

Flying high: A review of airport regulation in Australia

Infrastructure research note

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- Regulation is an important factor that must be taken into account when assessing the overall attractiveness of airports.
- The release of the Federal Government's Aviation White Paper in December 2009 marked the latest milestone in the evolution of airport regulation in Australia.
- The review recommended a continuation of the existing regulatory arrangements for Australia's major airports until 2013.
- We see this as a positive, as the current price monitoring regime represents one of the more attractive regulatory environments for airport investors globally.
- Considerable diversity in airport ownership and governance arrangements exists worldwide. This paper examines airport privatisation and regulation arrangements in other regions, highlighting the relative strengths and weaknesses of the various systems
- North America and Asia currently hold little opportunity for private airport investors, while Europe has had the most experience with airport privatisation to date. Australian, New Zealand and UK airports are among the most liberally regulated in the world.
- In addition to the light regulation, the dual-till approach to price monitoring in Australia is considered more favourable for airport owners, and is consistent with the growing importance of non-aeronautical revenues in modern airport operations.

Introduction

Since privatisation of Australia’s airports began in 1997, the regulatory environment has undergone significant change. Following periodic reviews by the Federal Government, the regulatory regime has become progressively light-handed, with formal price regulation abandoned in 2002.

The release of the Federal Government’s Aviation White Paper in December 2009 marked the latest milestone in the evolution of airport regulation in Australia. The White Paper did not recommend any significant changes to existing regulatory arrangements – an outcome we see as highly positive for the sector.

In this report, we review the main outcomes of the White Paper, and consider the implications for Australian airports. We also discuss the theoretical strengths and weaknesses of Australia’s light-handed approach, comparing it to regulatory arrangements for airports in other countries. One of the key findings here is that among the diverse models that exist worldwide, Australia’s regulatory system stands out as being highly attractive for airport owners.

Australian airport regulation

In this section we briefly review the evolution of the Australian regulatory system to date, and consider the potential changes to the current system as indicated by the 2009 Aviation White Paper.

Background

Australia began privatisation of its major airports in 1997, with Melbourne, Brisbane, Perth, Adelaide, Canberra and Darwin airports privatised by 1998. These airports were regulated via a five-year ‘CPI-x’ price cap for aeronautical services (these and other regulatory methods are discussed in the next section), with ACCC¹ approval required for any proposed increase in prices.

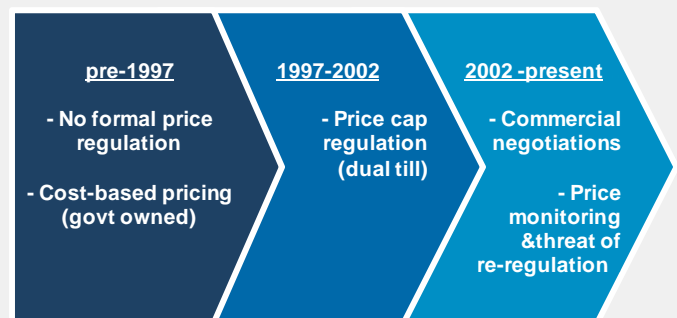
In 2002 a new price monitoring arrangement replaced the existing price cap for all major airports. The new system promoted commercial pricing negotiations between airlines and airports, but included a provision for access charges to be determined by an arbitration process in the event that commercial negotiations failed, and was extended to include Sydney Airport once it was privatised in 2003.

As Figure 1 highlights, this represented the last major change to Australian airport regulation. A subsequent review in 2007 resulted in some tweaks to the existing regime, such as an expansion of the definition of aeronautical services and facilities, and the addition of car parking services to the ACCC’s price monitoring scope. Canberra and Darwin airports were also excluded from the formal price monitoring regime, as the market power of these airports was deemed to have sufficiently diminished.

An important component of Australia’s airport regulation since the removal of price caps has been the threat of re-regulation. Specifically, the government reserves the right to reintroduce price controls at airports where ‘there is clear evidence of unjustifiable increases or other misuse of market power across the price monitored airports.’²

In its latest price monitoring review, the ACCC indicated that Sydney Airport might be earning monopoly rents from aeronautical services. There was no evidence that Adelaide, Brisbane, Melbourne or Perth airports were earning similar rents. The ACCC has also raised concerns over the level of airport car parking charges, arguing that they reflected ‘an element of monopoly rent.’ While the ACCC’s rhetoric falls short of unequivocally claiming the abuse of market power, it nonetheless serves as a reminder that airports are not unconstrained in their price setting.

