Bulletin

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Constructive Criticism

MAKING NEGOTIATIONS BETWEEN AIRPORTS AND AIRLINES WORK

Australia, New Zealand and the UK have adopted different approaches to regulating airports. However, all place some reliance on direct negotiations or 'constructive engagement' between an airport and the airlines it services. In Australia, the Productivity Commission (PC) recently delivered its final report on the Economic Regulation of Airport Services. This bulletin explores whether policy makers need to do more to ensure these negotiated settlements deliver efficient outcomes for airport users.

DO AIRPORTS HAVE MARKET POWER?

Airports have a number of characteristics which tend to favour the development of larger, spatially dispersed airports. First, one airport is likely to be able to provide aeronautical services more efficiently than two. Second, airlines tend to be able to operate more efficiently by making use of hubs.

These characteristics mean that an airport that serves a larger network of routes will be of greater value to an airline. They can also limit the scope for competition between airports. Without competition an airport can use its market power to raise prices, lower its service quality or restrict the capacity it makes available.

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However, there are other features of airports which may reduce their ability to exploit any market power they hold. In particular, airports may face competition from other modes of transport and some airlines may have effective alternatives that they can use to keep aeronautical prices down.

These competing forces make it difficult to universally conclude that airports have market power (in relation to some or all of their services) which complicates policy decisions on whether and how best to regulate them.

INTERNATIONAL APPROACHES TO REGULATING AIRPORTS

The major city airports in Australia, New Zealand and the UK are privatised and subject to different regulatory approaches.

In the UK the major airports are subject to *ex ante* price caps. This requires the regulator to estimate an efficient level of future expenditure for the airport and then determine a price path that will enable recovery of this. This approach means an airport will be constrained from exploiting its market power by raising prices. However, this approach requires the regulator to forecast future demands and expenditure. This can be complex and so impose a high regulatory burden.

Questions have also been raised about whether the regulator is delivering outcomes that end users really want. As a result, the UK sector regulator, the Civil Aviation Authority (CAA) introduced "constructive engagement". Under this process airports and airlines directly negotiated with each other in order to determine traffic forecasts, service requirements, and investment programmes — all roles that were previously taken by the regulator.

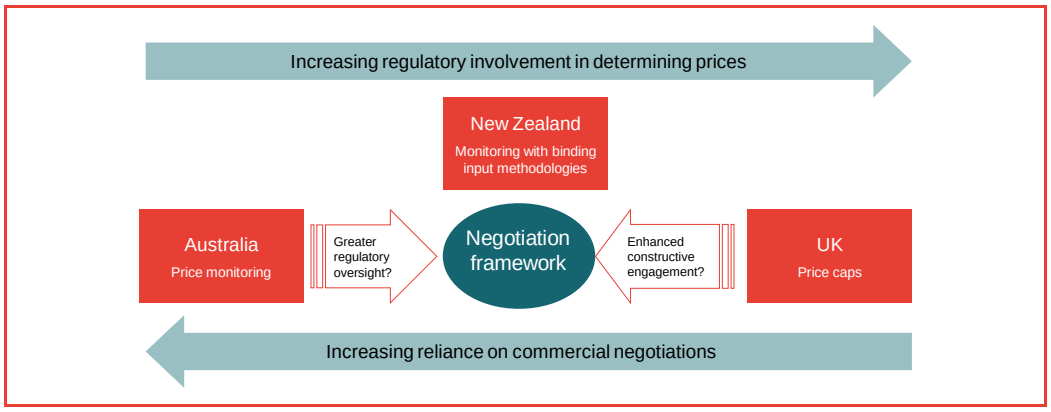
Australia and New Zealand have moved away from directly capping prices. Instead prices are determined by airports and airlines engaging directly in commercial negotiations. Some regulation still exists, in the form of price monitoring, which is intended to identify airport misconduct. Under these 'light handed' arrangements the constraint on pricing comes from the threat of the government reintroducing stricter regulatory measures.

There are some differences in the approaches adopted in Australia and New Zealand. In Australia, airlines can take legal action (under the national third party access regime) and if their access claim is successful, they can seek arbitration should they be concerned about the negotiated outcomes. In New Zealand, airports recently became subject to an enhanced disclosure regime. This requires airports to provide information that shows that their charges compare to costs, calculated using binding input cost methodologies (covering major input costs such as asset values and the cost of capital). These input methodologies are set by the Commerce Commission.

