AIRPORTS COUNCIL INTERNATIONAL

LESSONS FOR EUROPE FROM AUSTRALIA:

THE REVIEW OF AUSTRALIAN AIRPORT ECONOMIC REGULATION

Cover photo: Adelaide Airport / ADL

The authors

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Harry spent most of his career in HM Treasury where he focussed latterly on policies towards growth, science funding and privatisation and private finance. He was UK Director at the European Investment Bank 2001-2. He was made Companion of the Order of the Bath in the Queen's 2000 Birthday Honours.

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Dr Warren Mundy has over 20 years' experience in the aviation sector and he has worked extensively in both the public and private sectors including serving as a Commissioner on the Productivity Commission. He has advised governments, businesses and investors on airports and infrastructure regulatory issues in Australia, New Zealand, Europe and Asia.

He served as a Director of Airservices Australia for over five years, and was a member of the Steering Committee for the Joint Study on Aviation Capacity in the Sydney Region the report of which led to the Australian Government deciding to build a new airport for Sydney. Between February 2017 and May 2019 Warren was the Chief Economist of the Australian Airports Association.

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Introduction and Summary

The role of airport economic regulation in Europe in a new era & lessons from Australia

The role and purpose of the economic regulation of airports is receiving new attention as a result of the impacts of the COVID-19 pandemic, which has left many airports facing a debt cliff and resulted in capital expenditure being pushed years into the future. It it clear that consumers stand to benefit the most if airports can invest adequately.

The European Commission had in 2016 commenced a review of the EU's Airport Charges Directive. The review was postponed in 2020 as the European Commission needed to consider the impacts of COVID-19 on the air transport sector. Contemporaneously, the Australian Government has completed, and decided upon, its third independent public review by the Productivity Commission (the Australian Government's independent microeconomic reform and policy agency) of Australia's light-handed, monitoring approach to airport regulation first introduced in 2002. The Productivity Commission (PC) recommended in 2019 that the current monitoring approach should continue, with some minor modifications to improve transparency and information, proposals that were accepted by the Australian Government.

Monitoring of Australian airports has delivered good outcomes for 20 years

Australia's government removed the price cap regulation remaining at Australian airports in May 2002, recognising that the market had effective competition, strong buyer power from airlines, and airports were unable to use any market power that they may possess. This dose of realism about the merits of economic regulation is especially worth examining today, as Europe grapples with the impacts of the COVID-19 pandemic.

Successive reviews by the Australian Government Productivity Commission in 2006, 2011 and 2019 have shown that the system delivers good market outcomes and is capable of constraining the market power possessed by a number of Australian airports operating in a market where a more extended geography inevitably generates less potent competitive pressures on airports than exist in Europe. It has shown itself to be a viable and effective regulatory model as recognised by the Thessaloniki Forum of European airport

regulators. Beyond that, the PC's analysis has lessons which can be applied more widely to the ongoing analyses and decision making of European policy makers and national regulators under varying regulatory frameworks.

The PC had to consider issues that have featured in European regulatory debates in recent years, including assessment of airport market power, the objectives of regulation, costs and benefits of regulation, airline countervailing buyer power and consultation and contracting. In our view, there are important lessons in all these areas for European policymakers and regulators that should be considered in regulatory analyses going forward.

Amongst our key findings from analysis of the PC report are that:

- the existence of significant market power is not in and of itself a reason for intrusive regulation; the focus should be on evidence of exploitation of that position
- the risks of such exploitation are mitigated by the commercial incentives on airports themselves but, more significantly, the existence of airline countervailing power which should be examined at the airport level
- trigger regulation as embodied in the Australian monitoring arrangements can be an effective deterrent to exploitation of significant market power – as evidenced by the determination in successive PC reviews that the system is working
- airlines' interests cannot be assumed to be synonymous with those of passengers
- regulation should therefore be directed to the wider community and/or consumer interest rather than the balance of airport and airline interests
- those interests should instead be played out in commercial negotiations, recognising the reality that (as with commercial interactions generally) there will be noise and disagreement
- the potential for regulatory involvement in the case of disagreement between the parties may actually impede the development of commercial interactions
- in making judgments on market power and regulatory remedies evidence should be considered in the round and simplistic translation of regulatory techniques from other, different sectors should be avoided.

Implications of the Australian approach for Europe

The PC's review was fundamentally concerned with the future of the current light-handed approach to Australian airport regulation, and the approach it took has lessons which serious regulators will consider. In part this is about what might be termed the technicalities of economic regulation - the assessment of significant market power, the examination of evidence relating to airport performance and the identification of countervailing power.

