- Fourth, there is some commonality of interest: airlines and airports both wish to encourage growth in the market.
- Fifth, some (smaller) airlines may have been able to bring additional political and media pressures to bear, to offset their relative lack of bargaining power vis a vis the airports.

Some qualifications should be made. First, not all parties accept all aspects of the ACCC's previous determinations. Some question whether these determinations cover all the relevant issues (e.g. unexpected security funding and prefunding of new investments). And should the same parameters still apply in the different circumstances of today and tomorrow? Given the time and costs involved, the parties may not find it worth challenging these points.²² However, over time there will be a growing need to update and refine the relevant benchmarks for agreements between airports and airlines.

Second, as the PC anticipated, some feel that its 'line in the sand' was 'rough justice'. Some airlines still feel aggrieved at the extent of the revaluations before 2005, some airports feel aggrieved that they had not revalued sufficiently by then, or that others have stolen a march on them. From an economic perspective, over time there may well be a case for reflecting increased locational value in airline charges. Again, some process for refining the valuation benchmark may increasingly be needed.

Third, from the airlines' perspective, even though matters have improved since the days of the Federal Airport Corporation and government ownership, they claim they are still generally faced with a 'take it or leave it' situation. The airports differ in the extent to which they are prepared to negotiate and accommodate the preferences of the airlines. If an airline is unwilling to accept an airport's proposals, there is often little the airline can do about it: the airports have a degree of market power, and the airlines say they have little alternative but to fly into the airports if they wish to serve those cities. (This is unlike Europe where there may be alternative competing airports and there are many low cost airlines willing and able to switch their bases of operation and to use only airports that they regard as setting reasonable charges.) The airlines can protest with a view to encouraging re-regulation, but that would be uncertain and unappealing. There is no more immediate route of appeal open to them.

²² If, for example, it cost \$1.5m to present a case before the ACCC (BARA, Response to PC Draft Report, October 2006, p. 62), could a party expect to persuade the ACCC that the airport's asset beta had changed to a sufficient extent as to make referral to the ACCC a worthwhile investment of effort?

What might be different if the airlines had greater bargaining power? What would they change? Their outstanding concerns are not the airport opex and capex programmes, nor (in light of previous ACCC determinations) the cost of capital and resulting prices. Rather, the airlines find many of the airports less accommodating on non-price terms and conditions. These cover such things as the allocation of gates and parking bays, dispute resolution during the course of an agreement, and the right of the airport to vary such terms and conditions. (PC 2006 p. 34)

Qantas set out a range of practices that it found unreasonable.²³ It was concerned, in particular, about the refusal of many airports to incorporate desired quality of service standards in the agreements, and the insistence on charging even when agreed quality of service was not provided. Sydney Airport's behaviour in this area was also an important consideration in the ACT's decision to declare the airport's domestic airside services.

Some of the airports disputed some of these claims, and there was considerable difference in the stance taken by different airports. As noted, the PC concluded that there was scope for improvement here.²⁴ The variety and thoroughness of the latest provisions on these issues at London's Heathrow and Gatwick airports perhaps give some indication of the scope for developing provisions at Australian airports. Nevertheless, it bears repeating that the present situation is better than previously existed under government ownership or under the price cap regime.

7. The 'show cause' proposal

Airport and airline relationships are continuing to develop over time. With the framework modifications made following the PC 2006/7 report, it is possible that the next PC review will be able to report improvements with respect to non-price terms and conditions. However, to the extent that airport market power constitutes or is likely to continue to constitute a problem, what is the best solution?