THE CHALLENGES FOR CONSTRUCTIVE ENGAGEMENT

At first glance these international regulatory approaches appear quite different but there are similarities. In particular, all countries place some reliance on direct negotiations or constructive engagement between the airport and its airline (see Figure 1).

Figure 1: International approaches to regulating airport pricing



Common concerns have been raised regarding the success of these negotiations. In Australia, the PC noted there is scope to improve the conduct of commercial negotiations. In the UK, the CAA is currently exploring how to improve the constructive engagement process.

So can direct negotiations deliver efficient outcomes? The answer hinges on how several key challenges are addressed.

First, an airport with market power has the opportunity to exploit this market power in any negotiations with its customers, including airlines. A negotiated settlement, involving a party with market power, will not necessarily lead to efficient investment or prices. This exploitation could take a number of forms. For example an airport could adopt a 'take it or leave it' position. This limits customers' opportunities to shift the debate in any meaningful way. Alternatively, an airport could delay or refuse to provide necessary background information, thus delaying settlement and limiting its customers' opportunity to analyse and respond to this. Airlines in all three countries have raised these concerns.

The second challenge arises from the fact that the airlines, using an airport, may have different needs given their different business models. For example, point-to-point low-cost carriers may require a different level of service when compared to network and international carriers. Diverging interests can mean negotiations will not always lead to agreement between all customers and an airport on certain issues. This is not necessarily a problem where the airport is able to offer different price and service options. But it can make it difficult to agree on an overall investment programmes.

Finally, direct negotiations may not adequately take account of the needs of all prospective airport users. While airlines operating in a highly competitive market are likely to be well placed to represent the interests of air-travellers, there may be circumstances in which interests do not align. For example, airlines may not favour airport expansions where this would expose them to greater competition. Whether this is in fact a real concern will depend on the facts in each case.

ADDRESSING THESE CHALLENGES

Direct negotiations have the potential to deliver efficient outcomes. When an airport has no market power, this is how its prices should be determined.

However when negotiations involve an airport with market power, regulatory oversight or intervention may be needed.

In Australia the PC acknowledged that some larger city airports retain sufficient market power to be of policy concern. Therefore, it made some recommendations aimed at strengthening the threat of re-regulation. In particular it proposed that the regulator be able to nominate that an airport show cause why its conduct should not be subject to greater scrutiny under a price inquiry.

It also noted that there would be scope for improving the conduct of commercial negotiations through an industry code of conduct or by expanding on existing pricing principles. But the PC failed to elaborate on what would represent acceptable conduct or an acceptable negotiated settlement. Instead it recommended the 'show cause' mechanism be relied upon to deliver balanced negotiations. However, this recommendation was not accepted by government. Therefore, there is value in returning to the concept of developing a code or framework to guide negotiations.

It would seem sensible that this framework should start by identifying areas of commonality — where the interests and incentives of airports, its customers and the travelling public align. In these areas an efficient negotiated settlement should be possible with limited regulatory involvement.

In other areas an airport may have incentives to exploit any market power it holds. It may be helpful to take some issues "off the table", as has occurred in New Zealand, such as asset valuation and revaluation, and the cost of capital. More generally, in areas where interests diverge the framework could be more highly specified and potentially subject to greater regulatory oversight. Behaviour in contravention of the framework would presumably be viewed unfavourably.

Otherwise, to ensure that discussions take place on a level playing field and that parties are able to adequately present their views the framework could specify:

- The type of information that is to be shared between the parties.
- An acceptable process of interaction and exchange. This could include timetables for information provision; circumstances when charges can be varied and processes for resolving disputes.
- The revenue modelling process and model parameters that could be used.
- Approaches to sharing risks and any associated benefits (i.e. relating to changes in passenger traffic or productivity improvements).
- Service definitions and penalties for not delivering on service quality measures.
- Unacceptable forms of price and non-price discrimination.

In relation to all of the points above, the devil will be in the detail. Careful consideration will be needed of whether a highly specified framework will deter innovative negotiated settlements that would otherwise have been efficient.

Watch this space!

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