Figure 1: Australian airport regulation



Source: CFS GAM Research

Aviation White Paper

As expected, the December 2009 Aviation White Paper did not herald any radical changes to the existing regulatory regime. Key points included:

- a continuation of the existing price monitoring scheme in the five major airports to 2013
- the option of reintroducing price monitoring to Canberra and Darwin airports considered in the earlier Green Paper was ultimately not pursued

¹ Australian Competition and Consumer Commission

² ACCC website: <http://www.accc.gov.au/content/index.phtml/itemId/752716>

- the inclusion of car parking services in the price monitoring regime (introduced in 2007) was also preserved, and
- for second-tier airports (which include Canberra, Darwin, Gold Coast and Hobart airports), a self-administered price and quality of service monitoring scheme will be implemented. This will not be as comprehensive as the ACCC monitoring scheme applying to the five major airports.³

Another area to have received some attention in the White Paper was the planning and development of non-aeronautical airport infrastructure. The White Paper proposed a number of additional administrative hurdles for non-aeronautical developments, including a requirement for greater consultation with the community, state and local authorities as well as greater detail on proposed land usage in airport planning processes.

By and large, however, the changes proposed were cosmetic in nature. In preserving much of the existing regulatory arrangements, the government acknowledged the importance of regulatory stability for airport owners and operators as they make long term investment decisions. The current regulatory arrangements for Australian airports will remain in place until 2013, with a full review to be commenced by the Productivity Commission in 2012.

Regulatory models compared

In order to effectively appraise the regulatory regime that presently applies to Australia’s major airports from an airport investor’s perspective, it is useful to understand what alternative models of airport regulation exist. We discuss the level of privatisation and its influence on regulation, the different theoretical models that exist, and examine regulatory arrangements throughout the world.

Privatisation

The level of airport privatisation differs widely across regions. North America and Asia have had very little experience with airport privatisation. In the US, which launched a pilot airport privatisation program in 2006, Chicago’s Midway airport was due to become the first major airport privatised before difficult credit market conditions caused the planned sale to be cancelled.

The vast majority of airport privatisations to date have been in Europe, led by the UK, which has fully privatised most of its major airports. In countries such as Germany and France a popular model has been partial privatisation, with federal, provincial or

municipal governments retaining ownership stakes alongside private investors.

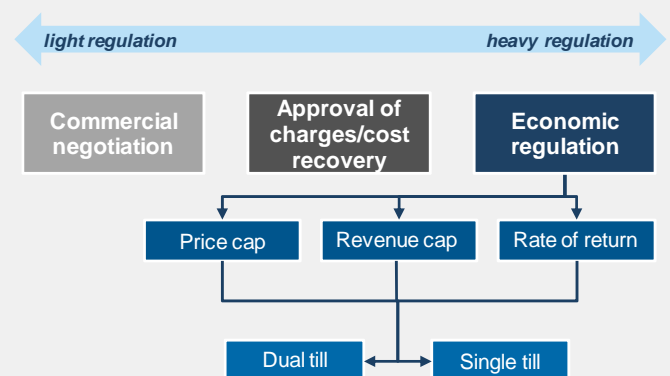
Other countries with relatively developed regulatory regimes include Australia, New Zealand, Argentina and South Africa. Airports in Australia (fully privatised) and New Zealand (partly privatised) are among the least regulated privately-owned airports in the world (along with the UK, which has deregulated many of its airports), having progressively moved to lighter regulation since privatisation.

Regulatory models

Figure 2 illustrates that airport charges may be set in different ways, ranging from market-based mechanisms such as pure commercial negotiation between airports and airport users, to charges set by the airport but requiring approval by a government ministry or independent regulator, or more formal economic regulation where the regulator has a more active role in setting airport charges and pricing. The three main systems of formal economic regulation are presented in Table 1.

In practice, many regulatory systems are hybrids. For example, the current Australian regulatory system is based on commercial negotiation, but also includes ACCC oversight (price monitoring) and the *threat* of re-regulation as a deterrent to monopolistic pricing. New Zealand applies a similar light-handed model to its three major airports.

Figure 2: Airport regulatory models



Source: CFS GAM Research

Formal price regulation typically goes hand in hand with airport privatisation. The majority of publicly owned, non-corporatised airports set their charges on a cost-recovery basis. Depending on the legal and organisation structure of the airport, the charges may also require governmental approval.

The differences between this form of governance and rate of return regulation are that the prices are not imposed by an independent regulator, and the airports

³ Sydney, Melbourne, Brisbane, Perth and Adelaide airports

may be run on a not-for-profit basis (unlike a privatised airport, which would need to earn a sufficient rate of return on capital). The US, Czech Republic, Finland, Greece, Italy, Norway, Portugal and Slovenia are all examples of countries where airport charges are set on a cost-recovery basis. Canada and Switzerland have similar systems, but with a greater degree of autonomy granted to airports.