The lessons also relate to the clear-eyed approach taken to the nature of airport-airline interactions - indeed, of commercial relationships generally - with the recognition that these will generate noise and disagreement, and that regulators should avoid being distracted by such surface turbulence and focus instead on the underlying economics and incentives influencing the parties. It is this combination of economic analysis and behavioural insight that marks out the PC's review for close attention by European policy makers and regulators.

Despite the differences in geography and therefore market structure, many of the underlying issues faced by European regulators and the PC are similar and the evidence should be analysed in a comparable way. As a result of its analysis, the PC determined that significant market power applies only to Australia's largest four airports, and in a limited range of services, and that the natural interplay of airport commercial incentives and the exercise of airline countervailing power significantly mitigates its exercise (and therefore risks of its abuse) such that a light handed monitoring regime (and the potential for regulatory intervention if things go awry) is sufficient to safeguard the public and consumer interest.

The resulting disjunction between this regulatory approach and that embodied in the Airport Charges Directive (ACD) and much European national regulation is difficult to either comprehend or defend. Indeed, the greater evidence of airport competition in Europe should make for more proportionate regulatory approaches. The PC report is a timely reminder, as the review of the ACD continues, that there are alternative analytical and policy approaches open to the European Commission and national regulators as we emerge from the COVID-19 pandemic.

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STRUCTURE OF THE PAPER

1. Structure of the paper

This paper first briefly sets out the history and context for Australia's light-handed approach and then the particular areas of focus for the most recent review before turning in more detail to the lessons identified above. In evaluating the extent to which these might translate to the European context we have been mindful of the differences between the Australian and European aviation (airline and airport) markets. However, even when taking these into account, the scope for translating the PC's analytical approaches and findings to the European debate is striking. The PC report (as, indeed, does its previous work) brings a refreshing clarity to issues that continue to bedevil European discussion long past the point where they should have been settled.

2.

ORIGINS AND KEY THEMES OF THE AUSTRALIAN APPROACH

2. Origins and key themes of the Australian approach

1997
Privatisation of airports starts in Australia

2002
SYD privatised (last of major Australian airports privatised)

2002
Government removes all price controls and implements price and quality monitoring

2006
CBR and DRW ceased to be monitored after the PC review

2011
ADL stopped being monitored after the PC review

2019
Government confirms effectiveness of monitoring approach

The Australian Government privatised, by way of 99-year leases, 23 airports (including 8 general aviation airports) operated by the Federal Airports Corporation (FAC) between 1997 and 2002, the vast majority in the first two years of the programme. Sydney Airport (SYD) was the last airport to be privatised. Eleven of the largest twelve airports, Sydney being excluded, were subject to separate, dual-till CPI–X[1] price caps with provisions to pass through "necessary new investment" costs that were incurred to provide additional capacity, new or enhanced services or to meet new compliance requirements (such as enhanced security required after the events of 11 September 2001).

The price cap regime was always intended by Government to be a transitional measure with a review to be undertaken by the regulator, the Australian Competition and Consumer Commission (ACCC), after five years. However, given concerns about the performance of the ACCC and the appropriateness of it reviewing its own administration, the review task was given to the PC which commenced its work in December 2000 and reported in January 2002.

During that review, in addition to the terrorist attacks in the United States on September 11, 2001, Australian aviation was significantly disrupted by the collapse of Ansett Australia. This quickly led to Qantas achieving a domestic market share well in excess of 80% (and an effective monopoly on many routes) and undermined connectivity for many international carriers, particularly those in the Star Alliance – Qantas' domestic market share remains in excess of sixty per cent. Of particular concern was future access to the significant domestic terminal infrastructure controlled by Ansett.

The immediate response (October 2001) of the Australian Government to these events was to remove the price caps for all airports other than Melbourne, Brisbane and Perth which were allowed one-off price increases of 6.2, 6.7 and 7.2 per cent. Price monitoring continued for Adelaide (ADL), Canberra (CBR) and Darwin (DRW) whilst all forms of price regulation at other airports ceased.

