Report prepared for Wellington International Airport Ltd

Recent developments in airport regulation in Australia and the UK and implications for New Zealand

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1. Introduction

The Commerce Commission (the Commission) has commenced its review[1] of the effectiveness of the information disclosure regime in relation to Wellington International Airport Ltd (WIAL) pursuant to 56G of Part 4 of the Commerce Act (the Act). Within the context of this review, WIAL has requested that we review economic regulation applying to Australian and United Kingdom (UK) airports, and recent assessments of the same, and draw from that material insights relevant to the 56G review.

1.1 Context

The 56G review was legislated for as a component of Part 4 of the Commerce Act in 2008. Part 4 imposed an information disclosure regime on the three main New Zealand international airports, replacing a pre-existing disclosure regime under the Airports Authorities Act (AAA). WIAL has published its first annual disclosures under the Part 4 regime for the 2010/11 financial year, as well as its price-setting event disclosures for the pricing period ended 31 March 2012, and for the new pricing period ending 31 March 2017. Thus the Part 4 information disclosure regime is in its infancy.

Section 56G requires the following.

> *(1) As soon as practicable after any new price for a specified airport service is set in or after 2012 by a supplier of the service, the Commission must—*
>
> *(a) review the information that has been disclosed by suppliers of specified airport services under subpart 4; and*
>
> *(b) consult (without necessarily holding an inquiry) with interested parties; and*
>
> *(c) report to the Ministers of Commerce and Transport as to how effectively information disclosure regulation under this Part is promoting the purpose in section 52A in respect of the specified airport services.*

Our report focuses on the design of and trends in the regulation of airports in Australia and the UK as regards information disclosure, and the reasons for them as articulated in publicly available reports. We note that most of the assessments of the Australian and UK regimes involve comparative analysis of information disclosure relative to other forms of regulation (e.g. with forms of price control, or with no regulation). We recognise the Commission's 56G review does not extend to comparative analysis of regulatory mechanisms (see paragraph 20 of the *Process and issues* paper). We have nevertheless included comments on this comparative analysis where it provides insights as to the effectiveness or otherwise of information disclosure in these jurisdictions. Given the time to prepare this report it does not extend to assessing the effectiveness of the recently implemented New Zealand information disclosure regime under Part 4.

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[1] The most recent paper on this review is *Airport services – s56G Reports; Process and issues*, Commerce Commission, 31 May 2012 (Process and issues).

The s56 G review includes reporting on 'how effectively information disclosure regulation under this Part is promoting the purpose in section 52A in respect of the specified airport services'. The purpose of Part 4 reads:

> *The purpose of this Part is to promote the long-term benefit of consumers in markets referred to in section 52 by promoting outcomes consistent with outcomes produced in [workably] competitive markets[2] such that suppliers of regulated goods or services—*
>
> *(a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and*
>
> *(b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and*
>
> *(c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and*
>
> *(d) are limited in their ability to extract excessive profits.*

In order to draw together the material on the Australian and the UK airport regulatory regimes in a manner relevant to the purpose of Part 4 and to the 56G review we have focused our analysis on the effectiveness or otherwise of information disclosure in these regimes to:

1. Promote the long-term benefit of consumers (promote long-term consumer benefit)
2. Promote outcomes that are consistent with outcomes produced in workably competitive markets (promote workably competitive market outcomes)
3. Provide an airport incentives to innovate and invest (provide incentives to invest)
4. Provide an airport incentives to improve efficiency and provide services that reflect consumer demand (provide incentives to meet consumer demand), and
5. Have an airport share with consumers the benefits of efficiency gains, including through lower price, and limit an airport's ability to extract excessive profits (limit excessive profits).

We cover Australian airport regulation in section 2 and UK regulation in section 3. In section 4 we provide a summary of a report by Copenhagen Economics on airport regulation in Europe.

1.2 Summary of findings

The aeronautical industry in the UK (and wider continental Europe) has undergone significant changes over recent years. The 1990s saw the liberalisation of air services, along with strong growth in passenger and freight volumes. New routes have opened up and there

[2] The term 'competitive markets' in the Act has been interpreted by the Courts and the Commerce Commission as 'workably competitive markets', see Commerce Commission (2010), *Input methodologies (airport services): reasons paper*, 22 December 2010

is an increasing number of alliances between airlines and increased choice for inbound tourist travellers. According to Copenhagen Economics, European airports now face greater competitive pressures than previously was the case.

Common to both the UK and Australia, as well as New Zealand, has been the emergence of Low Cost Carriers (LCCs) and associated evolution in airlines' business models. This has created a more dynamic and competitive market, and also impacted on the demand for airport services. The nature of consumer demand has changed, with growth in leisure travel (due to lower airfares) and increased price sensitivity due to the internet.

In both Australia and the UK, the form of airport regulation differs to that applying to other regulated sectors (e.g. to electricity, gas and telecommunications network services). In the other regulated sectors, economic regulation typically involves price control; whereas with airports in Australia no airports are subject to price control, and in the UK only the largest three are. Instead, the larger airports in both Australia and the UK (including the three largest also subject to price control) are subject to information disclosure requirements aimed at providing information relevant to monitoring and negotiation of price and service levels. The reasons given for the form of airport regulation differing to other regulated sectors include that:

- Airports' paying customers for aeronautical services are generally the airlines, and they are well-informed and can bring to bear significant countervailing pressure in negotiations or consultations on price and service quality. Good quality and relevant information is perceived to assist these negotiations or consultations, whereas price control mechanisms often impede or substitute for them.
- The cost of the airport services comprises a relatively small component of the end consumer ticket price, meaning the consumer market is relatively insensitive to changes in the levels of airport charges. Combined with the fact that airlines routinely price differentiate their services, this means variations in airport price levels (around the competitive level) are unlikely to have a significant impact on the demand and therefore the economically efficient use of aeronautical services. In these circumstances the wider economic benefits from price control are likely to be low.
- Many airports run significant businesses complementary to providing aeronautical services, and the success of many of these businesses is influenced by the volume of the people using the aeronautical services, and their customer experience. Thus the success factors for these non-aeronautical businesses encourage airports to align their aeronautical service offerings with customer demand as regards service levels and also price (if and where price influences volumes, such as congestion charging).
- In some locations there is perceived to be adequate competitive disciplines with respect to price and service quality.

