



Should Australia regulate or monitor?

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Decision of Federal Government in May 2002

Adopted recommendations of Productivity Commission

- Remove price regulation and introduce price monitoring for major airports from June 2002.
- ACCC to devise system of price monitoring.
- Monitoring to be reviewed after 5 years.

Reasoning of the Productivity Commission

“Where airport market power is not substantial, or where there are commercial constraints on the misuse of market power, price monitoring has significant advantages over stricter forms of price regulation. Providing there is no easy recourse to regulatory intervention, a price-monitoring regime can promote efficient outcomes while reducing the risk of regulatory failure. Price monitoring also has the potential to reduce compliance costs and promote commercial negotiations.”

PC claimed major Australian airports have market power but are subject to ‘commercial constraints’:

1. Non-aeronautical revenue can constrain aeronautical pricing;
2. Long-term growth strategies; and
3. Countervailing power of airlines.

1. Constraint of non-aeronautical revenues

- This was a simple mistake on the part of the PC.
- Cournot showed that, if a monopolist is selling two products that are complements in demand, the monopoly profit-maximising prices will be less than if the two products have their prices set by separate monopoly firms. (Think of a monopoly on left and right shoes.)
- PC interpreted this as saying that non-aeronautical revenues will constrain prices of aeronautical services – in the sense that competition or regulation constrains monopoly prices.

2. Constraint of long-term growth strategy

1. “To a considerable extent, airports’ market power relies on the relatively small effect of an increase in airport charges on air travel costs.” But ...
2. “State Government departments commented on the close working relationships that have developed with airports since they were privatised. That privatised airports have sought and maintained such relationships does not sit well with the notion of them exploiting whatever market power they may have.”
3. Confusing shifts and movements along demand curve.

3. Airlines countervailing power

1. Countervailing power depends on outside options.
2. Airlines have no options but to use the major airports.

Price monitoring versus price caps

- Debate over rate of return regulation compared with incentive regulation.
- Prior to June 2002, each major airport had a 5-year price cap of the CPI-X form, where X was set with reference to expected traffic growth. Starting prices were those at time of privatisation.

Difficulties with ACCC monitoring

1. Allocating costs and revenues between aeronautical and non-aeronautical services. ACCC also reports on total airport measures.
2. Return on equity (how to measure?) or assets; but ‘a number of airports have effected significant upward revaluations of their assets, which has the effect of lowering the reported return on assets.’ (speech by Graeme Samuel, 14 November, 2005)



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