No party seems to advocate going back to the earlier price caps – nor, indeed, to any form of ex ante price control. Indeed, there seems to be a strong and widespread aversion to that possibility.²⁵ Nor do there seem to be advocates for a different or

²³ “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 PC 2006, Box 2.4 p. 34)

²⁴ “given the acknowledgement by some airports that this is an area where there is some scope to improve behaviour, and given the Tribunal's concerns in relation to non-price terms and conditions at Sydney Airport, it seems reasonable to conclude that non-price outcomes under the light handed approach have been less satisfactory than charging outcomes.” (PC 2006, p. 36)

²⁵ On the part of the airports and airlines, and not least the PC. “A return to the previous arrangements would make it more difficult for airports to undertake the new investments required to cater for strongly growing demand for air travel. ... Indeed, with several of the monitored airports now entering a new phase of the investment cycle, a return to a more heavy handed regulatory regime could be costly. A reversion to stricter price controls would also put at risk the good productivity performance of

more precise specification of the Aeronautical Pricing Principles (beyond the modifications already implemented). Finally, the ACCC and the PC have each rejected the possibility of more detailed monitoring. Indeed, the PC suggested that quality monitoring should be refocused and streamlined, and that price and quality monitoring should be combined.²⁶

During the PC's review, the Federal Court's determination of Sydney Airport's access appeal caused some consternation. A number of parties, particularly airlines, favoured facilitating such appeals, and developing a process of independent dispute resolution. The PC rejected this approach, but considered that some further measure was needed.

“The post-2007 price monitoring arrangements must continue to provide for a degree of latitude on outcomes if they are to foster commercial relationships between airports and their customers and thereby place reliance primarily on negotiations to set charges and terms and conditions. Nonetheless, the Commission sees the need for some ‘framework’ changes to facilitate such negotiations and to enhance the credibility of the light-handed approach as a means to constrain misuse of market power by the major airports”. (PC 2006, p. xxi)

The PC suggested ‘a process for triggering further investigation of conduct’ by means of a ‘show cause’ procedure.

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. As well as offering the prospect of remedial action if airports behave inappropriately, the threat is also designed to condition negotiations between the parties.

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.

This requirement would remove the possibility of ‘passive’ rather than ‘determined’ inaction. In so doing, it would both enhance the credibility of the threat of reregulation, and reinforce the notion that price monitoring is simply intended to be a screening mechanism — an initial step in the light handed regulatory approach. As such, the proposed new process should not put at risk the latitude on outcomes necessary to allow commercial negotiations to develop. (PC 2006, p. xxii)

Australian airports which seems at least partly attributable to the more light handed regulatory approach. Amongst other things, considerable managerial resources would once again be diverted into dealing with the regulator and seeking ways to ‘game’ the system.” (PC 2006, p. xviii)

²⁶ (PC 2006, p. xxii) The PC's draft report went further, suggesting that the reports be produced every two years rather than annually, and “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.” (PC draft 2006, p. xx)

The Government supported this recommendation and said that the Minister would issue a statement each year indicating whether the Government will be asking any of the monitored airports to 'show cause'. Two ACCC monitoring reports have since been published. The Government has not issued any such policy statement yet, but has reaffirmed its commitment to the approach. It therefore remains to be seen what form the 'show cause' approach takes, in what way it sharpens the threat of re-regulation, and what impact it has on airport (and airline) conduct.

But is the threat of re-regulation the most appropriate avenue down which to proceed? In the event of a dispute between an airport and an airline on a particular issue, is it helpful or credible to threaten a 'solution' that may be worse than the problem? Would it not be better to look for a way of resolving each particular dispute without abandoning the whole light-handed approach? This takes us to the debate on dispute resolution procedures.

8. The Part IIIA National Access Regime and Sydney airport²⁷

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.²⁸ 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, 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. Following commercial agreement on terminal access, 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.

²⁷ For a general account of developments here, see PC 2006, Appendix C.

²⁸ 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.

On 6 January 2006, Sydney airport applied for review of the ACT's decision. In October 2006, the Full Federal Court dismissed the appeal. Sydney airport applied for leave to appeal to the High Court, but in March 2007 this was refused. This means that until December 2010, domestic airlines unable to reach agreement with Sydney airport over charges or terms and conditions will be able to seek arbitration by the ACCC.

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 SACL. ACCC began to arbitrate the dispute. However, in May 2007 Virgin Blue withdrew the notification, indicating that the parties had resolved the dispute through commercial agreement.