The factors discussed above, as well as a concern to ensure regulation is fit for purpose, have meant that the Australian and UK governments have decided they can increasingly rely on information disclosure requirements and the provisions of general competition law to discipline airport pricing and service levels.

In Australia and the UK there is a trend towards commercial negotiations and agreements, supported by information disclosure requirements, and backed by the threat of *ex post* enforcement if necessary. Both governments employ a cautious use of price control, due to

the costs it imposes and the associated impacts on the incentives to invest (and ultimately prices and service quality for users), as well as the risk of regulatory error.

Airport regulation in Australia and the UK is placing greater reliance on various forms of information disclosure mechanisms, relative to the regulatory mechanisms in the other regulated sectors.

This reliance on information disclosure (or price monitoring) in Australia has been in place since 2002 and has been confirmed subsequent to a review in 2011.

The proposed reforms to airport regulation in the UK would continue to place reliance on information disclosure for all but the three largest airports.

In general, we observe that there is a high degree of alignment between the current New Zealand Part 4 approach and the direction of airport regulation in both Australia and the UK. The three jurisdictions have been considering a similar range of issues in relation to the economic regulation of airports, and come to generally consistent positions on how to best address them.

2. Australia

2.1 Context

2.1.1 History

In 1997-98 long term leases were sold to private sector companies for 17 airports in Australia that had previously been owned by the Federal Airports Corporation. At the same time, Sydney Airport was corporatised; and it was sold in 2002. All these airports were regulated under the Airports Act 1996.

Twelve of the larger leased airports were subject to prices surveillance[3] by the Australian Competition and Consumer Commission (ACCC) under the Prices Surveillance Act 1983[4] for a period of five years after the leases were sold. The intention was that there would be a review prior to the end of this period to determine whether regulatory arrangements were required to counteract market power.

2.1.2 Rationale for price monitoring

During 2001/02, the Australian Productivity Commission (PC) undertook the first of three reviews of the economic regulation of airport services. The PC found a range of issues specific to the airport application of cost-based and incentive regulation around transparency, clarity of pass-through guidelines, and poor design of price caps. More generally, they noted the conceptual and information problems associated with these types of regulation, the risk of regulatory error and the potentially damaging consequences for investment. They concluded that price caps should be 'reserved for situations where there is a strong likelihood of excessive pricing and where such pricing is likely to impose major costs on the community' (PC 2002, p. xxxii).

> *At best, a lack of clarity has promoted strategic behaviour by all parties, increased compliance costs and discouraged commercial negotiation. At worst, the arrangements, which combine elements of incentive and cost-based regulation, have discouraged efficient investment by sending poor price signals both to airport operators and users about the costs of providing aeronautical services and by requiring very detailed regulatory assessment of every investment proposal* (PC 2002, p. xxxii).

The advantages of price monitoring over stricter controls were considered to be:

- Greater scope for effective commercial relationships to develop

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3 Under prices surveillance, the responsible Australian Government Minister formally declares organisations and certain goods or services. A declared organisation cannot raise the price of a declared good or service unless it fulfils certain requirements, otherwise it commits an offence.

4 In 2003 the Prices Surveillance Act 1983 was repealed and the prices surveillance functions, including prices surveillance and price monitoring, were transferred to Part IIA of the Trade Practices Act 1974 which was later renamed the Competition and Consumer Act 2010.

- A lower level of regulatory intervention and hence less scope for regulatory error to distort investment and production, and
- Lower compliance costs.

Based on these findings, the price caps were replaced with a price monitoring regime.

Since then there have been two further reviews of the regime, in 2006 and 2011. These both recommended the retention of the price monitoring regime, with some refinements including the removal of some airports from the regime.

> *Overall the evidence indicates that the concerns about aeronautical charges mainly reflect a distributional tussle between airports and airlines, rather than inefficient impacts on the demand for air travel by consumers. While distributional issues involving people are clearly important, it is less clear that battles by corporations over profits have any significant regressive impacts* (p.182, PC 2011).

As of July 2013, the ACCC monitoring regime will apply only at Brisbane, Melbourne, Perth and Sydney. A second tier self-administered price and quality disclosure scheme proposed in the National Aviation Policy White Paper will apply to Canberra, Darwin, the Gold Coast (Coolangatta), Hobart and Adelaide.[5]

2.1.3 What is price monitoring?

Under the Airports Act 1996, airports submit annual financial statements for aeronautical and some non-aeronautical services to the ACCC. They are also required to supply information on costs, revenues and profits relating to the supply of aeronautical and aeronautical related services. In addition, the ACCC undertakes quality of service monitoring of the airports using surveys of airlines, passengers and border agencies (although the latter is to be discontinued in 2013) and some objective measures.

The purpose of the monitoring is to provide stakeholders with transparent information on airport prices and profits. This is intended to assist airlines to negotiate effectively on airport access charges and allow the government to determine whether further investigation of an airport's behaviour is warranted under Part VIIA of the Competition and Consumer Act 2010.

In addition to the price monitoring regime, Australia has Part IIIA (National Access Regime) of the Competition and Consumer Act which allows any interested party to seek declaration of aeronautical services. Declaration means that any airline could then seek legally binding private arbitration or arbitration by the ACCC if they are unable to secure what they consider acceptable terms. A declaration under Part IIIA of the Trade Practices Act was made in 2005 by the Australian Competition Tribunal (Virgin Blue Airlines Pty Limited [2005] ACompT 5) of the airside services at Sydney Airport.

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[5] Department of Infrastructure, Transport, Regional Development and Local Government (2009) *National aviation policy white paper: flight path to the future* (Australian Government: Canberra).

2.1.4 Form of regulation of other sectors

The electricity and gas sectors in Australia are subject to both price controls and information disclosure requirements. The regulatory framework is determined by the Australian Energy Market Commission (AEMC) and implemented by the Australian Energy Regulator (AER). There are some slight exceptions in coverage, for example, not all gas pipelines are designated.

The regulation of telecommunications networks in Australia is currently in profound transition due to the emergence of the National Broadband Network (NBN). The NBN itself is idiosyncratic and unlikely to be replicable in other types of regulated industry. We are therefore of the view that the current state of regulation in this industry is unlikely to be able to shed light on either the regulation of airports in other jurisdiction, or regulated industries more generally.

