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Licence to build, licence to charge? Market power, pricing and the financing of airport infrastructure development in Australia

Gui Lohmann [a,*], Jakob Trischler [b]

[a] Griffith University, Australia
[b] Karlstad University, CTF Service Research Center, Universitetsgatan 2, 651 88, Karlstad, Sweden

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ABSTRACT

In 2017, airport privatisation in Australia reached a 20-year milestone, with its regulatory framework been shifted to a light-handed regulation in 2002. The light-handed regulation (LHR), as in place at Australia's top four airports, has been suggested as the 'frontier of international policy', leading to increasing interest among transport policymakers and researchers. This article offers an in-depth examination of the LHR with focus on a) the market-power of the regulated airports, b) the commercial price negotiations between airports and airlines, and c) the airports' behaviour towards infrastructure investment. The article reports on data from 21 semi-structured interviews conducted with key stakeholder groups affected by, or with expertise in, the LHR. Findings suggest that despite airports possessing significant market power, particularly in the domestic market, the light-handed approach seems to balance the forces in a market where an airline duopoly prevails (Qantas and Virgin Australia groups). In addition, both airports and airlines perceive that commercial price negotiations are improving and refrain from a return to a stronger regulation environment. For airlines, value-for-money is the primary concern in new infrastructure investments. Interviewees also outlined specific recommendations for improving the LHR framework, including a more accessible arbitrator and improved methodologies to monitor prices and quality of service. The findings point towards the significance of vertical relationships, long-term arrangements, and transparency as key aspects of the LHR and the development of airport infrastructure.

1. Introduction

Australia is heavily reliant on air transport due to the long distances between its population centres, and the absence of ground transport options, especially between the major population centres and the continent's remoter regions. This reliance on air transport is corroborated by statistics from the Bureau of Infrastructure, Transport and Regional Economics (BITRE, 2010) which has forecasted a yearly increase of 4.2 per cent in passenger movements until the year 2035. By 2029–30, air passenger movements will have more than doubled (235 million movements) from their 2008-09 level. These forecasts further suggest that significant investments in infrastructure and facilities at major Australian airports will be required during the decade commencing in 2020 and beyond. Australia's airports are already recognising the need to increase investments: Brisbane Airport is currently developing a new parallel runway (AUD 1.35 billion), Sydney Airport is upgrading its international Terminal 1 (AUD 500 million), Perth Airport opened a dedicated terminal for Virgin Australia in November 2015 in addition to currently planning a new runway, and Melbourne Airport has recently opened a dedicated terminal (Terminal 4) for low-cost carriers.

There are over 2000 airports and airfields in Australia, but only around ten percent operate to provide regular passenger services for financial reward (i.e., regular public transport services) (Productivity Commission, 2011). In 1997, the Australian Government began a privatisation process of 22 airports, concluding with the sale of Sydney Airport in 2002 (Abbott and Cohen, 2014). Accompanying the privatisation process was the recognition by the Government that some airports possessed significant market power. Therefore, privatisation was initially accompanied by a regulatory framework comprised of (a) price monitoring; (b) price caps and 'show cause' procedures for new investments; and (c) quality-of-service monitoring (Gillen, 2011; Adler et al., 2015). With the sale of Sydney Airport, the Government introduced regulatory changes towards a light-handed price and quality of service monitoring regime (Littlechild, 2012). A light-handed regime (LHR) is a regulatory scheme that "… Places no immediate constraints on aeronautical charges but monitors prices intending to 'taking action' if prices are judged to be

* Corresponding author.
E-mail addresses: g.lohmann@griffith.edu.au (G. Lohmann), jakob.trischler@gmx.net (J. Trischler).

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too high" (Gillen, 2011, p.9). The regulator does not determine aeronautical charges up-front; instead, airports and airlines negotiate and agree on contracts to govern their commercial relationships (Arblaster and Hooper, 2015). The aim of this regulatory change was to minimise compliance costs for airport operators and the Government and encourage airports to undertake required aeronautical infrastructure investments that ensure economically efficiency (Productivity Commission, 2002).

While the LHR has been widely examined and discussed (e.g., Forsyth, 2008; Littlechild, 2012; Arblaster, 2014), few studies and industry reports have examined the regulatory framework from a stakeholder perspective. It, therefore, remains unclear how the key stakeholders operating under this regulatory regime perceive the light-handed approach. Opinions on the LHR diverge. For example, while Littlechild (2012) describes the LHR as the 'frontier of international policy' as it fosters efficiency and reduces administrative costs, other studies point to the possibility that Australia's airports might abuse their market power owing to lacking substitution between airports and other transport modes (Oum et al., 2004; Fu et al., 2006; Forsyth, 2008). This paper contributes to this ongoing discussion by providing an in-depth investigation of how key stakeholders perceive the LHR applied to the four largest airports in Australia. Accordingly, this paper seeks to answer the following research question:

How do key stakeholders perceive the current LHR framework, particularly in terms of a) the market-power of the regulated airports, b) the commercial price negotiations between airports and airlines, and c) the airports' behaviour towards infrastructure investment?