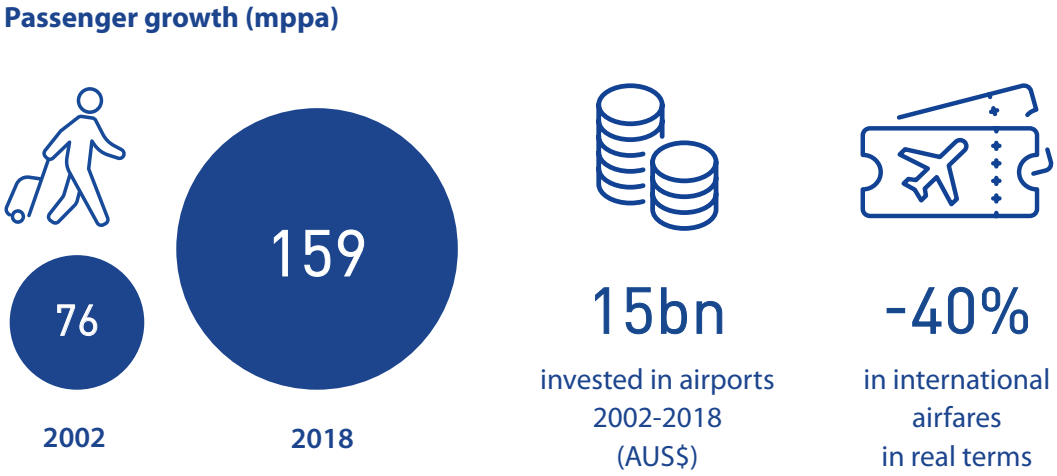
1. Consumer Price Index (CPI) minus an efficiency factor of X.

In May 2002, the Australian Government accepted the PC's preferred position to remove all forms of price control and to implement a system of price and quality monitoring for the mainland capital airports. Canberra and Darwin ceased to be monitored as a result of the 2006 review and Adelaide after the 2011 review. Whilst the monitoring framework is primarily directed at the provision of aeronautical services, public concerns, particularly about price levels, have seen the provision of car parking and other ground access services included in the data collected.

Part of the Government's 2002 response was to set out Pricing Principles which would form the basis against which airport conduct would be judged. The Government also indicated that these principles (including the dual till), which remain largely unaltered, should act as a guide to good-faith commercial negotiations that it expected would underpin constructive engagement between airports and airlines.

The public benefits of these reforms are clear – since price controls were removed in 2002 every major Australian airport has negotiated multiple multi-year commercial agreements with airlines that led to the airport sector investing in excess of AUD15 billion between 2002 and 2018, two thirds of which has been in aeronautical assets, which facilitated national passenger growth from 76 million passengers per annum in 2002 to 159 million in 2018.[2] Service quality has been maintained or improved and investment in international capacity has stimulated airline competition that has led to a 40 per cent reduction in international airfares in real terms.[3]

FIGURE 1 - **PUBLIC BENEFITS OF THE MONITORING REGIME**



2. Australian Airports Association (AAA), AAA Submission to the Productivity Commission 2018 Inquiry in the Economic Regulation of Airports, September 2018, p.5.
3. Ibid., p.6.

3.

KEY ISSUES FOR THE 2019 REVIEW

3. Key issues for the 2019 review

The PC commenced its most recent review towards the end of June 2018. This review, being part of the normal regulatory cycle, was long anticipated and not initiated as the result of any concerns within government nor as the result of airline lobbying.

Relevant to the European context is the overwhelming "outcomes" focus of the terms of reference provided by the Australian Government. The terms of reference asked the PC to...

> *report on the appropriate economic regulation of airport services, including the effectiveness of the price and quality of service monitoring, in achieving the following objectives:*
>
> - *promoting the economically efficient operation of, and timely investment in, airports and related industries;*
> - *minimising unnecessary compliance costs; and*
> - *facilitating commercially negotiated outcomes in airport operations.*
>
> *Following on from its 2011 findings, matters the Commission should also consider include:*
>
> - *the effectiveness of the monitoring regime conducted by the ACCC, including the methodology used and the adequacy of the information collected*
> - *whether the current regime impacts on the ability of airports to price, operate and invest in airport infrastructure in an efficient and timely manner*
> - *whether the existing regime is effective in appropriately deterring potential abuses of market power by airport operators…*

Although coming from very different perspectives airports, investors and international carriers (represented by the Board of Airline Representatives in Australia (BARA)) in their submissions sought to address outcomes by focusing on issues of investment, efficiency, quality of service and the facilitation of commercial negotiations.

Not surprisingly, the Australian Airports Association and monitored airports, relying on data published annually by the ACCC, and supported by international benchmarking material, sought to demonstrate that they had not abused their market power and that the outcomes delivered were in the public interest. These conclusions were supported by the Australian Government department responsible for aviation policy.[4]

4. Department of Infrastructure, Redevelopment and Cities, Submission to the Productivity Commission Inquiry into the Economic Regulation of Airports, September 2018, pp.2-4.