2.2 Long-term consumer benefit

The overarching purpose of policy intervention through Part 4 of the Commerce Act is to promote the long-term benefit of consumers. The PC considers the long-term benefit of consumers when it discusses the policy relevance of a problem.

The PC considers the use of market power is only policy-relevant if it negatively affects community welfare. To the extent that the airport increases their price due to market power (increasing the return to their shareholders), passengers and airline shareholders lose through higher airfares and lower profits respectively. In addition, there is a deadweight loss arising from the loss of allocative efficiency.

However, in the case of an airport, users do not directly purchase the airport's services, so the effect of a change in airport charges on consumer welfare depends on the proportion of an airfare that the airport charge comprises and the response of the airlines to the change in the airport charge. It also depends on the sensitivity of the users to the particular destination and their willingness to substitute other destinations, modes of transport or communication, or the scope for them to use an alternative airport to access that destination. Hence the ability of the individual airport to exercise market power varies.

In general, airport charges are a small portion of airfares, and to the extent that airlines price discriminate, an even smaller portion of airfares for those customers who are least price sensitive. This minimises the welfare loss of any over-charging as there is little effect on demand.

In the course of reviewing the monitoring regime, the PC received numerous submissions from participants and other interested parties, including from the ACCC (which is the body tasked with administering the price monitoring regime and at times has a different perspective to the PC).

In the case of LCCs, the ACCC considered that the proportion of an airfare that is the airport charge is likely to be higher and hence the welfare loss more significant (PC 2011, p. xxvi). However, the PC notes that in the case of LCCs the lowest fare quoted is often restricted to a few passengers, and quoted fares generally underestimate the true cost of travel as LCCs charge extra for ancillary services such as baggage. In addition, they note that airports may also price discriminate, offering lower rates for the lower service levels sought

by LCCs, and discounts on the rack rate for new entrants. LCCs exhibit more 'footloose' behaviour than full service airlines and are more likely to drop a route in response to airport charges.

The ACCC offers a number of other possible inefficiencies from the exercise of market power by airports, but with the exception of their concerns over quality-degradation at Sydney Airport, these are largely theoretical rather than evidence-based (ACCC 2011, pp.8-13). We discuss quality monitoring in section 2.5. The PC summarises the key economic trade-offs in the design of airport regulation as follows.

> *In essence, while 'permissive' regulation can allow income transfers from customers to airports, overly restrictive regulation can distort production, chill investment and deter risk taking and innovation – which would work against the long-run interests of Australian consumers. These are not just theoretical possibilities* (PC 2011, p.182).

We note the Australian Government has adopted the PC's recommendation of retaining the price monitoring regime.

2.3 Workably competitive market outcomes

The purpose of Part 4 of the Commerce Act includes the promotion of outcomes that are consistent with outcomes produced in a workably competitive market. We consider three aspects of this that the PC uses in its assessment: commercial negotiation; constraints on market power; and regulatory constraints.

2.3.1 Commercial negotiation

Both the PC and the ACCC emphasise the importance of commercially-negotiated solutions to providing efficient solutions similar to a competitive market.

> *Declaration of aeronautical services [under Part IIIA of the Competition and Consumer Act 2010] would amount to a continuation of current practice whereby airlines can negotiate access terms with airports. However, airlines could credibly threaten ACCC arbitration because the need to first have the services declared is avoided. Importantly, it is this threat that encourages the development of commercial relationships between the airports and their customers* (ACCC 2011, p.21).

> *The impact of monitoring on firms' pricing decisions is..., through moral suasion, providing customers with better information, publicity, and the threat of stricter forms of price regulation being re-introduced.... 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 sees price monitoring as promoting efficient outcomes by the disclosure of relevant information to inform negotiations and for the monitoring of outcomes, but it notes that the monitoring period should be neither too short, as parties might not deal in good faith if they want to encourage re-regulation, nor too long, as airports might use their market power. It considered five years the right balance in 2002, and in 2011 recommended extending this to seven years.

> *The Commission emphasises that it 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).

The PC considered that it would take some time for the effectiveness of the price monitoring regime in constraining the misuse of market power to be fully tested (PC 2006, p. xviii). In 2006, their review concluded:

> *[t]hough the light handed approach has not been without problems, there are good reasons for continuing with it; namely, to provide an environment that will facilitate investment, innovation and productivity improvement at the major airports, and encourage the further development of commercial relationships between the airports and their customers* (PC 2006 p. xxviii).

The PC notes in its 2011 report that the commercial negotiation culture is taking longer to develop than it envisaged. However, it does not find a systemic problem with airports' attitude to negotiations, and both airports and airlines appear to agree that commercial negotiation should be retained (see for example PC 2011, p.184).

2.3.2 Commercial constraints on market power

The PC recognises that airports are unlikely to be subject to competition at a particular location due to significant barriers to entry. However, 'the presence of market power does not automatically mean an airport will exercise or misuse it' (PC 2011 p.170), There are a number of constraints on an airport's use of market power from both a commercial and regulatory perspective: '[g]iven that airports face commercial constraints and incentives that will moderate the abuse of any market power, the Commission sees significant advantages in a more light-handed approach involving price monitoring' (PC 2002, p. xxxv).

There are commercial constraints on airports in the form of the non-aeronautical revenue an airport gains by increasing the volume of passengers at its airport (in markets where they are sufficiently price sensitive), or improving the customer experience. In Australia, the operating profit derived from non-aeronautical services was about two thirds of airports' total operating profit in 2010/11. The PC cites examples in its reports of discounts to new entrants and small operators and the emphasis placed on service quality by some airports as evidence of this. Finally, they note that a number of airports have close relationships with related providers (tourism sector and State Governments) in order to attract passengers and that this 'does not sit well with the notion of them exploiting whatever market power they may have' (PC 2002, p. xxviii).

The PC also notes the importance of the countervailing power of airlines. This is seen as more significant at holiday destinations than the major airports. In the current environment (which has prevailed throughout much of the period the PC has reviewed) it is likely that the countervailing power of airlines is greater as there is reduced demand for airport services meaning that threats to withdraw or not increase services carry greater weight.