Table 1: Types of economic regulation

Rate-of-return regulation	Also commonly referred to as cost-based regulation, this system allows airport operators to charge prices at a level which will both cover costs and earn a normal rate of return on capital, which is determined by the regulator.
Revenue-sharing arrangements	An airport operating under this form of regulation may, for example, have per-unit charges inversely related to the level of passenger growth at the airport (sliding scale). While ensuring stability of total revenue for the airport, this also undermines the relationship between output and total revenue.
Price cap regulation	Under this system, overall price levels are allowed to increase by the rate of inflation (I) less an efficiency or productivity factor (X), summarised by the formula $(I - X)$. Unlike the cost-based and revenue-sharing systems, the operator may keep any profits resulting from efficiency gains beyond the level prescribed in the pricing mechanism. This provides a strong incentive to improve efficiency relative to other systems.

Rate of return regulation is considered a 'low-powered' form of regulation because it offers little in the way of efficiency incentives. An airport operator would have little incentive to reduce costs under this system because the rate of return is capped. Instead, behaviours such as cost-padding (also referred to as 'gold-plating') and other ways to expand the capital base are implicitly incentivised. Revenue cap or revenue sharing agreements, while a step away from rate of return regulation, offer only moderate incentives to increase patronage levels due to the requirement that a portion of the resultant profits are shared with airlines. Rate of return regulation is used in the Netherlands and Belgium, while Revenue caps apply at the major French airports.⁴

Price caps are considered a better alternative to cost-based and revenue sharing arrangements due to the superior efficiency incentives for operators. In addition, regulatory costs can be kept to manageable

levels by having sufficiently long regulatory periods (such as regulatory reviews or resets every five years). One potential weakness of this system is that asset owners may have an incentive to cut costs to the point where quality standards begin to deteriorate. Price caps are used to regulate airports in the UK, Ireland, South Africa and Argentina.

Price monitoring is favoured in situations where a credible threat of re-regulation can be established, and sufficient competitive forces are perceived to exist. An effective price monitoring regime will achieve qualitatively similar outcomes to heavier regulation, but typically with lower regulatory costs and greater flexibility across different economic conditions. However, price monitoring is not without its limitations, including the difficulty the monitoring body faces in determining whether prices are acceptable or, in fact, reflect monopoly power.

In practise, most regulatory regimes bolster each of these basic regulatory methods with additional mechanisms designed to overcome their inherent weaknesses. For example, price cap and price monitoring systems are usually augmented with minimum service quality standards to limit any adverse effects of cost-cutting measures.

Single versus Dual-till

In addition to the forms of price regulation described above, airports may be regulated under a single or dual-till approach. Of relevance here is the idea that an airport's revenues can be categorised as aeronautical (such as landing fees, hangar, ground handling and airport security charges), and non-aeronautical (such as revenue from retail, car parking and other ancillary services).

Under a single-till approach all revenues of an airport are subject to regulation. From an airport owner's perspective, this can reduce the incentive to develop and grow non-aeronautical services. By contrast, a dual-till system only considers aeronautical revenues (which are considered the monopolistic part of the airport business), leaving the non-aeronautical businesses unregulated.

Single-till regulation is still prevalent in Europe – 13 of the top 20 airports in the EU are single-till (accounting for 72% of the combined traffic at these airports). However, the dual-till approach has grown in popularity as airports have evolved into more complex businesses with a greater proportion of non-aeronautical revenues. Airports with dual-till regulation, therefore, are seen as more desirable for airport owners than airports regulated on a single-till basis.

⁴ For more discussion on the theoretical strengths of different types of regulation, please refer to the World Bank's *Annotated Reading List for a Body of Knowledge on Infrastructure Regulation* (2008).

Summary and conclusions

The release of the Federal Government's Aviation White Paper in December 2009 largely preserved the existing regulatory arrangements for Australia's major airports until 2013. In a positive sign for investors, the government acknowledged the importance of regulatory stability for airport owners and operators as they make long term investment decisions.