BARA's focus was on the effectiveness of the regime in delivering to international airlines, in particular, the quality of service they should expect and in some cases were promised by airports. Airport negotiating conduct was also a primary concern. BARA sought to have the system strengthened rather than fundamentally reformed. It is interesting that over the course of the inquiry airports and BARA were able to find common ground on the need to develop an industry-wide understanding on issues relating to quality of service, consultation and engagement in the contracting process, a position endorsed by the PC and the Government.

Alternatively, Airlines for Australian and New Zealand (A4NZ), representing largely domestic carriers, argued that the monitoring regime had failed and that airport market power needed to be reined in without any substantive demonstration of the existence, nor use, of such market power by the vast majority of airports A4ANZ sought to have regulated. A negotiate-arbitrate framework was A4ANZ's preferred alternative approach. The regime was to cover virtually all regular passenger transport airports previously operated by the Federal Airports Corporation despite the PC finding only four possessed market power.

Whilst the ACCC made no comment on A4ANZ's detailed proposal, the ACCC argued that the current regime was not effective in constraining significant market power and also suggested a negotiate-arbitrate framework as it had in the previous review. It suggested the framework used to regulate certain gas pipelines was a suitable departure point for the development of an airport specific regime. It can be inferred from the ACCC's previous papers that its proposal would have limited the negotiate-arbitration model to the monitored airports with significant market power.

It is interesting to note that in formulating its approach A4ANZ suggested that the existing (dual till) Pricing Principles (discussed above) – the principles against which, in part, the PC had determined that the four large monitored airports had not abused their market power – could form the basis for consideration of pricing matters by an arbitrator. It seems to us that this could suggest pricing outcomes under arbitration might be similar to those currently achieved but with the addition of the significant additional cost and risks inherent in an arbitration framework (as discussed below).

4.

ASSESSING MARKET POWER

4. Assessing market power

4.1 Relevance to discussion of the Airport Charges Directive

The coverage of the EU ACD is determined by an arbitrary size threshold unrelated to any market power that the over 80 airports concerned may hold. Many, perhaps most, are unlikely to hold significant market power of a degree that would merit consideration of whether sector specific regulation is required let alone whether it should actually be applied. In this regard the ACD departs from regulatory best practice, not least as evidenced by other EU wide regimes. The issue of market power has therefore been a live one in current debates about possible revisions to the ACD. But discussions have been bedevilled by questions around whether significant market power in and of itself constitutes grounds for regulation (potentially of the most interventionist kind) and how far any exercise of market power might be constrained by the countervailing airline buyer power. The PC report has important lessons in these areas.

4.2 Analysing the exercise of market power

The PC's report is important in the clarity it applies to the question of whether and to what extent the existence of significant market power, which it found at four airports, is sufficient to merit regulation. The PC accepts that a significant level of market power creates a prima facie case for regulatory intervention, but in assessing whether regulation additional to the current monitoring regime is required it has explicitly focussed on whether airports have exercised their market power. While it recommended maintaining (with some minor enhancements) the monitoring regime, it rejected more intrusive regulation. In doing so, it balanced both the costs of regulation (on which more below) and the risks and experience of airport behaviours under the monitoring regime. The PC did not accept, nor does its analysis demonstrate, that airports with significant market power will necessarily abuse it. This is partly about the revenue generating incentives that apply to businesses with both significantly fixed cost bases and revenue potential from non-aeronautical commercial businesses.[5] Their interest lies in attracting and retaining business rather than restricting supply in the classical monopolist way. However, the PC did not consider this alone 'a significant constraint'. It devoted considerable analysis to the existence of airline countervailing power.

5. Starkie, David, Reforming UK Airport Regulation, Journal of Transport Economics and Policy (2001).

4.3 Airline countervailing power

While in Australia (as is broadly the case in Europe) airline bargaining power is reinforced by a legal framework that allows airlines to continue using an airport without paying the charges determined by the airport (which then has to rely on legal redress), the PC also identified the juxtaposition of the mobile assets of airlines (and the options this mobility creates) and the more clearly physically fixed assets of airports as well as other elements of airline bargaining power, including through influencing and media.