In its 2002 report, the PC refers to a New Zealand example of the countervailing power of airlines. After the announcement by Auckland Airport of an 18.5% price increase to be phased in over 2000-02 Air New Zealand instigated legal action. In November 2001, the parties agreed to a 12.5% price increase to be applied to all parties.

The ACCC notes that airlines are 'comparatively larger customers, there are fewer of them, and they have demonstrated the ability to coordinate as an industry. They are typically experienced in negotiating with airports, and have a greater understanding of airports' costs for providing the various aeronautical services' (ACCC 2011, p. 7). However, they note their view that not all airlines will have countervailing power, and 'monitoring has limitations in its scope to correct market failure when the causes extend beyond information asymmetry' (ACCC 2011, p.4).

2.3.3 Regulatory constraints on market power

In addition to the commercial constraints from non-aeronautical revenue and the countervailing power of airlines, the PC has consistently noted the importance of a credible threat of re-regulation. The 'potential to exercise market power... can be constrained by a credible threat that the government would in time re-introduce stronger regulation at airports where market power is clearly being abused' (PC 2002, p. xxxiii).

An important emphasis of the PC's work is the asymmetric risk of excessively stringent regulation: '[i]t is important that this threat only be exercised if an airport has clearly misused its power, and that the consequences of misuse are significant.... Indeed, a perception that the Government was prepared to re-impose prescriptive controls in the face of minor indiscretions by airports could create a more uncertain environment than would exist under formal price regulation' (PC 2006, pp.63-4).

The ACCC position is less supportive of pricing monitoring, but neither does it support a return to price control.

> *In sum, the ACCC considers that the benefits of continued monitoring are unlikely to outweigh the costs. Although monitoring has played a role in problem identification, it is ineffective as a tool to address the problems it identifies. In recognition of the costs it imposes, there is little justification for its continuation. Indeed a continuation of monitoring might represent an unnecessary regulatory burden on airport businesses.*
>
> *The ACCC would also conclude, on the basis of its monitoring experience, that there is little justification for a return to price controls. However, the existence of market power and the risks of associated inefficiencies remain. There is greater justification, instead, to look to regulatory arrangements that respond appropriately to the risks that have been identified, and can facilitate market based outcomes* (ACCC 2011, p.6).

The price monitoring regime continues to be in place for Australian airports.

2.4 Incentives to invest

Key to the rationale for moving away from price caps was the PC's concern that they discouraged efficient investment, and that this resulted in a welfare loss to the community. Ensuring efficient capital investment by airports remains a focus in the PC's assessments.

The PC notes that there has been strong investment at most airports since privatisation, and that investment outcomes rate favourable compared to other Australian infrastructure. It notes the difficulty with determining whether investment is efficient given the difficulty of establishing a sensible counter-factual (i.e. what investment would occur in a competitive environment). It also notes the relative advantage of investment decision making using

commercial processes (assisted with information disclosures) relative to regulatory ones, as follows.

> *In the Commission's view, negotiation between airports and airlines over new investment proposals is likely to represent a form of 'iterative cost-benefit analysis'. Airports and airlines are also likely to be the best placed parties to undertake such negotiations, with the competitive tension between them (that is, the desire by airports to grow versus the desire by airlines to reduce costs and maximise the use of existing facilities) likely to most closely approximate an efficient outcome.*
>
> *A third party seeking to do an ex ante cost-benefit analysis would confront formidable complications* (PC 2011, p.120).
>
> *It is not possible to definitively conclude whether an aeronautical investment is occurring at the efficient time…[but] the overall evidence is that since privatisation, outcomes have at least been consistent with the objectives of the government in achieving more efficient investment at airports* (PC 2011, p.121).

The PC also notes that if an airport allows long-term capacity constraints to persist they could open the door to competitors (the PC cites the example of regulated constraints in Sydney, in the form of a curfew and movement limits, allowing Melbourne and Brisbane to capture increased numbers of international flights).

2.5 Incentives to meet consumer demand

The PC relies in its 2011 report on a study by Assaf of productivity, efficiency, scale and technological change at 13 Australian airports between 2002 and 2007.[6] This study demonstrates that, with few exceptions, Australian airports have shown increasing productivity, and increasing or constant efficiency in the post-privatisation period.

The ACCC has monitored quality at airports since 1997, when such monitoring was introduced to detect any misuse of market power in the form of quality degradation under the price cap regime. Initially based on surveys of airport users (passengers, airlines and government border service agencies), some objective (quantitative) criteria were added in 2002.

All five monitored airports submitted to the 2011 inquiry that they undertake quality of service monitoring for their own customer service and broader commercial reasons. This practice is consistent with airports' significant retail and commercial business in addition to the aeronautical services.

Overall the PC suggests that the role of quality monitoring should be to highlight issues for further investigation. . To this end, they note that 'recent quality of service monitoring results... alone do not indicate any persistent trends that would suggest the misuse of market power' (PC 2011, p.156).

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6 Assaf, A. (2011) 'Bootstrapped Malmquist indices of Australian airports', *The Service Industries Journal*, Vol. 3, No. 5, pp 829-46.

2.6 Limit excessive profits

In Australia price monitoring covers profit, price and cost. These are all factors in the purpose of Part 4 of the Commerce Act and we consider them in this section.

The PC reviewed a number of international studies that provide comparisons of airport charges per turnaround and aeronautical revenue per passenger, which are both used as price indicators. These studies are compiled by organisations such as the Air Transport Research Society (ATRS), the Airports Council International (ACI) and the International Air Transport Association (IATA).

Effective benchmarking across airports is difficult to achieve because of problems identifying 'apples-to-apples' comparisons. MAp Airports Ltd has significant investments in six European airports, and Sydney Airport as well as smaller investments in Japan and Mexico. The PC quote their submission: 'MAp found that there were often location-, geographic-, or configuration-specific reasons, unrelated to airport efficiency per se, that could lead to wide variations in costs across its airports. Benchmarking was most useful in identifying specific activities for detailed investigation. This was compounded by the joint product problem' (PC 2011, p.42).

In addition to these 'apples-to-apples' problems there can also be data issues in terms of quality and methodology. The PC suggests that some of these issues can be alleviated by using a within-jurisdiction sample for the benchmarking, but such a comparison does not illuminate the performance of the regulatory regime. As such, they conclude that 'unless benchmarking is constructed and interpreted carefully, there is a risk that inaccurate policy inferences will be drawn from unreliable estimates' (PC 2011, p.41). However, they proceed with the comparisons to provide additional information and context to the performance of the price monitored airports.