9. Concern about the Part IIIA decision and independent dispute resolution

The PC completed its report in December 2006, which was released in April 2007, before the resolution of the dispute in May 2007. Its concern was 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". (PC 2006, p. xii)

The concern was that the Federal Court's decision had not only upheld the ACT decision but had also 'lowered the bar' to the Part IIIA access regime.²⁹ The PC feared that, instead of being a mechanism of last resort, "a more readily accessible Part IIIA regime *could* 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 major airports".³⁰ The PC 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.

Most airports shared the view that airport-specific provisions for dispute resolution or arbitration could undermine light-handed regulation. The NCC, in its earlier judgement on the Sydney airport dispute, had taken a similar view.

10. Support for independent dispute resolution

In contrast, the ACT had explicitly disagreed with the NCC and argued that a binding dispute resolution process (such as would be provided by the Part IIIA access regime) would enhance the prospects for commercial negotiation.

"603 The NCC accepted that declaration did not mean that the opportunity for commercial negotiations was foregone but contended that declaration would limit or

²⁹ 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.

³⁰ (PC 2006 p. 56) "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." (PC 2006, p. xxv)

alter the nature and outcomes of commercial negotiations between access seekers and service providers such that the potential benefits of commercial negotiation without any recourse to a binding dispute resolution process would be foregone. We do not agree. Nor do we agree that early recourse to arbitration may result in an imposed outcome that is not as efficient as one that may have been developed by the parties themselves.

604 We consider that the availability of a binding dispute resolution process provides an incentive for parties to negotiate in a realistic, practical and positive manner in an attempt to resolve differences which affect, and have a real impact on, their daily commercial activities. Indeed, we consider that the availability of a binding dispute resolution process will bring about a more efficient outcome than a situation where no such process is available. More particularly is this so where the arbitrator has to take into account the matters specified in s 44X(1) of the Trade Practices Act 1974.” (ACT 2005)

The Department of Transport and Regional Services (DOTARS) endorsed the ACT’s position.³¹ 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.³² 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.”³³ It took up valuable management time and effort, when the airlines preferred to negotiate and work with the airports.³⁴ Melbourne Airport admitted that the resolution of the Sydney airport dispute “has taken absurdly long” and “has to some extent poisoned airport-airline relationships more generally”.³⁵

Airlines explained the role of arbitration.³⁶ They argued that it was in the interests of parties to settle rather than use Part IIIA or go to arbitration.

³¹ “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, submission to PC, July 2006, p. 11.

³² Qantas, Response to the PC’s Draft Report, October 2006, p. 4.

³³ Virgin Blue, submission to PC, 21 July 2006, p. 59.

³⁴ “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 PC Hearings Sydney, 31 October 2006, pp. 139-140.

³⁵ Melbourne Airport, submission to PC, July 2006, p. 67.

³⁶ “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, Response to PC’s Draft Report, 17 October 2006, p. 51.

“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.”³⁷

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.

The PC invokes '*[e]xperience in other sectors*' suggesting that '*easy access to a sector-specific arbitration process can fundamentally undermine genuine negotiations*'. No examples are given.³⁸

Examples were also given from the rail and gas pipeline sectors to show that availability of binding arbitration does not mean that arbitration would become the default.³⁹ Yet other examples can be given.⁴⁰

Subsequent to the PC’s report, experience at Sydney airport supported the airlines’ general proposition. The confirmed possibility of arbitration evidently sufficed to enable the parties to reach agreement without arbitration. The ACCC chairman welcomed this. “The outcome of this arbitration illustrates that Part IIIA is working as

³⁷ Ibid. See also Qantas, Response to PC’s Draft Report, October 2006, p. 5 “[t]he PC’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.”

³⁸ Qantas, Response to PC’s Draft Report, October 2006, p. 5. As another example, a dispute between Melbourne Airport and Delta Car Rentals relating to the location of drop off and pick up sites resulted in Delta seeking confirmation from the ACCC that the service they were purchasing from Melbourne Airport was covered by declaration under the Airports Act. After the ACCC determined that the service was covered, Melbourne Airport and Delta negotiated a resolution of their dispute.