Whilst the Australian airline market is very concentrated, much more so than Europe's, it is clear that the PC's view is that airline countervailing power varies depending on market segment and airport. As a general principle, it is possible that 'a customer will have as much or more bargaining power than a supplier'.[6] So, the appropriate read across to the European context is less at the level of the EU aviation market overall and more at the level of the individual airport. The key question therefore is whether individual airports face sufficiently powerful airline counterparts that the market power they possess is significantly constrained? The nature of Europe's geography and the greater choice of airport options available, particularly to the most mobile low-cost carriers, would prima facie suggest a greater degree of countervailing airline power than is relied upon by the PC in making its regulatory judgements about Australia's major airports. Furthermore, as discussed in the section below on airport-airline relationships, airlines have strong political levers to pull in Europe, as a way of exercising buyer power, which are also present in Australia.

It also seems likely that the possibility and consequences of more intrusive regulation temper airport conduct. Australian airports are subject to the National Access Regime (more on this below) and the PC and successive Governments have also made it clear that if a view was formed that airports were exploiting market power, there would be no hesitation in implementing more intrusive regimes. It is clear from the evidence presented to the PC that the returns airports are seeking from commercial agreements are consistent with those they would expect to receive from a reasonable regulator.

Of course, the existence of the ACD and, more so national regulation, mean that European airports with significant market power are generally regulated quite intrusively. It is therefore more difficult to assess their underlying behaviours and incentives than of those in Australia where the long-standing monitoring regime has enabled a track record of behaviours to be established. The PC was able to look at indicators of price, efficiency, service and profitability uncontaminated by prior regulatory constraints or guidelines. The Australian experience in a market less amenable to competitive constraints than Europe's does suggest that a lighter handed approach than traditionally applied in Europe carries fewer risks than is commonly supposed, suggesting that regulatory authorities in Europe are inclined to attach more weight to the risk of abuse than is necessary. They are therefore overly attracted to more intrusive regulation than is merited, given in particular the countervailing power of airlines. On the evidence of Australia, price and service monitoring is more commensurate with the degree of market power possessed by airports, and the likelihood of it being exploited.

6. Productivity Commission (PC), Economic Regulation of Airports, June 2019, p.123.

KEY LESSONS

- the existence of significant market power is not in and of itself a reason for intrusive regulation; the focus should be on evidence of exploitation of that position

- the risks of such exploitation are mitigated by the commercial incentives on airports themselves but, more significantly, the existence of airline countervailing power which should be examined at the airport level

- trigger regulation as embodied in the Australian monitoring arrangements can be an effective deterrent to exploitation of significant market power – as evidenced by the determination in successive PC reviews that the system is working

5.

DEFINING THE OBJECTIVES OF PUBLIC POLICY AND REGULATION

5. Defining the objectives of public policy and regulation

5.1 Emphasising consumer and community interests

The ACD had its origins in airline complaints about levels of airport charges and it has therefore been formulated in terms of seeking to correct a perceived imbalance between two sectional parties, namely airports and airlines. The issue of passenger (and other end-user) interests is left unaddressed. Whilst the complaints of A4ANZ and European airlines are similar, the ACD contrasts starkly with the Australian approach, which is to see *'Regulation [as] a policy tool available to governments to improve the welfare of society as a whole'.*[7] The PC's judgements are therefore expressed in terms of how they affect 'the community' including passengers. Reflecting this, the Australian government's response to the PC's report is couched in terms of the impact on the 'community' and 'consumer outcomes'.[8] Australian policymakers clearly recognise that airline interests do not necessarily align with those of passengers, let alone the wider community. As the ACCC, quoted by the PC, puts it:

> *'...airline interests do not necessarily coincide with the interests of the broader community. Airlines naturally care about their own profitability which depends primarily on their position relative to competitors'.*[9]

This lack of airline-passenger alignment could impact passenger outcomes. There is, for example, potential for airlines to seek to constrain airport investment as a way of limiting competition and thereby increasing the fares that passengers pay – examples of such airline conduct were provided to the PC.[10]

And it should not be assumed, as airlines often argue, that reductions in airport charges will necessarily be passed through to passengers. Indeed, as the PC suggests, airlines' ability to price discriminate means that fares will reflect passengers' (widely differing) willingness to pay rather than costs, including airport charges which anyway constitute a relatively small proportion of airline costs. An approach, as embodied in the ACD, of seeking to bear down on airport charges is therefore at odds with underlying airline economics as set out by the PC.

Clarity about the distinction between airline and broader community interests also affects the analysis of airport market power. Where airports are congested higher airport charges may well be an efficient means of rationing scarce capacity. Increased airport profitability for these reasons (as seen in Perth during the 2006-2010 resources construction boom) does not represent exploitation of market power and, following the PC's logic on airline pricing, the reduction of such rents through lower airport charges would largely transfer the rents to airlines rather than benefiting passengers. This could, indeed, jeopardise the very investment needed to relieve the capacity constraint.