These studies indicate that Australian airports charges are not 'at the extreme end of the spectrum' (PC 2011, p 51). However, there are a range of views on what constitutes a reasonable charge, and whether a result that is above average is acceptable or not.

The ATRS study finds that Australian airports' performance is reasonable (PC 2011, p.46). The Australian Airports Association says the charges are 'broadly aligned with the charges at other international airports' (PC 2011, p.50). The Department of Infrastructure and Transport says that 'Australian airports are providing at least a satisfactory to good service in international terms and at reasonable levels of charging' (PC 2011, p. 50).

Airlines draw attention to an ATRS study that shows that Sydney airport charges are 57-69% above average. However, illustrating the problems with benchmarking, an IATA study showed that Sydney charges are only 9-11% above average.

In other parts of the report, context is provided that suggests that differences between benchmarked outcomes could be the result of rational business practice. For example, in Sydney regulatory restrictions on the number of flights and a curfew limits the capacity of the airport. This could result in congestion pricing, whereby higher prices are used efficiently to ration capacity.

The PC also reports on the ACCC monitoring of price. The ACCC uses aeronautical revenue per passenger as a proxy for price. The PC's conclusion given the overall context of airport services sector, even though there have been substantial increases in price at most

monitored airports is that 'systemic misuse of market power' is not indicated (PC 2011, p. 146). Two key contextual points are raised:

- Reliance on aeronautical revenue as a measure of price does not reflect changes in capital or operating expenditure, nor does it say anything about the desirability of the changes. For example, government security requirements, quality improving investment that is agreed to by the airline and 'gold-plating' will all show up in the same way.
- A change in the composition of passengers (say more international passengers relative to domestic passengers) would change the level of revenue per passenger (the ACCC's 'price' variable) because international passengers are more expensive to process. The monitored 'price' would rise, even if actual prices (what the airport charges) had not changed.

The PC notes that changes in the level of revenue have often been driven by investment.

A Department of Infrastructure and Transport benchmarking study shows that Brisbane, Perth, Melbourne and Sydney had 'substantially lower costs than the average of a sample of 34 airports from Asia Pacific, Europe and North America' (PC 2011, p. 56). These results were consistent across total costs, operating costs and staff costs per passenger. The same study indicated that these airports were relatively profitable compared to the sample average.

The PC is not persuaded by airlines' claims that airports are inefficient in terms of costs, as it considers there is no reason to expect owners are not monitoring cost levels appropriately, in the pursuit of improved profitability.

Overall, the PC considered that the price monitoring approach is achieving reasonable outcomes in terms of charges, revenues, cost, profits and investment at Australian airports, compared with (the mostly commercial) overseas airports (PC 2001, p. xx).

3. United Kingdom

3.1 Context

3.1.1 The Civil Aviation Bill

Overview

The regulation of airports in the UK currently comprises three categories of economic regulation. Three airports are designated for price regulation (price cap) – Heathrow, Gatwick and Stansted (Manchester has recently been de-designated). Non-designated airports with a turnover in excess of £1 million require permission to levy airport charges and must provide financial information to the UK Civil Aviation Authority (CAA). However, these airports face no active regulation of their airport charges. Other airports are not subject to any sector-specific economic regulation.[7] The regulatory arrangements for the current control period, known as Q5, are due to expire in March 2014.

This regulatory framework is poised to move to a more flexible regime, which will allow the development of more targeted and proportionate regulatory responses on a case-by-case basis.[8] A Civil Aviation Bill is currently before the House of Lords which, if passed in its current form, will introduce a new, more flexible licensing regime for airports that continue to be subject to economic regulation and introduce powers to the CAA to enforce competition law in the airports sector.

The new regime comprises three tiers of licensing, to reflect the size and market power of individual airports.

- **Tier 1** will be for those with substantial market power or dominance, where generic competition law is considered an insufficient safeguard, and the benefits of regulation are expected to exceed the costs. Controls will involve targeted price regulation and/or service quality control, with licence conditions and price controls variegated for each airport. This will apply to the currently designated airports.
- **Tier 2** will apply to those airports with more than five million passengers per year. Under the new European Airport Charges Directive (ACD), these airports will have to comply with consultation requirements regarding the setting of their charges and disclose certain financial information. This criterion currently captures 13 airports, including those that will be subject to the Tier 1 licence.

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7 UK Department for Transport (2007a) *Consultation on European directive on airport charges (*UK Government: London), pp.3-4.

8 UK Civil Aviation Authority (2011) *Review of price and service quality regulation at Heathrow, Gatwick and Stansted airports: setting the scene for Q6*. Consultation document, July 2011 (UK Government: London), p.4.

- **Tier 3** will cover other airports where the CAA considers it appropriate to introduce a licence.[9] If no airports are initially licensed on this basis, it will mean that 42 airports that are currently subject to airport charging regulation will not require an economic licence to operate.

All other airports will be able to operate without an economic licence.

Rationale

A need for flexibility to deal with changing and varied requirements

The current regulatory regime was established by the Airports Act in 1986. Since that time, there has been considerable change in the aviation sector, including the liberalisation of air services in the 1990s and resulting growth in competition and the development of regional airports. There has been strong growth in passenger and freight volumes over many years. The entry of LCCs has seen change in the types of airlines using airports, bringing with it changes to the service requirements of airport users.

The reforms reflect a desire for more flexible and targeted regulatory responses, in order to reflect differences in the competitive interaction between airports, as well as in their size and location, market composition (varying passenger priorities) and differing business models.

Scope to bring the regulatory framework closer to best practice

Furthermore, there have been major developments to the regulation of other utilities, including changes to the institutional frameworks for all other major regulated sectors in the UK (Department for Transport (DfT) 2009, pp.10-11). Economic regulation was initiated for telecoms in 1984 and for gas in 1986, and along with the regulatory framework for airports, was focused on ensuring that private sector monopolies did not make excessive profits. Since that time, evolution in these other sectors has included a move towards greater promotion of competition, an increase in the scope of competition (into a wider range of areas), the emergence of more varied and complex financial structures, as well as the introduction of generic competition law (DfT 2009, pp.23-4).