³⁹ Virgin Blue, Response to PC’s Draft Report, 17 October 2006, p. 52. Virgin Blue also cites the PC itself as having previously acknowledged the benefits of a negotiate-arbitrate model.

⁴⁰ Australian Rail Track Corporation’s access undertakings under Part IIIA incorporate an arbitration framework which has not been invoked in the seven year period of experience because any disputes that have arisen have been resolved through negotiation.

intended, and that the regulatory framework provides a useful backdrop that supports effective commercial negotiations.”⁴¹

11. Further evidence on dispute resolution

Elsewhere in the world, evidence is beginning 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. In effect, they have the ability to trigger regulatory arbitration simply by failing to reach agreement. Nonetheless they have not in general found it advantageous or necessary to do this. For example

- In the UK, the CAA has instituted a process of constructive engagement (as noted with approval by the PC). It has invited the airlines and regulated airports to agree certain elements of the price control (baseline traffic forecasts, service standards and future capex programmes). With some hiccups, they have been able to do so.
- 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.⁴²
- In the Florida electricity sector, settlements have gradually taken 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 most recent decade 1996-2005 there were only 10 base rate cases, of which all but one were settlements.⁴³
- In Canada, almost all pipeline toll cases at the National Energy Board (NEB) before 1997 were litigated; since then almost all have been settled.⁴⁴

The PC 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.” (PC 2006, p. xxv) However, the actual outcomes of settlements seem to have been the opposite of this feared trend. Far from being limited to the ‘previously arbitrated outcomes’, they have been more rather than less innovative than the ‘institutionalised’ determination would have delivered.

Admittedly one benchmark for the parties will be their expectation of what the regulator or regulatory process would otherwise decide, particularly with respect to allowed cost of capital. In Canada the NEB actually 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. This seems to have been found helpful

⁴¹ ACCC press release #MR 130/07, issued 24 May 2007.

⁴² Z Wang, “Settling Utility Rate Cases: An Alternative Ratemaking Procedure.” *Journal of Regulatory Economics*, 26(2), September 2004: 141-164

⁴³ S C Littlechild, “The bird in hand: stipulated settlements in the Florida electricity sector”, *Utilities Policy*, 17 (3-4), Sept-Dec 2009: 276-287. Also S C Littlechild, “Stipulations, the consumer advocate and utility regulation in Florida”, *Journal of Regulatory Economics* 35(1), 2009, February, 96-109.

⁴⁴ J Doucet and S C Littlechild, “Negotiated settlements and the National Energy Board in Canada”, *Energy Policy*, 37, October 2009: 4633-4644.

rather than unhelpful in enabling the parties to reach settlement. It did not stop them from agreeing slightly higher rates on occasion in return for exceptional service.⁴⁵

More strikingly, 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, revise information and publication requirements, and agree investments and risk-sharing arrangements for new facilities.⁴⁶ In Alberta, another settlement was the means of implementing the Regulated Rate Option in the electricity sector. This was an innovative 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.

12. Assessing the key features of Australian airport regulation

It is seven years since Australia's pioneering policy of light-handed regulation removed price controls on the privatised major airports. The Productivity Commission has found substantial achievements in terms of new investment, charges, profits, productivity, service quality, compliance costs and the development of commercial relationships. It also found continuing airport market power, limitations in terms of some non-price terms and conditions, some strained commercial relationships and protracted negotiations, a lack of policy guidance on asset revaluation, no clarity on acceptable airport conduct and hence a question about the credible threat of re-regulation. The Productivity Commission made recommendations to address these points, which the Government accepted, albeit not to the satisfaction of all parties involved.