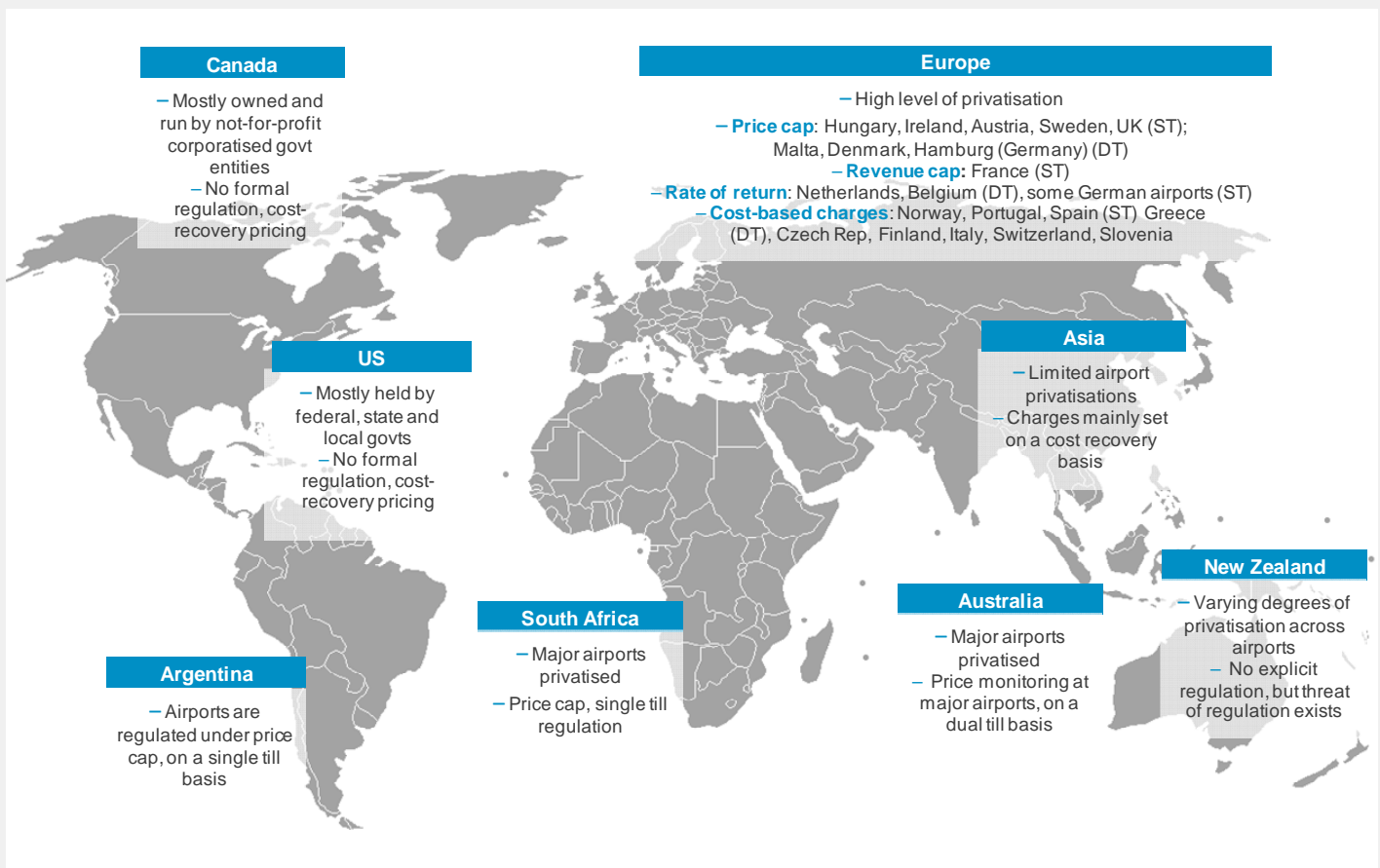
Considerable diversity in airport ownership and governance arrangements exists worldwide, as highlighted in Figure 3. The level of privatisation in the Australian market compares favourably to countries such as the US, where privatisation is at a more nascent stage. Furthermore, the current price monitoring regime, administered on a dual-till basis, represents one of the most liberalised airport pricing regimes in the world. Indeed, Australia's regulatory arrangements are likely to be emulated by other regions once their privatisations take place. This is despite Australian airports operating in a less competitive environment than airports in regions such

as Europe – a double boon for Australian airport investors.

The major risk to Australian airports from a regulatory point of view is that price controls are re-imposed as a result of excessive price increases. However, given that only one of the five monitored airport has been highlighted as *potentially* earning monopoly rents so far, we see this as a low medium-term risk rather than a sign of imminent re-regulation for the entire airport sector.

Regulation is an important factor that must be taken into account when assessing the overall attractiveness of airports – although factors such as demand growth outlook, political risk and other asset-specific features of an airport are also vital considerations. From a regulatory perspective, however, the outlook for the Australian market appears highly attractive to investors relative to its peers.

Figure 3: Airport regulatory models around the world



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