The differences in the institutional design of the economic regulation of airports compared with other regulated sectors were highlighted by the Competition Commission in its 2008/09 Investigation into the supply of airport services by BAA. Significant variations they identified included the absence of statutory duties and licence provisions (on BAA), the limited scope for the regulator to act between reviews, the narrow focus of the CAA's statutory duties in economic regulation and the way in which the CAA has given effect to its statutory objectives in fulfilling those duties. In their view:

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[9] UK Department for Transport (2009) *Reforming the framework for the economic regulation of airports*, March 2009 (UK Government: London), p.6.

the system of economic regulation of airports is a feature which distorts competition between airlines [sic] by adversely affecting the level, specification and timing of investment and the appropriate level and quality of service to passengers and airlines.[10]

The reforms are also intended to make the regime more consistent with the UK Government's principles for good regulation.[11] In this context, the application of these principles implies that regulation should not be extended to airports that are already facing competitive pressures and delivering good outcomes for passengers. Instead, regulatory solutions should be considered on a case-by-case basis, and subject to net benefit assessment. The ability to impose bespoke regulatory arrangements will allow more proportionate regulatory responses than a 'one size fits all' approach, such as tailored price monitoring/information disclosure obligations, and varied/time-limited duration of regulatory controls.

3.1.2 The Airports Charges Directive

An ACD was negotiated by European Union (EU) Member States, and transposed into UK law through the Airport Charges Regulations 2011 which came into effect on 10 November 2011. The ACD sets a common framework for the establishment of airport charges, with a focus on information disclosure and consultation requirements. In particular, airports will have to provide information to airport users on the total costs and revenues in relation to charges, the methodology used for setting charges, the overall cost structures with regards to the facilities and services provided in return. Airlines will have to provide airports with information on their traffic forecasts and requirements at the airport.[12]

The Directive stops short of imposing price controls, instead setting minimum standards for the calculation of charges, and common principles and rules of conduct for the determination of charges. The accompanying impact assessment states that:

[i]n recent years there has been a move towards conduct regulation by encouraging direct negotiation between airports and airlines on aeronautical charges, service levels and capital investment with regulators retaining reserve powers to impose price caps if negotiations are not successful.... so called shadow economic regulation can potentially ensure that the threat of regulation will act as a powerful incentive on the unregulated airport to behave responsibly without having the associated administration costs of a fully-fledged price-capped regime.[13]

In implementing this Directive, the UK Government has taken the view that an overly prescriptive approach to information disclosure requirements would impede competitive

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10 UK Competition Commission (2009) *BAA airports market investigation: a report on the supply of airport services by BAA in the UK*, 19 March 2009 (UK Government: London), p.12.

11 UK Department for Business Innovation and Skills (2011) *Principles for economic regulation*, April 2011 (UK Government: London), pp.3-5.

12 European Commission website: http://ec.europa.eu/transport/air/airports/airport_charges_en.htm. Accessed 16/7/12.

13 Commission of the European Communities (2007) *Full impact assessment*. Commission staff working document – accompanying document to the Proposal for a Directive of the European Parliament and of the Council on airport charges, 24 January 2007 (Commission of the European Communities: Brussels).

pressures. The CAA expects to issue a template for the minimum scope and detail of information that would be likely to meet the requirements of the Directive.

3.1.3 Form of regulation in other sectors

The UK electricity and gas networks are regulated by Ofgem, and are generally subject to price controls and information disclosure requirements. Ofgem has recently introduced a new performance-based price-control model – Revenue = Incentives + Innovation + Outputs (RIIO) – for setting price controls. The RIIO model aims to provide a more sophisticated, long-term framework that delivers sufficient and efficient investment for meeting future demand. It involves longer (eight-year) price control periods, with incentives for delivering results.

Telecommunications networks in the UK are regulated by Ofcom. Those networks with significant market power are subject to wholesale price controls designed to promote competition, facilitate investment and to incentivise the incumbents to make efficiency gains. The UK approach is noteworthy for the operational separation of BT into three operating entities (network, wholesale, and retail divisions). Targeted price controls, coupled with information disclosure obligations and accounting obligations have been credited with the development of one of the most competitive fixed line markets in the world – so much so that the point has been reached where a degree of deregulation is now occurring.

3.2 Long-term consumer benefit

A primary objective of the reforms is improving the passenger experience. This involves a 'greater focus on the interests of passengers and a greater focus on promoting competition where that can deliver the best outcomes for passengers', including by delivering greater choice for passengers (DfT 2009, pp. 24 and 26).

According to the CAA, most stakeholders agree that there is a strong case for continued regulation of Heathrow beyond Q5 and that general competition law is unlikely to provide an adequate safeguard against abuse of its market power through higher prices or lower service quality than would be consistent with passengers' interests. There is less consensus regarding the need for continued economic regulation of Gatwick and (particularly) Stansted.[14]

In general, the reforms reflect the Government's view that the interests of consumers and airports are generally well-aligned, and that the benefits to consumers from imposing price controls or intervening in service quality at smaller airports are relatively small compared to the costs to the industry and the regulator. The Government is therefore of the view that the long-term interests of consumers are best served by a targeted and proportionate approach to regulation. This results in price regulation only for the three Tier 1 airports, with information disclosure and consultation requirements considered sufficient for all the other airports captured by the ACD, and lesser or no economic regulation of all remaining airports.

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[14] UK Civil Aviation Authority (2012a) *Review of price regulation at Heathrow, Gatwick and Stansted airports ("Q6"): policy update*, May 2012 UK Government: London), p.9.

3.3 Workably competitive market outcomes

The Government's general approach to economic regulation is that:

> *[c]ompetition is preferable to regulation which may distort market decisions and stifle innovation. Even where competition acts as a weak discipline on behaviour, regulation should only be preferred if it can be expected to deliver a clear net benefit. So economic regulation needs to be appropriate and proportionate.*[15]

With respect to airports, the Government is of the view that (apart from the designated airports) competitive pressures in general, backed by information disclosure requirements and generic competition law, provide sufficient safeguards for protecting consumers (*vis a vis* pricing and service quality) and promoting timely investment (DfT 2007a, pp.12 and 14).