Although airlines remain critical, light-handed regulation of airports seems on balance to be a remarkably successful achievement. The Productivity Commission has been commendably even-handed in its appraisals, and firm in its support for efficient, commercially negotiated and competitive outcomes, and successive Governments deserve credit for instigating and maintaining the policy.⁴⁷ In general the airports and airlines have responded constructively (albeit to different extents) to the new opportunities offered. Relationships in the industry have improved.

Although the term 'price monitoring' is often used as an alternative name for light-handed regulation, it is in fact only one of some half a dozen components of that policy. Which components of the policy seem to have brought about its success, and

⁴⁵ Doucet and Littlechild, *op. cit.* The NEB recently discontinued its generic cost of capital formula, as no longer needed, but indicated its willingness to resume it if required.

⁴⁶ 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. N J Schultz, "Light-handed regulation", *Alberta Law Review* 37 (2) 1999: 387-418.

⁴⁷ In terms of individuals, the PC's 2002 report was signed by Gary Banks (chairman), Richard Snape (Deputy Chairman) and Neil Byron (Commissioner); its 2006 report was associated with Gary Potter and Neil Byron (Commissioners); and the previous Government statements were made by Treasurer Peter Costello.

which are less critical? How far do the measures taken so far address the concerns of the parties, and is there scope for yet further improvement?

No price control is the most obvious hallmark of the light-handed policy. It removes a significant burden on all parties that is generally agreed to be costly, time-consuming and restrictive. Importantly, it is considered not conducive to efficient planning and development of airport capacity.

An emphasis on *commercially negotiated outcomes* sets the tone for the preferred approach. Airports are not given *carte blanche*, and a ‘take it or leave it’ approach is unacceptable. Rather, prices (including service levels and terms and conditions) should “be established through commercial negotiations undertaken in good faith, with open and transparent information exchange between the airports and their customers and utilising processes for resolving disputes in a commercial manner (for example, independent commercial mediation/binding arbitration)”. But is a statement of principle enough? Some airports have embraced this approach more than others, and there is some concern that the policy does not adequately reward the more responsive airports and discipline the laggards.

The previous Government gave further guidance in the form of *Aeronautical Pricing Principles*. Like the principle of commercially negotiated outcomes, they set the tone, but are couched in generalities, leaving scope for interpretation, and to some extent they reflect the ‘old world’. In practice, a significant benchmark has been the building block method and the parameters adopted by the ACCC during the brief initial era of price control. Some would regard these parameters as increasingly dated. The main subsequent modification, to address the concerns and uncertainties about asset revaluation, has been ‘the line in the sand’ as at 30 June 2005. Some would regard this as rough justice and needing refinement.

The ACCC engages in *monitoring* of airport prices, financial performance and quality of service, based on airport submissions. These annual reports have provided a helpful general picture of the sector. They are useful for understanding comparisons and trends over time, without putting an undue reporting burden on the airports. There seems no widespread concern about airport investment plans or operating costs. But the monitoring reports are not regarded as providing sufficiently detailed and robust information for airlines to negotiate with the airports, or for the ACCC to make a proper assessment of whether the airports are acting consistently with the Pricing Principles, or operating and investing efficiently. However, more precise specification of the Principles, or more detailed information provision, or more thorough measurement and appraisal by the ACCC, does not seem the most productive ways forward. Indeed, the airline view seems to be that monitoring could be discontinued in the event of a greater role for Part IIIA access determinations or binding dispute resolution methods.⁴⁸ In effect, empowered airlines could arrange to do their own monitoring, securing such information as they needed from the airports.

The *threat of re-regulation* is presented as the main limitation on airport market power. This cannot be discounted, particularly given the strong aversion to returning

⁴⁸ As one representative put it to me, the ACCC monitoring arrangements “could go the way of the dodo if an effective (and timely) dispute resolution process existed”.

to price control. However, its effectiveness is limited by uncertainty about what conduct would be unacceptable, and by the absence of an explicit process for re-regulation. To address these issues, the Commission and Government have endorsed a new 'show cause' procedure whereby the Government would each year either accept or challenge an airport's performance on the basis of the ACCC monitoring report. The way in which the Government will implement this procedure is not yet known. Given the limitations of the monitoring reports, and the widely acknowledged limitations of regulation, it seems questionable whether re-regulation is a credible threat.