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7. PC, op. cit., p.83.
8. Australian Government response to the Productivity Commission Inquiry into the Economic Regulation of Airport, December 2019.
9. PC, op.cit.
10. Queensland Airports Limited, Productivity Commission Economic Regulation of Airports, September 2018, pp. 10-11.

The distinction between airline and broader, including passenger, interests therefore matters both for the definition of regulatory objectives and analysis of airport issues. There have been recent signs of the European Commission recognising this in its concern over the market power that airlines can exert over airports, and the resulting potential for airlines to impede investment.[11] This suggests that any revision of the ACD needs to recognise that the ultimate objective of policy and regulatory intervention should be the passenger and/or the wider 'community interest' (to use the PC's formulation) which might thereby encompass the broader climate change objectives that the Commission now seems intent on pursuing.[12]

5.2 Encouraging airport-airline commercial relationships

The refocusing of policy and regulation on passenger and broader interests does not mean that airline and airport relationships should be ignored, rather that they should be treated as the commercial interactions that they are. The objectives of the Australian government have therefore included since 2002 the facilitation of commercially negotiated outcomes. This is because such negotiations, in the PC's words, *'directly link the interests of airport users to airport operations' and provide investment incentives with fewer distortions than the previous price cap arrangements'.*[13] The Government's response to the PC report was therefore encouraging of airports and airlines working together to establish principles that could assist in guiding negotiations, so helping to reduce some of the frictional and transactional costs involved.[14] But the emphasis in the Government's response was very much on leaving this to the parties to resolve rather than Government itself taking on a role.

Recognition of the commercial nature of the interactions between airports and airlines entailed the PC taking a view of the resulting tensions as somewhat inevitable, a product of the interplay between parties that can also be found in other industries - *'threats, rhetoric and leveraging media attention are commonplace'.*[15] The PC found that there had been a small number of instances of poor behaviour on both sides, indicating that both parties were able and willing to inflict commercial and reputational injury.[16] But that the negotiating process was accordingly challenging did not amount to airports systematically exercising their market power to the detriment of the community. Rather some of the difficulties encountered could be put down to the prospect of *'complex and contested investments that affect many parties, including competing airlines with different objectives'.*[17]

11. European Commission, Inception Impact Assessment, Charges for the use of airport infrastructure (Ref. Ares(2017)5533746 - 13/11/2017), p. 2.
12. The European Green Deal, European Commission Communication, Brussels, 11.12.2019, COM(2019) 640 final.
13. PC, op.cit., p.120.
14. Australian Government response, op.cit., p.1.
15. PC, op.cit., p.135.
16. Ibid., p.145.
17. Ibid., p.119.

FIGURE 3 - **MEDIA COVERAGE OF AIRLINE LOBBYING**

An airport cost row that has no wings

The Financial Review's take on the principles at stake in major domestic and global stories.

Sep 20, 2019 — 12.00am

Save Share

For weeks, Australia's oligopolistic airlines and monopolistic airports have been using megaphones to persuade the travelling public that it is really the dastardly other one responsible for profiteering out of expensive airline tickets. But the argy bargy is really a public extension of the sort of vigorous private negotiations over aeronautical fees that the airports and airlines regularly go through. The difference now is the airlines are trying to put pressure on the Morrison government to impose more regulatory costs and political risks on the airports, for no obvious benefit to airline passengers.

Source:
Australian Financial Review

ACCC should ground Joyce's latest flight of fancy

JUDITH SLOAN 1:00AM OCTOBER 5, 2019

The Qantas chief has launched a brazen lobbying effort for cheaper airport charges

Source:
Weekend Australia

Ray Finkelstein backs airports ahead of final PC report

Jenny Wiggins
Infrastructure Reporter

Oct 15, 2019 — 3.22pm

Airports have stepped up pressure on the federal government to ignore airlines' demands for regulation by bringing in former Federal Court Justice Ray Finkelstein to bat on their behalf.

The Honourable Mr Finkelstein, who was president of the Australian Competition Tribunal between 2008 and 2011, has told the federal government that it should stick with the current "light handed" system as it prepares to release a final report on airport regulation from the Productivity C...