Economic regulation (through price control) is reserved only for those airports assessed as having substantial market power or dominance, and for whom general competition law is considered insufficient to address the risk that this position may be abused. The current criteria for this assessment relate to market power, *prima facie* evidence of excessive profitability or abuse of monopoly position, the scale and timing of investment (and their implications for profitability) and the efficiency and quality of service (CAA 2012, p.43). In their 2007 consultation document on changes to the designation criteria, DfT proposed that they be amended to *inter alia* make a clearer distinction between the relevant tests and the evidence that may be used, require an assessment of the likely future circumstances rather than focussing solely on the past and present, and involve greater transparency as to the degree of market power that may trigger designation.

The Civil Aviation Bill seeks to clarify the criteria for assessing market power, and better align them with generic competition law, economic regulation in other sectors, and good regulatory practice (in particular the principles of flexible, targeted and proportionate regulation). Consistent with the preference for the minimum level of regulation necessary, the DfT has noted that 'the threat of designation, backed by clear criteria, may act as a deterrent to potential abusive behaviour, reducing the need for actual designation' (DfT 2007b, p.8).

In its consultation on the proposed ACD, the DfT issued a Partial Regulatory Impact Assessment. This paper observed that the Directive would extend regulation 'where the UK to date has not found it necessary to do so' and that the 'costs of the greater degree of regulation proposed by the Directive might accordingly be seen as outweighing its benefits' and 'could impose additional regulatory burdens and costs on existing operators with potential effects for their competitive positions' (DfT 2007a, pp.13, 14 and 17). Costs falling on airports would be passed on to airlines and could in turn be reflected in passenger ticket prices.

The CAA went further, with a view that 'the detailed provisions of the Directive risk cutting across airports' incentives to invest and undermining normal commercial relationships

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[15] UK Department for Transport (2007b) *Consultation on proposed designation and de-designation criteria for airports*, February 2007 (UK Government: London), p.6.

between airports and airlines'.[16] The CAA noted that no other sector of the European economy requires small firms operating under competitive conditions to provide the information required by the Directive, and that it is 'not clear why airports should be treated differently'. They also stated that they could see 'no rationale for prescribing in detail a process of consultation for airports which do not possess substantial market power' (CAA 2007, pp.4-5).

The Government's approach to implementing the Directive therefore seeks to impose the minimum necessary additional regulatory burden on airports, and therefore that the provision of high-level financial information is sufficient.

In summary, the Government is of the view that price control for airports other than those meeting the market power test would impede competitive outcomes. As noted above, this is reflected in a primary reliance on information disclosure for all other airports, other than the smaller regional airports where economic regulation is not considered to be justified.

3.4 Incentives to invest

One of the stated policy objectives of the reforms is encouraging appropriate and timely investment in additional capacity to help deliver economic growth in line with wider Government policy (DfT 2009, p.11). This is enabled by the more flexible, variegated responses provided to the regulator. One of the reasons for the targeted approach, with its primary reliance on information disclosure, is to avoid the impediments to investment that tend to be associated with price controls.

The DfT considers that there is currently a lack of competitive pressure between airports in the South East of England (i.e. Tier 1 airports). However, there are differences of views amongst stakeholders on the case for continued economic regulation of these airports, and the extent to which current regulation has contributed to under-investment in capacity (and resulting congestion and deterioration in the passenger experience).

The Competition Commission has also expressed concern over the lack of sufficient capacity expansion, particularly in the South East of England and also in Lowland Scotland. It identified a number of contributing factors, primarily the common ownership by BAA:

> *[w]e acknowledge that to some extent BAA's actions [at Heathrow, Gatwick and Stansted] can be attributed to government policy and/or the planning system... However, in our view, BAA's common ownership of [these three airports]... – given its reluctance to press for more runway capacity, its sequential approach to major investments and its constraining development at one airport in order to not jeopardize development at another – appears to have exacerbated delays in the delivery of runway capacity, with consequent effects on service* (Competition Commission 2009, p.11).
>
> *We have found that common ownership adversely affects competition between Edinburgh and Glasgow and that under separate ownership there would be potential for competition – on*

[16] UK CAA (2007) *The CAA response to DfT's consultation paper on European Airports Charges Directive*, June 2007 (UK Government: London), p.5.

price, investment and innovation – between them, hence BAA's common ownership of Glasgow and Edinburgh prevents competition between them (Competition Commission 2009, p.9).

Their 2008/09 Investigation recommended that BAA divest itself of both Gatwick and Stansted and of either Edinburgh or Glasgow airports, in order to promote the development of competition in and around London and Lowland Scotland. (Gatwick was subsequently sold in 2009[17] and Edinburgh in 2012). This divesture is expected to help promote more timely and appropriate investment, though the Department considers there may still be a need for *ex ante* regulation, at least until there has been a significant increase in capacity.

3.5 Incentives to meet consumer demand

Research commissioned by the DfT found that a priority for passengers is end-to-end reliability and efficiency (including lack of delays and queues) (DfT 2009, p.30). Heathrow's performance in terms of delays has been shown to be worse than its two main European hub competitors. According to the Department, this poor performance is 'likely to underpin stakeholder concerns that delays and poor reliability at Heathrow airport are adversely affecting the competitiveness of the UK economy' (DfT 2009, p.35).

The Department is of the view that the introduction of the Constructive Engagement (CE) process for designated airports 'has added value to the regulatory system at some of the airports by increasing the information available to the CAA when setting price caps, and also better aligning the outputs delivered by the airport with the needs of its customers and consumers' (DfT 2009, p.110). The CE process is expected to be retained in the new regulatory framework, with adjustments to improve the appropriate and timely flows of information between participants.

However, the Department considers that there are already strong competitive conditions between the non-designated/Tier 1 airports, which have resulted in better services, greater choice and lower prices for passengers. Evidence to support this includes the emergence of a greater variety of routes and destination, increasing quantity of scheduled services and mix of services, fierce price competition between low cost carriers (reflected in increasing churn and switching) (DfT 2009, p.21). And results from consumer surveys suggest that passengers have relatively positive airport experiences (though noting that passengers generally had low expectations of their through-airport experience) (DfT 2009, pp.29-30).