The *Part IIIA access regime* provides for the ACCC to arbitrate on access disputes. This is another potential limitation on airport market power. However, application of the Part IIIA regime was time-consuming, costly and uncertain in the case of Sydney airport: it took 4 1/2 years simply to get an airport service 'declared', without any subsequent determination of access terms. The High Court decision in that case is thought to have 'lowered the bar' for subsequent application. Airlines would find a lower bar helpful in principle but are not convinced that such a costly approach as Part IIIA will restrain airport market power effectively in practice (even if a future application were not so protracted); airports and the Productivity Commission see a lower bar as undesirably undermining commercial negotiations and encouraging a reversion towards regulation. The Government has promised a package of reforms to the Part IIIA regime but their content is not yet known.

Airport market power thus remains an issue. It is not generally perceived as leading to airport over-investment or inefficiency, or to overpricing on a major scale. Rather, from the airlines' perspective, it is slowing the rate at which airports in general – and some in particular - adjust to the good faith commercial negotiations that would characterise a competitive market. The treatment of non-price terms and conditions, and quality of service arrangements, are particularly cited. There is also a question how far ACCC decisions from an earlier price control era could and should continue to be relevant as the market evolves over time.

The major airlines and the ACT see provision for independent and binding dispute resolution as a significant part of the solution. The airports and the Productivity Commission fear that such a provision would discourage serious negotiation and lead back to regulation. Economic analysis and the available evidence would seem to cast doubt on these fears. As far as possible, the parties would prefer to settle disputes between themselves and to avoid arbitration or re-regulation. In practice this has happened not only in Australia but also in regulated sectors in other countries such as the US and Canada and (to a limited extent) in the UK airport sector. Parties have consistently chosen negotiated settlement, to the extent that it is open to them, in preference to leaving the decisions to regulation. In other words, provisions for binding dispute resolution by regulators do indeed seem to facilitate commercial negotiations rather than undermine them.

Arbitration by an entity other than the regulator would seem well able to respond to changing conditions in an industry. There would be recourse to such arbitration only as and when differences of opinion are so great as to be unsustainable, rather than according to a routine regulatory timetable regardless of need.

This would be a further step in the direction of a philosophy that is common to light-handed regulation both in Australia and in other jurisdictions that encourage settlements. That is, the role of regulation is not to take all the decisions and to substitute the regulator's own views for that of the parties. Rather, the role of regulation is to facilitate the competitive market process whereby the parties negotiate commercially (and use such appeals to arbitration as are normally used in competitive markets) without the distortions imposed by market power.⁴⁹

The question whether, and if so how, provision for independent binding arbitration might be incorporated into the regulatory framework in Australia is unlikely to disappear. It will no doubt be an issue for consideration in the scheduled 2011/12 airport review, but it seems likely to appear before then in the form of the promised more general modifications to the Part IIIA regime and perhaps also the 'show cause' procedure. It might conceivably be the most significant step forward yet, in developing light-handed regulation.

13. Possible application in UK

How does Australian airport regulation compare with other regulatory regimes in a more general context? LECG has assessed the conventional ex ante price control approach as used in the UK against a couple of ex post regulatory regimes (thresholds and competition policy).⁵⁰ It concludes that ex ante price control is markedly superior, at least in the context of energy networks. It discusses but does not assess Australian airport regulation.

I have elsewhere assessed the Australian approach against LECG's own criteria, and argue that it is superior to ex ante price control.⁵¹ It might be argued that the ex ante regime is more effective in terms of preventing excessive pricing. But the regimes seem to be comparable in terms of improving operating efficiency, and predictability and stability of the regulatory process. The Australian approach seems better at securing efficient and timely investment and innovation, particularly at ascertaining and securing the kinds of investment and innovation that the customers themselves want. And it is markedly less burdensome than ex ante regulation UK style. In addition, it scores more highly on a criterion not mentioned by LECG, namely, in terms of the company-customer relationships within the industry.