Source:
Australian Financial Review

The consultation processes recognised and encouraged by the ACD have some of the features of commercial interaction – including exchange of information and the ability of airlines to exercise their bargaining power. But they are constrained by access to the regulator in case of disagreement (on which more below), and an appropriate scepticism is not always applied to the resulting noise - assertion and grievance are too often accorded the weight of evidence. It is arguable that more healthy, realistic relationships would result from the European Commission recognising more clearly - indeed, encouraging - the commercial interplay that should take place. The PC treated contracts between airports and airlines as confidential.[18] To the extent that it, or its successors, needed access to ensure, for example, that the contracts did not restrict competition this could be done on an in-confidence basis and therefore without undermining the tailored nature of the arrangements the parties had agreed between them.[19]

18. Ibid., p.169.
19. Ibid., p.298.

KEY LESSONS

- airlines' interests cannot be assumed to be synonymous with those of passengers
- regulation should therefore be directed to the wider community and/or consumer interest rather than the balance of airport and airline interests
- those interests should instead be played out in commercial negotiations, recognising the reality that (as with commercial interactions generally) there will be noise and disagreement

6.

COSTS OF REGULATION

6. Costs of regulation

6.1 Historic recognition of regulatory costs

Australia's price monitoring approach had its origins in a clear recognition of the costs and distortions of the preceding price cap system and regulation more generally. That the PC remains alive to such costs was apparent in its refusal to pursue the proposal for an industry specific negotiate-arbitrate regime, in line with its approach in five previous inquiries. More generally, the terms in which it approached its key judgements on whether airports have exploited their market power err, rightly in our view, on the side of caution, avoiding the instinctive recourse to regulation that too often results from potentially marginal assessments of detriment (on which more below).

6.2 The negotiate-arbitrate issue

A4ANZ had proposed that the airport sector should be subject to a regime whereby there would be automatic recourse to an arbitrator where there had been failure to reach agreement. The PC rejected this for a number of reasons, including that it involved circumventing safeguards in Australia's National Access Regime (NAR). This airline proposal would have meant subjecting airports to regulatory intervention without a prior finding of the intervention benefiting the community – a test applied in the NAR.[20]

This, in the PC's view, would not result in a levelling of the playing field but an imbalance as airports, with their physically fixed assets, would have to live with the arbitrator's judgement whereas more mobile airlines would have some options not to do so.[21]

Some of these factors, in particular regulatory intervention in the absence of a finding of the airport causing detriment (indeed, in the ACD case, even an assessment as to the existence of market power), will resonate in a European context. But it is perhaps the PC's concern that automatic access to an arbitrator would cast a shadow over prior negotiations that needs particularly to be considered in any revision of the ACD. The PC was concerned (as it has been in the past) that the parties, rather than focussing on the discussions in hand, would be forever looking over their shoulders to the potential reactions of an arbitrator, resulting in a chilling effect on negotiations.[22]

20. Ibid., p.300.
21. Ibid., p.305.
22. Ibid., p.303.

6.3 Implications for European Regulation

In the case of the EU Airport Charges Directive the ability to appeal to the relevant national Independent Supervisory Authority (ISA) under Article 6 (3) in the case of failure to reach agreement is a very similar arrangement carrying similar risks. Consistent with the PC's analysis of 'negotiate-arbitrate' the airport will have to live with a regulatory decision – an airline may have the option of relocating its aircraft in the event of an unfavourable (from its viewpoint) finding. More generally, however, recourse to a regulator in case of disagreement is likely to cast a shadow over the preceding discussions. There may be less interest in looking for areas of agreement and compromise than in striking poses that will resonate with the regulator at a later stage. Parties behaving in this way will be behaving rationally, given the incentives created by recourse to the regulator.

The resulting shadow of regulation, particularly in circumstances where significant market power has not been proven let alone an abuse of it, risks therefore both constraining the development of commercial airport-airline interactions and in fact generating the very disputes that the ACD framework is broadly intended to ameliorate through transparency and consultation provisions.

The likely chilling effect on any normalisation of the sector needs to be factored into any ACD revision. If access to a regulator in the event of disagreement is to be maintained it should be restricted to airports which have significant market power, and should be conditional on an adverse finding as to conduct or exploitation of market power. Such an approach would be consistent with an objective for the development of commercial relations in the sector.

These issues are even more pressing as airlines and airports handle distressed balance sheets following COVID-19. Airlines will strongly oppose any airport investments that may impact the level of airport charges; while an airport must be able to remunerate investment to proceed with necessary projects for capacity and quality.

KEY LESSONS

- the potential for regulatory involvement in the case of disagreement between the parties may actually impede the development of commercial interactions, especially following COVID-19 and distressed airline and airport balance sheets

7.