3.6 Limit excessive profits

The Competition Commission has expressed concern that insufficient investment in the South East airports could limit capacity and allow these airports to exploit their market power and earn more than economic rents, issues that the current regulatory regime has been unable to fully address (in DfT 2009, p.41). However, as noted above, the Commission identified the primary inhibitor of competition has been the common ownership of these

[17] UK Competition Commission (2009) *BAA airports market investigation: a report on the supply of airport services by BAA in the UK* 19 March 2009 (UK Government: London), p. 15.

airports by BAA. The Commission did also identify a number of ways in which the regulatory framework had contributed to the lack of competition.

In comparison, evidence suggests competitive conditions between the regional airports. The DfT cites evidence of a strong commercial outlook amongst these airports as well as falling airport charges (DfT 2009, p.21). The recent decision to de-designate Manchester airport is based on its recognition of the competitive interaction between the Manchester and Liverpool airports.

The Tier 2 airports which will be captured by the new European ACD regulation will have to provide certain financial information and comply with consultation requirements for the setting of their charges. These disclosures are designed to reduce the information asymmetry between airports and users (e.g. airlines), and vice versa. It also allows users and the regulator to be better informed as to possible anti-competitive conduct. [18]

The CAA has expressed the view that reliance on existing management information and consultation processes is likely to be a sufficient and effective way of implementing the requirements of the ACD (CAA 2010, pp.6 and 20), and that overly detailed disclosure requirements could 'undermine the normal competitive tensions and negotiations that drive efficient outcomes in the market'. In particular, the CAA considered overly stringent information disclosure requirements risk imposing undue costs on airports, would undermine incentives to invest, and could flow through to higher prices for consumers and poorer service quality, thereby undermining the benefits sought from regulation (CAA 2007, p.5).

[18] UK Civil Aviation Authority (2010) *Implementing the Airport Charges Directive in the UK: CAA emerging thinking*, December 2010 (UK Government: London), p.5.

4. Reflections on European airport regulation

This section is a focused summary of a report by Copenhagen Economics for Airports Council International Europe, which brings together a considerable breadth of evidence, both empirical and qualitative on airport competition in Europe and implications for the design and practice of regulation. We have included a review of this report because it is recent (June 2012) and insightful relative to the s56G review.

The report reaches similar conclusions to the PC reviews, as follows.

> *In order to design effective regulation it is necessary to ask what competition is supposed to do, and to base the design of good airport regulation on an understanding of the meaning of effective competition. Effective competition can be described as a process of rivalry rather than an absolute outcome…with three main properties:*
>
> *A: eliminating excessive profits*
> *B: discovering more efficient methods of production*
> *C: discovering what customers want …*
>
> *One of the problems of traditional approaches to regulation, with a focus particularly on price, is that they pay insufficient attention to dynamic development, including investment, and so risk distortions to behaviour and outcomes that may be more disadvantageous to consumers than the risk of abuse of airport market power* (pp.114-115).

The analysis in the report shows a range of factors about the air travel sector that have led to increased competition between airports and greater constraints on their market power, including:

- Airline business models have developed in terms of LCCs creating a more dynamic market with higher churn, and less demand for airport facilities; new routes opening (the entry of Asian and Middle Eastern airlines is relevant in the New Zealand context); and increasing numbers of alliances between airlines.
- Changes in technology in terms of both aircraft technology and competing transport modes within Europe.
- Changes in consumer behaviour such as the growth of leisure travel as airfares have decreased; increased price sensitivity due to the internet (for both leisure and business travellers); increased inbound tourist travellers who have destination choices.
- Airports are more likely to operate to a commercial model, are more active in marketing to airlines, and have increasingly significant non-aeronautical revenue such as retailing.

The report notes that European airports face greater competitive pressures than many other areas in the world (p.96) so only some of the above factors may be relevant to New Zealand.

The report highlights three attributes of airports' businesses that affect and magnify the impact of competition; airports are:

- Fixed cost businesses
- Two-sided businesses, and
- Geographically fixed.

Airports have high fixed costs and usually have two sides to their business. This means that marginal decisions by airlines have a large effect on profitability.

> *Airports have been considering passengers as an important customer and source of revenue independently from airlines for years....This implies that airports, airlines and passengers are linked by positive interdependencies. If passengers stay away, airlines will suffer and consider leaving the airport. If airlines leave, or reduce route coverage or frequency, that will deter passengers compounding the impact on the airport and its retail revenues.... even with market power on the aeronautical side of the business, [an airport] would have less incentive to use it because of the complementarity between airside and non-airside revenues* (pp.20-1).

Even an airport with capacity constraints will have an incentive to compete for those airlines or routes with passengers that are most likely to add to the airport's commercial revenues.

Copenhagen Economics argues that even the fixed geographic nature of an airport drives competitive behaviour as 'most airports cannot achieve the desired scale of passengers by attracting only those very close to the airport' (p.21). For an airport such as Wellington this may be reflected in competition as a hub for regional airports.

Competitive constraints arise from those airlines and passengers who are most sensitive to changes in price or quality at an airport. The five indicators suggested in the report for assessing the level of competitive constraints at airports are:

- Local departure choice – if passengers have choices then the airport is less likely to have market power
- Transfer choice – if transfer passengers have the option of a different transfer then that provides a competitive constraint
- Multi-hub – if an airport hosts a hub carrier that has multiple hubs there is scope for buyer power
- Dominant carrier – if the largest carrier at an airport has a dominant share of total traffic there is scope for buyer power, and
- Inbound leisure – inbound tourists have scope for destination switching

Copenhagen Economics suggests that the effect of these changes to the airport market means increasing reliance can be placed on competitive disciplines, and information disclosure to support those disciplines, rather than on other more intrusive sector-specific economic regulation (while recognising airports are subject to differing degrees of competitive discipline). However, they recommend avoiding price control and related forms of regulation where competition and information disclosure are effective, as the former is likely to harm consumers' interests.

> *Regulation which is inevitably slow moving, focussed on the present and the past rather than the future is likely to work against those aspects of competition which relate to discovering more effective ways of producing and investing, and discovering what customers want* (p.114).

Where competition has yet to develop (and they consider that few, if any airports are untouched by competition) more account should be taken of those constraints that exist and the developing dynamics of the market. 'There is a strong case for the regulator standing back and allowing the commercial parties to negotiate commercial outcomes subject only to

limited regulatory recourse. The Australian example shows that such arrangements can work successfully even in more monopolistic circumstances than now prevail in Europe' (p.7).

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