The present article addresses this question from the perspective of key stakeholders involved, thus gives voice to those who operate under the current regulatory regime. The involved key stakeholders included Australia's major airports and airlines, government regulatory bodies, national aviation associations, and leading Australian academics who had extensive experience in the underlying topic. Thereby, the focus on the Australian case sheds light on the specific challenges of expanding and improving airport infrastructure, particularly with respect to the vertical relationships and commercial price negotiations between airports and airlines under the LHR. By bringing together the view of multiple stakeholders, the article contributes to a more nuanced understanding of the specific positions taken by key players towards the LHR and, as such, may assist policy advisors to improve its current design.

In the following section, the literature related to the LHR as currently in place in Australia' top four airports is reviewed. This section is followed by a description of the study methodology. Then, the findings from semi-structured interviews with key 21 stakeholders are presented, followed by a discussion of the theoretical and managerial implications of the key findings. The article concludes with a description of the limitations of this research and directions for future research.

2. Literature review

2.1. The light-handed regulation and market power of Australia's airports

A key aim of privatising government-owned enterprises is to improve productive efficiency (lowering costs) and allocative efficiency (producing goods and services that are attractive to the market), imposed through the competition against private firms (Domberger and Piggott, 1986). Government-owned enterprises that typically fall into this category include telecommunications, health insurance, transport, energy and aviation. Within these sectors, firms often absorb natural monopoly characteristics due to the absence of competition or high entry barriers for new players (Abbott and Cohen, 2014). Consequently, the lack of competitive pressures in these markets usually leads to some form of regulation (Spence, 1975). However, a significant drawback of conventional regulation frameworks for government-owned enterprises is that they impose only a few incentives for the regulated firm to pursue productive efficiency (Laffont and Tirole, 1986). Economists, therefore, tend to argue for deregulation or the introduction of regulation incentive approaches, that is, contracts that delegate individual pricing decisions to the firm and allow the firm to reap profit increases from cost reductions (Vogelsang, 2002). In Australia, the deregulation of airports following their privatisation has been recognised as the 'frontier of international policy' (Littlechild, 2012) because it is among the first regulatory approaches that impose no direct regulatory control over prices, revenues or profits (see Abbott and Cohen, 2014, Arblaster, 2014, Forsyth, 2008, Littlechild, 2012 for a detailed overview of the evolution of airport regulations in Australia).

Currently, the Australian Government exercises an LHR which removes direct regulatory control over prices, revenues or profits, but which includes price and quality-of-service monitoring at top four airports, i.e. Sydney, Melbourne, Brisbane and Perth, by the ACCC until June 2020 (ACCC, 2014). It can be argued, however, that the approach to price and quality monitoring might be insufficient as it can allow an airport with significant market power to invest in infrastructure that might not foster the efficiency of its operation or increase the quality of service levels. In addition, the current approach might not sufficiently protect for sunk investments made by airlines, which consequently can lead to a hold-up owing to the risk that a monopolist airport could raise its prices to extract some of the value from this investment (Biggar, 2009, 2012). For example, Virgin Blue Airlines (2011, p.31) argued in an inquiry to the PC that "price monitoring alone will never be sufficient to constrain airports' market power and ensure that they provide services in an efficient manner and at appropriate prices." Specifically, the airline suggested that (a) more transparency of cost information, (b) greater certainty in the approach taken in the pricing of aeronautical services, and (c) a credible threat of appropriate and effective sanctions are required. Although the Productivity Commission (2011) recommended a 'show cause' mechanism for new investments to strengthen the threat of a stronger regulatory measure, this recommendation has not been adopted by the Australian Government. The reason for this was partly based on the consideration that such a mechanism would increase the costs of administration and hold up necessary airport investments (Arblaster, 2014, 2016).

2.2. Airport pricing, cost and infrastructure investment

Important questions that arise in light of the LHR is a) how large infrastructure projects might be effectively funded by privatised airports, and b) how sunk investments made by customers (e.g., airlines) could be promoted and protected. Airport infrastructure investments require long lead-times with respect to planning, financing and construction to meet the future needs of airlines and passengers (Gillen, 2011). Privatised airports must finance their own operating and infrastructure development costs as well as diversify their revenue sources by relying not only on the revenue derived from aeronautical charges such as landing charges and ground handling services, but also from non-aeronautical sources such as real estate, retailing, and car park facilities (Rowley, 1997; Schulte, 2009). In fact, airports are increasingly pushed to increase revenue and reduce costs which might, incentivise short-term thinking in terms of profit generation (Aulich and Mark, 2013; O'Donnell et al., 2011), or in contrast lead to the exploration of forming various long-term vertical relationships with downstream airlines to utilize synergy effects (Fu et al., 2006).

In Australia, the airports were sold subject to 50-year long-term lease agreements with the Australian Government, extended automatically for a further 49-year period (Productivity Commission, 2011). These lease agreements reflect the attitude of Australian investors who tend to take a strategic focus and long-term perspective on their investments. This enables airports to form strategic vertical arrangements or contracts with airlines, particularly with those that have a large market share (Fu et al., 2006). The result can be important benefits for both parties. For example,