
Economic Regulation of Airports – the Commission’s Draft Report

Infrastructure Partnerships Australia Industry Lunch Sydney, Tuesday 19 March 2019

Paul Lindwall, Commissioner

Thanks Adrian, it is a pleasure to be here to talk about the Productivity Commission’s *Economic Regulation of Airports* draft report, which we released on 6 February.

I might start by letting you know the key dates for the inquiry. Next week, starting in Canberra on 25 March, we will be holding hearings, and we have also invited submissions preferably by then too, although we are flexible and will continue to accept submissions, hopefully before the inquiry has finished.

Of course what I’m describing today is our draft report and we are open to changing our recommendations and findings if persuasive evidence is presented via submissions or at hearings or meetings.

We are required to provide the Government our final report by 21 June at the latest. The Government has 25 Parliamentary sitting days to table the final report, generally accompanied by its response. It’s important to emphasise that the Commission’s role is to conduct an independent, evidence-based, open inquiry making recommendations to the Government which it may accept or reject as it sees fit.

Aviation is a fascinating topic and its importance to our society cannot be overstated. Humans have had the desire to fly since time immemorial – Ovid tells the story of Daedalus – who built the Labyrinth that imprisoned the Minotaur – and his son Icarus who flew too close to the sun which melted the wax of his wings.

In Australia, the first powered controlled flight was made by magician Harry Houdini at Diggers Rest Victoria on 18 March 1910 – and this was real not an illusion. But it is still magic when I board a plane whether it was my first flight many years ago on a Boeing 707, or a 1942 Stearman bi-plane in Key West, and my recent purchase of a share in a 1973 Bonanza A36 parked at Canberra airport.

Airports — like airlines — are heavily regulated for both safety and security. Our inquiry, though, looks at the economic regulation of airports which has been characterised as ‘light-handed’.

In 1994 the Australian Government announced the privatisation, by long-term lease, of airports operated by the then Federal Airports Commission (FAC). At the time the 22 federally leased airports were subject to price regulation.

In 2000 the Government asked the Productivity Commission to conduct an inquiry into the price regulation of airports and the report found that the price caps led to distortions in production and investment decisions as no regulator is able to set prices accurately.

The Commission recommended a move to a price monitoring regime, which has stood (with modifications and changes to the airports monitored) through two subsequent Commission inquiries (2006, 2011) to our present inquiry, with the four Australian Competition and Consumer Commission (ACCC) monitored airports and a voluntary second-tier self-reporting monitoring for Adelaide, Canberra, Darwin, Gold Coast and Hobart airports.

The system as it stands is designed to facilitate commercial negotiations between airport operators and airport users, ideally to promote the efficient investment in what is well characterised as a large, lumpy investment cycle. It comprises the annual monitoring of the major airports by the ACCC with five-yearly reviews of the system by the Productivity Commission.

In our draft report, using benchmarking of comparable international airports over time, we concluded that Sydney, Melbourne, Brisbane and Perth airports had market power, but they were not exercising or exploiting that market power.

The data we drew upon to undertake the benchmarking included the annual monitoring reports of the ACCC, Air Transport Research Society (ATRS) data and other data from the Bureau of Infrastructure, Transport and Regional Economics (BITRE). Our international benchmarking used the ATRS data for airports with more than 10 million passengers as these are at least as large as Perth Airport – there were more than 100 such airports in total.

All datasets have their limitations, and we attempted to control for these – for example, the ACCC monitoring report excludes terminals covered by a Domestic Terminal Lease. Similarly, the quality of service indicators have a level of subjectivity.

That said, our benchmarking included the costs of the airports, input utilisation and quality of service (i.e., operational efficiency), revenue per passenger and airport charges and profitability (return on aeronautical assets).

On most indicators, across the four monitored airports, there is no evidence that the airports have been exercising their market power. We did have potential concerns about the cost of Perth airport, and the international charges for Sydney and Brisbane airports and we have sought further information for our final report.

Overall, we found the quality of service meets users' expectations, returns are reasonable given airport investments and constraints, car parking prices are not the result of market power, although we also requested further information on landside access (that is, drop off and pick up) where an airport could restrict access to limit competition for its on airport car parking. In particular, it is evident that substantial investment has been made by the airports to increase their capacity and quality of service. Sometimes — such as during the mining investment boom — an airport has been caught by surprise with a large increase in demand. But, overall, we found that airports have managed, and continue to manage, their investments to benefit their customers and potential customers.

To us there is a critical distinction between an airport (or any other organisation) having market power, and the exercise of that market power.

The mere fact that an airport has market power is insufficient to justify more heavy handed regulation. To increase regulation, we would need to find that the airport was using that market power in a way that resulted in harm to the community.

Regulation has both costs and benefits – we at the Commission have frequently examined regulatory regimes, for example I worked on the *Regulation of Agriculture* inquiry a few years ago. In that inquiry we saw that there were many examples of excessive regulation that caused a net harm to the community.

Ideally regulation should be carefully designed for a particular purpose — and it should be calibrated to meet that objective in the least burdensome way. Regulation can change the incentives which individuals and organisations face and how they behave.

