

CONFERENCE ON THE ECONOMICS OF AIRPORTS AND AIR NAVIGATION SERVICES

(Montreal, 19 - 28 June 2000)

Agenda Item 4: Determinants of the economic regulation of airports and air navigation services

AIRPORT ECONOMIC REGULATION

(Presented by the International Air Transport Association)

SUMMARY

This paper gives an overview of economic regulation for airports and argues that it plays an important role in improving airport efficiency and countering the potential abuse in the setting of charges. This consideration is particularly important for those States that will or have already commercialised or privatised their airports.

1. Introduction

1.1 IATA supports the aim to motivate airports to achieve the lowest possible user charges, consistent with a high standard of service, while protecting Member airlines against possible monopoly abuse.

1.2 Particularly in the case where an airport has been commercialised or privatised, it is important to recognise those behaviours that users might view as monopolistic could equally be construed as appropriate business behaviour on the part of the airport. Indeed, the airport has a primary accountability to either its shareholders (to maximise profit in the case of a privatised airport) or to its proponent (government) for a return in the case of a concession.

1.3 Therefore, it is essential that an appropriate regulatory framework be established to satisfy the requirements of the users for:

- just and reasonable charges (i.e. value for money and no anti-competitive discrimination between users);
- timely and cost-effective infrastructure development;
- acceptable service standards; and
- an ability to redress users' weak bargaining position.

1.4 Such framework should, per se, also permit the airport to earn a reasonable rate of return for its shareholder(s) whilst avoiding monopolistic rates of return and patterns of behaviour.

2. Discussion

2.1 Airlines' experience with economic regulation at a number of airports has highlighted some key areas that the regulators should address to ensure overall efficacy of any regulatory formula.

2.2 Firstly, it is important to recognise that if a regulatory formula is put in place which does not define a guaranteed level of service, this can in itself lead to further abuse, by way of a reduction in service quality as savings are sought.

2.3 Therefore, there must be protection against falling service standards since users have no alternative facilities. This can be achieved through defining the level of services, establishing performance measures for the purpose of benchmarking against best practice, and establishing a mechanism to ensure the proper level of investment in a timely manner. All of these requirements should be developed in consultation with the users. The regulatory framework should include these requirements in order to emphasise that cost reductions cannot be pursued without due consideration for quality of service.

2.4 Prior to discussing the structure of any potential regulatory formula, it is necessary (in addition to the definition of service levels) to consider a number of other issues, all of which may have an impact on the regulatory formula, including:

- (i) definition of the appropriate rate of return,
- (ii) valuation of the asset base,
- (iii) treatment of commercial rentals paid by users,
- (iv) appropriately timed infrastructure development,
- (v) benchmarking of airport capital and labour productivity against best practice, and
- (vi) "Use Agreements" as a partial replacement to external regulation.

Appropriate rate of return

2.5 When calculating the maximum rate of return that an airport should be permitted to earn, many issues will require consideration because of the diverse commercial/economic requirements of different countries:

- different rates of return required by and within the private sectors of different States;
- different costs of borrowing and different capital structures;
- the need to balance the users' desire to ensure that they only pay a return on existing assets against the threat that this could act as a disincentive to long-term capital investment.

2.6 In deriving the appropriate cost of capital and applicable rate of return, due regard should be had to:

- the monopolistic, relatively low-risk position of the airport; and
- the fact that an airport has a responsibility to the well being of an area's overall economy – overpricing its services affects a much larger constituency than its immediate users.

Valuation of the asset base

2.7 The capital base will be highly sensitive to the accounting methods adopted for valuing assets. Furthermore, changes to such accounting methods during a review period can have a significant impact on the assets thus re-valued.

2.8 Care needs to be taken regarding reclassification of land as investment property. Investment properties may be valued by some airports on an “open market” (capital value being calculated as a multiple of rent) therefore producing a higher market value.

2.9 Certain airports may attempt to re-value their asset bases with the intention of charging depreciation on the new asset values, even when the assets in question may have been already fully depreciated.

2.10 It is also necessary to be cautious about the risk of inclusion in the asset base of both the assets during the course of construction and the capitalisation of interest associated therewith. To allow both capitalisation of interest and a rate of return on assets in the course of construction results in double counting of the opportunity cost of capital during that period.

2.11 If the asset base is not recorded in the balance sheet on the basis of an historic cost valuation (that is, if a current cost methodology is employed), the need to link the asset base to a stable cost/price index is essential, to avoid fluctuations in the capital base valuation due to unforeseen economic circumstances and the resultant distortions of permitted rates of return.

Treatment of commercial rentals paid by users

2.12 Airline space is not a commercial retail space in the sense of traditional concessions such as gift shops, restaurants, bars, etc. Airline space is support space and is often used in common (ticket/check-in counters, hold rooms, air cargo buildings, baggage claim) under strict rules imposed by the airport that leaves little room for product identification or differentiation. Therefore, rents to airlines should preferably be cost-related and regulated. They should not be set by reference to the value of premises at other locations.