Would the Australian light-handed approach be feasible elsewhere? In the UK, increasing competition between airports has enabled Manchester airport to be de-designated (ie deregulated) and it is possible that some of BAA's London airports will be de-designated once it disposes of Stansted and Gatwick. Constructive engagement has already taken the airport sector some way down the path of light-handed

⁴⁹ There is an interesting question whether constraining market power would be sufficient or whether further considerations are relevant. For example, some might argue that prices should be 'efficient', others would argue that this is an example of 'baggage from the old regime'.

⁵⁰ LECG, *The case for ex post regulation of energy networks*, 7 October 2009

<http://www.ofgem.gov.uk/Networks/rpix20/forum/for/Documents1/Final%20report%20ex%20post%20regulation.pdf>

⁵¹ Stephen Littlechild, Consumer involvement, ex post regulation and customer appeal mechanisms, Ofgem RPI-X@20 Web Forum, 29 November 2009.

[http://www.ofgem.gov.uk/NETWORKS/RPIX20/FORUM/ROGAG/Documents1/Consumer%20involvement%20ex%20post%20consumer%20appeal%2029%20Nov%2009%20\(2\)%20\(2\).pdf](http://www.ofgem.gov.uk/NETWORKS/RPIX20/FORUM/ROGAG/Documents1/Consumer%20involvement%20ex%20post%20consumer%20appeal%2029%20Nov%2009%20(2)%20(2).pdf)

regulation, albeit still leaving the final price control to be set by the CAA (as required by statute). If and when there is another price control review (or for any potential change of plan during the course of the present quinquennium) it would be open to the Civil Aviation Authority (CAA) as regulator, and the Competition Commission (CC), to enable and encourage the airports and airlines to take constructive engagement a step further. The parties could be invited to negotiate whole agreements for, say, the next five years, which could then form the basis of a price control set by the CAA, rather than be limited to agreeing inputs into a price control whose structure is set by the CAA beforehand.⁵²

The CAA could perhaps facilitate such agreement by indicating what it would be minded to set as an allowed cost of capital in the event that an airport and its airlines were unable to agree that parameter. (It has done this in the ongoing case of air traffic control services.) It could remind the parties of its views on other significant issues. On any issue where the parties were unable to agree, it would be open to the CAA to encourage binding resolution by an independent arbitrator. The CC has in fact endorsed this.⁵³ Presumably, acceptance of such an arbitration process could in due course be made obligatory on the airport.

Could the Australian approach be relevant in UK utility regulation beyond airports? It does not require competition in the sector. The same considerations apply as with constructive engagement and negotiated settlements. I believe that the utility network companies and the major users of those networks would be willing and able to negotiate in lieu of regulation, provided there is the effective threat of binding arbitration. The main question is whether representatives of domestic and other small users would be willing and able to do so. My own conjecture is that the opportunity to negotiate, and thereby determine the outcome, would be attractive to them, and that resources could be made available as required. At any rate, Australian light-handed regulation, including the possibility of dispute resolution via independent binding arbitration, seems to extend the range of regulatory tools available to policymakers in the UK, and deserves serious consideration.

⁵² The Airports Act requires the CAA specifically to impose conditions regulating the ‘maximum amounts’ that a designated airport can raise by way of charges. It would seem possible for agreements negotiated between the airport and airline to be written in this form.

⁵³ “13.24 Where, after a process of consultation, there is still no agreement between the parties on an issue, they may choose to disagree or, if a decision is needed, they may agree to seek independent mediation or arbitration, either from the CAA or from a mutually agreed arbitrator. Although not binding on the CAA at the end of the quinquennium, when the CAA must decide the amount of capex to allow into the RAB, we would expect the decision of an arbitrator to be considered by the CAA as good evidence of a reasonable capex decision.” CC Final Report on Stansted, 23 October 2008, p. 116.