Of course we need to be wary about whether an company with market power would actually use the power.

And that's why it's important to have a range of information about airport operations published through ACCC monitoring. In exchange for benefiting from a light handed regulatory system, which should promote efficient investment, the airport is subject to a greater deal of scrutiny compared to other businesses — because it has market power.

It is reasonable to ask why an airport with market power is not actually exercising that market power. There are several reasons for this. First, the airlines have significant countervailing power — the Airports Act requires an airport to accept an aircraft even if it is in dispute with an airline over payments. Airports and airlines are

mutually dependent on each other — while a major airline will obviously want to land at Sydney, Melbourne, Brisbane and Perth, it has a large degree of freedom in how to manage its fleet in terms of frequency and aircraft size. And our domestic airline market is quite concentrated.

Second, airports offer a large range of services, including retail and parking, where the exercise of market power in one part of the operation could negatively affect another.

Third, there is a genuine threat of additional regulation should an airport be found to be exercising its market power. Were we to find evidence that market power was being exercised we would not hesitate to recommend additional regulation. Any short-term benefit from the exercise of market power needs to be considered against the long-term costs to the airport of additional regulation.

This is why it remains important to keep a close eye on airport operations, and why we proposed strengthening the ACCC monitoring regime in several areas including the split between international and domestic operations, and landside access.

A number of participants, mainly airlines, but also the ACCC, have proposed a form of compulsory arbitration — negotiate-arbitrate — which they say would be a modest increase in the burden of regulation. On that we disagree. Our preliminary view is that we think it would profoundly change the way in which contracts are negotiated between airports and airlines, disrupt investment and harm the community. An arbitrator would need to balance the interests of an airline and airport and would not consider the broader public interest, nor the interests of the numerous users of airports not subject to arbitration or not being party to arbitration. Airports are far more complicated businesses than a gas pipeline or a railway and this type of regulation would, we think, lead to gaming and increased costs. Were we to find that an airport was exercising market power, we might look elsewhere for additional regulation, something we will examine in the final report.

I also note that some participants have pointed to what they see as high whole-of-airport profits, implying that other activities should effectively cross-subsidise aeronautical services. There is no case for this at all. It makes no more sense for an airport-owned business park profit to cross-subsidise landing fees, than for an airline owned health insurance profit to cross-subsidise passenger fares. If you don't have an equity stake in a business you shouldn't really expect a share of the profits.

We also heard from some participants that some anti-competitive clauses have crept into airport/airline contracts. These include clauses which do not allow an airport to offer an incentive to a new airline or which limit the ability of an airline to exercise its legal rights under the Competition and Consumer Act. Such anti-competitive clauses do not belong in contracts and we recommend that they be banned.

I don't want to understate the complexities in reaching agreements in contracts between airports and airlines — they are by nature fraught with an increasing use of performance metrics and incentives for airports to improve their services to airlines. But as contracts are renegotiated following their expiration, these complexities should be expected to diminish. One of the key advantages of Australia's approach to regulation is that there are individual contracts with each airline - sometimes negotiated for a number of international airlines by the Board of Airline Representatives of Australia (BARA) that allows a tailored approach in keeping with the requirements of an airline.

Turning briefly to other airports, from Canberra, Adelaide, Hobart, Cairns, the Gold Coast and smaller airports handling Regular Public Transport traffic, we concluded that they do not have market power. If, in the future, one or more of these airports were found to have market power, we think they should become monitored airports.

Many of the issues relating to small regional airports lies with how their capital projects are funded and accounted for — many are unlikely to make a profit, but provide an essential service for the local community. Attempting to fully cost recover airline activity through landing charges would likely be counterproductive if it led to the exit of a carrier or a significant scale back in activity.

We were asked specifically to examine the market for jet fuel given its importance as a cost centre for airlines. This area is fraught given the limited public information about the structure of joint ventures of fuel companies at airports. We have asked for further information, but did make the observation that there are anti-competitive implications of the Joint User Hydrant Installations (JUHI) at airports being owned by fuel companies. We recommended that Western Sydney airport be established with an open access JUHI, and it is worth noting the move in that direction by Melbourne and Darwin airports.

Car parking is also an area of attention, especially by the public. This is understandable as car parking can appear expensive. But we do not find evidence that airports are exploiting their market power by excessively pricing car parking, it being more reflective of the value of the land used by the car parks. Arbitrarily forcing airports to reduce car parking prices is more likely to lead to a dwindling in supply and shortages. Most important is landside access, as off-airport parking is a significant competitive pressure to on-airport parking. Technology, too, is offering passengers and their friends and families new opportunities to reduce their costs by comparing prices and pre-booking as well as being sure of the arrival time of a flight.

In the interests of time I haven't discussed Sydney's regional access regimes, slot management and noise management. In these areas we have put forward some options and invited feedback from participants. We will have more to say about these areas in the final report. But we will not be recommending that the curfew at Sydney airport be removed.

So there is a potted summary of our draft report — it's a mixed report card for airports, but we think the current regulatory framework remains appropriate subject to a number of improvements including strengthening the monitoring regime.