SECURING BALANCED REGULATORY JUDGMENTS

7. Securing balanced regulatory judgments

7.1 A holistic approach

In making its judgments about market power, whether market power had been exploited or on the negotiate-arbitrate proposal, the PC applied what might be termed a precautionary margin to its analysis and decision-making, consistent in our view with both the inevitable evidential uncertainties and the costs that might result from unnecessary regulation.

The PC was clear, as discussed above, that the existence of significant market power was not of itself an argument for regulation greater than the monitoring regime. There needed to be evidence that such market power had been exercised to the detriment of the community and that the benefits of regulation outweighed the costs. But that still left the PC with the task of assessing that evidence and giving clarity on the thresholds to be applied in determining whether market power had effectively been exploited. It could have attached weight to individual indicators and sought to build a case for additional regulation on that basis. It took the opposite approach, emphasising instead the limitations of the data before it and the holistic nature of the judgments it was making. So, in determining whether market power had been exploited to the detriment of the community the threshold was embodied in the word 'systematically', with the implication that any such exploitation needed to be more than fleeting or accidental and grounded in a general pattern of persistent behaviour.

Similarly, and consistently, evidence from indicators of pricing, efficiency, service and profitability was interpreted in the round - indicators were 'on *balance within reasonable bounds'*. Indeed, the PC's assessment was that while some indicators might *'in isolation'* be concerning, the *'overall'* performance of the airports was satisfactory.[23] In particular, the PC drew attention to the need to place short term indicators in a longer term perspective given the cyclical nature of the airport business and the lumpiness of investment, and also to the need to avoid viewing investment decisions with the benefit of hindsight.[24]

7.2 Contrast with the European debate

The approach applied by the PC stands in stark contrast to that, often featuring in discussion of airport regulation in Europe, which seeks to fasten precisely on evidence 'in isolation' and to argue for more general regulation from such specific instances. That way lies excessive and unnecessary regulation with attendant costs outweighing speculative benefits. The lesson from the PC's approach is that there needs to be both greater balance and more rigour in determining whether and to what extent regulation is required. The PC quotes with evident approval the view of an independent economist that even if airport returns were moderately excessive the regulatory system would still be performing well if it increased efficiency compared with other options, such as price caps.[25]

23. Ibid., p.147.
24. Ibid., pp.161,184.
25. Ibid., p.87.

The implication of this approach to evidence and assessment is that policymakers and regulators in Europe need to think hard about the perfectability and costs of regulatory tools. Discussion is too often conducted as though enhanced regulation is capable, without costs and side effects, of finessing market performance when the reality is that the evidence on which decisions are being made is inevitably uncertain and often subject to a wide margin of interpretation, that aviation markets are constantly evolving, making for a moving target (as, for instance, with the continuing development of airport competition in Europe), and that the side effects of regulation are unclear, evolve and may be under-estimated because they are not immediately apparent.

Against this background there is a wisdom in an approach, reflected in the PC report, that is not too ready to pronounce imperfection, nor to claim that there is always a solution but rather recognises the reality of firms acting in an uncertain commercial environment with the tensions and difficulties that involves and is therefore prepared to be suitably cautious before pronouncing a 'guilty verdict'.

7.3 Lessons from other sectors

In reaching a view of what is appropriate there should be no automatic recourse to regulation as applied in other sectors. In the PC's view there is no single model of regulation that should apply to infrastructure provision.[26] Indeed, it is interesting to note that whilst it has long supported price monitoring in the airports sector, it has a similar history in supporting the much more intrusive National Access Regime as well as, on a case by case basis, more intrusive industry specific regimes.

The PC was clear that while lessons can be learned from other sectors, a sector by sector, case by case approach is likely to lead more effective regulation.

KEY LESSONS

- in making judgments on market power and regulatory remedies evidence should be considered in the round and simplistic translation of regulatory techniques from other, different sectors should be avoided

26. Ibid., p.294.

Conclusion

The PC report is a reminder that there are alternative analytical and policy approaches open to the European Commission and national regulators as the sector emerges into a new world dramatically changed by the COVID-19 pandemic.

The PC took a clear-eyed approach to the nature of airport-airline interactions – indeed, of commercial relationships generally - with the recognition that these will generate noise and disagreement. The report finds that regulators should avoid being distracted by such surface turbulence and focus instead on the underlying economics and incentives influencing the parties. For the airport sector, the PC finds that the light-handed monitoring regime (and the potential for regulatory intervention if things go awry) is sufficient to safeguard the public and consumer interest, and has indeed delivered good outcomes.

It is this combination of economic analysis and behavioural insight that marks out the PC's review for close attention by European policy makers and regulators as we reconsider the role of regulation.

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