

Light-handed economic regulation¹

Thank you for the opportunity to provide some insights into the economic regulation of airports. Starting with the Australian context, I'd like to briefly cover what we set out to achieve, where we are today and the principal issue of commercial negotiations in setting the price and quality of airport services. I think that then allows for a consideration of what overseas experiences may have to offer.

Light-handed economic regulation: what was the opportunity envisaged?

As the Board of Airline Representatives of Australia (BARA) saw it, the stated reason for moving to light-handed economic regulation was to deliver more productive and responsive airport services. There were opportunities to deliver airport services that could better match the changing needs of airlines and passengers.

Higher airport prices would likely occur from the new arrangements. After all, light-handed economic regulation is not known to suppress prices. But the idea was the airlines would enjoy greater value for money in airport services. The simple value equation for airlines was that the improved service outcomes would outweigh the price increases.

The essential change would be that airlines and the airport operator would now express their requirements and deliverables directly to one another. The regulator would not be involved in this process.

A commercial negotiation would resolve:

- What are the services to be delivered?
- To what standard?
- What's necessary to deliver them?
- How should we measure success?
- What are the accountabilities for the airport operator and airlines?
- What are the legal rights and limitations?
- And finally, pricing.

By sorting through all these issues, the overall commercial agreement and outcomes would be better than any the regulator could have determined here in Australia. Or so people thought.

¹ Address to the ACCC Regulatory Conference on 27 July 2017 in Brisbane.

Have we succeeded after 15 years?

The consensus view of the international airlines is that they have not received the anticipated improvements in value for money from their commercial agreements. This is not to dismiss the improvements in service delivery that have been made. BARA continues to acknowledge solid progress when it's achieved. Rather, the view is that the higher prices paid have not been matched or exceeded by improvements in service outcomes.

As far as we can see, the regime gives the airport operator major incentives to build physical assets and investment levels have become the talked about measure of success. The regime also gives the airport operator a clear incentive to maximise passenger retail revenues.

But what really matters to international airlines is the level of capability and innovation in service delivery. Airlines want a quality of management and service delivery that supports their key performance outcomes. These being on time performance, baggage, safety and the passenger experience. And this is where the regime has not delivered as promised and is why international airlines would say they have not seen the improvements in value for money.

Before starting to negotiate with an airport operator, BARA surveys its members out at the airport. The survey provides a snapshot of key issues and improvements members want to see. Members do continue to report to BARA ongoing issues of concern. They can be broadly summarised as:

1. Resistance by the airport operator to modernise its operating procedures, and inadequate communication with airlines over operational changes.
2. A failure to follow through and resolve issues raised by international airlines. Difficult issues can be left to drag on and remain unresolved.
3. The need for better contingency planning to quickly restore service outages.
4. Limited sharing of performance data. Australian airports often engage by anecdote rather than consistently collected and reported data.

It's important to note that members also raise positive points. Efforts to improve the efficiency and effectiveness of security screening is an often-cited example. BARA presents the findings of its survey, both areas of concern and positive points, directly to airport management.

There are also signs of progress at a commercial level, one being the initial service level framework negotiated with Sydney Airport, some 13 years into the regime. But overall, it's clear to international airlines that far more could and should have been done so that airport services meet airline expectations, especially given the higher prices paid for those services.

The commercial process

Given the international airlines' view over value, it's worth asking why the commercial process is not providing the foundations for ongoing improvements in value for money.

BARA's summary would be that, while the light-handed regime can encourage serious discussions, airport operators are not yet prepared to accept enough accountability over service delivery and a fair allocation of commercial risk. If accountability for service delivery is largely contracted away in a financial sense, the airport operator has little incentive to invest in its delivery capability. Instead, the incentive lies in building physical assets.

In considering this, it's important to recognise there's no underlying driver for solid commercial agreements. One of the fundamental principles of Australian contract law is 'freedom of contract', under which parties are generally at liberty to strike whatever bargain they choose. The law does not require that an agreement be balanced, fair or reasonable for it to be enforceable. It's also not clear to BARA that the Australian Government's Review Principles for this regime have had any influence on airport operator conduct, whether it be good, bad or ugly.

To try and encourage productive commercial outcomes, BARA published its policy document, *Timely and reasonably priced airport infrastructure*. It details BARA's commercial expectations in five key areas: pricing for service delivery; reasonable investment returns; efficient airport operations; balanced and consistent agreements; and a service quality culture. There is nothing radical in these principles – they are largely procurement 101.

Unfortunately, BARA has not been able to translate these principles into practice consistently across airport agreements.

Right now, the airport operators accept little to no financial exposure over service delivery. One way this is done contractually is through 'sole remedy' arrangements, designed to limit financial exposure and negate the commercial value of other apparent service level commitments. Another way is by limiting the definition of 'airport services' to an asset's physical existence, without reference to whether it has enough capacity or is well managed. The airport operator may also require international airlines to collectively pre-pay any amounts it may rebate back to individual airlines for service failures.

Under such arrangements, the airport operator has successfully limited the financial exposure of its shareholders to poor service delivery. While this may be fulfilling shareholder expectations, it's not a good fit with the regime's purpose, namely to provide more productive and responsive airport services.

Solid accountabilities and exposure to financial risk makes innovation and continuous improvement necessary to earn a commercial return. The goals of the airlines and airport operator are aligned when innovation and continuous improvement in service delivery is the best way for the airport operator to mitigate its financial risk.

This is not to say that projects and initiatives to help international airlines never occur. BARA has seen efforts by the airport operators to listen to airlines and investigate the issues raised. But this is essentially a discretionary activity rather than a contracted commitment. Our observation would be that projects to drive 'increased passenger retail revenues' (encouraged under 'dual till' pricing) and 'airport company corporate promotion' (to seek to protect the current light-handed regime) seem to gain the highest priority and resourcing. The same amount of effort we see spent on these activities needs to find its way into supporting the operational efficiency of international airlines.

Overseas experience

For BARA, the biggest challenge for any economic regulatory regime remains the setting of realistic performance benchmarks underpinned by solid accountabilities. Any form of arrangements that establish strong links between airport service outcomes and profitability to is likely to be the best way forward.

One potential option to address both capacity and quality issues is to align the airport operator's KPIs with final industry outcomes, such as on time performance and the rate of mishandled bags.

Finally, it's worth noting that real international airfares to and from Australia have fallen by about 40% over the last decade, supporting a doubling of international passenger numbers. From an infrastructure perspective, most of that growth to date could be accommodated through existing surplus capacity at the airports. But airline operations are now becoming increasingly congested over the expanding peak periods. How well this growing issue is addressed by the airports and airlines over the coming years is likely to be the real test of this regime. The current commercial agreements will need significant modification to align the incentives of the airport operators to supporting efficient international aviation in an increasingly congested operating environment.