2.13 Particularly where space at an airport is limited and/or capacity demand is very high, there is a risk of on-airport rentals being considerably higher than those off-airport. It may be appropriate to examine the introduction of a formula, using a combination of weighted indices, to remove the lack of certainty over airport rental rates in the longer term. Such indices could include:

- movements in the consumer price index;
- passenger growth;
- construction prices; and
- movements in off-airport rentals.

Appropriately timed infrastructure development

2.14 If one accepts that an airport will seek to maximise its return on assets to its shareholder(s) then it also follows that there could be a risk that it would seek to defer timely infrastructure development until the last possible moment in order to maximise its returns from existing assets. This would have the dual effect of frustrating users' expansion plans and cause additional operational delay/disruption costs.

2.15 It is critical that the regulatory regime imposed recognises the existence of such risks to users and has the ability to intervene, possibly reducing the airports' permitted rate of return until suitable remedial steps have been taken. An alternative that could be considered, to prevent such abuse, would be the development of airport infrastructure by third parties after a proper bidding process.

Capital and labour productivity

2.16 If an airport is to earn a "commercial" rate of return, it should be achieving industry best practice on both capital and labour productivity. This can be measured by using appropriate benchmarking techniques.

"Use Agreements" as a partial replacement to external regulation

2.17 Where an airport has entered into a use agreement with contractual obligations on service standards and prices, a lower level of economic regulation may be appropriate.

3. Airport Economic Regulation

3.1 The international airlines have now had 12 years experience with inflation-based regulation in certain States. During that time some shortcomings of regulating charges on the basis of general inflation have surfaced. In line with the overall experience we can say, however, that there are practical merits in a form of regulation which takes account of inflation.

3.2 In order to ensure that the actual regulation is fair to all concerned and serves as effective protection against possible monopoly abuse, several safeguards need to be built into the regulatory mechanism. IATA has produced the following information which would enable the protection of the airline interests while providing the necessary incentives and motivation to the airports to improve their productivity and increase their concession revenues.

4. Basic Features of Airport Economic Regulation

4.1 In order to be acceptable to the airline industry, airport economic regulation needs to meet certain criteria. The following is a list of the essential criteria:

- a) The starting base charges to be set at an acceptable level.
- b) The airport to be motivated to improve its productivity.
- c) Airlines to share the benefits of traffic growth and improved productivity.
- d) Commercial revenues to be taken into account.
- e) All charges to be regulated.
- f) The regulation to be transparent and simple to understand and administer.
- g) An effective and meaningful consultation process must be established.
- h) Independent regulatory review process.

- a) The starting cost-base and related charge levels should be discussed and agreed with the users.

If it is not possible to analyse the existing cost-base and charges, the following approach could be taken: a reasonable return on investment (ROI) should be agreed with the airport authority which would reflect the performance of other large businesses in that country adjusted for the lower level of risk.

In principle, the starting base would then represent the actual charges in the year preceding the establishment of the regulation, adjusted for the difference between the revenues producing the actual ROI and the agreed ROI.

- b) The airport needs to be motivated to improve its productivity, as improvements should benefit both the airlines and the airport authority. The formula needs therefore to regulate the charges (rather than the revenues) and it should address two criteria:
 - (i) charges increases should be lower than inflation to incentivise productivity; and
 - (ii) the regulatory formula should contain an “x” factor specifying the difference between the allowable charges increases and inflation.

In addition to increasing productivity, the airport should also be incentivised to provide sufficient and timely capacity to meet the needs of the airlines when traffic grows.

- c) Certain studies suggest that airport costs grow at a rate less than actual traffic growth. Other studies indicate that in the long run, costs grow in line with traffic growth. It is appropriate that revenues are restrained from increasing faster than traffic growth.
- d) In general, commercial revenues grow at a different rate to traffic volumes. The formula may therefore contain a factor which would reflect the impact of commercial revenue changes. Alternatively, commercial revenue development could be reviewed at regular intervals (e.g. every 3-5 years) and regulated charges adjusted accordingly. Care should be taken here not to disincentivise the airport from appropriate infrastructure development.
- e) Charges means those charges levied in respect of landing, lighting, parking and passenger processing (i.e. “aeronautical charges”) and any other charges, rates and fees over which the airport has a monopolistic control. Though it may take a different form, the regulation of other charges (airline rentals, common space, etc.) may also need to be defined.
- f) The word “transparency” is frequently used without the party using it having the opportunity to formally define exactly what they mean. In short, transparency is the means of facilitating knowledge, assessment and opinion on what is happening within the bodies under consideration.

In order to ensure that the regulating formula is transparent, simply understood, controlled and administered, the following is proposed:

- The allowable increase should be based on the previous year's actual inflation rate.
 - **Either:** The formula could apply to an airport "tariff basket" under which the weighted average price of a specific basket of tariffs is allowed to increase by the allowable percentage. The weights are derived from the proportion of total revenue earned in the most recent year by each of the tariffs included.
 - **Or:** The formula may be applied to a single airport "yield" figure such as income per passenger as this is the simplest and most easily verifiable measure (passenger growth).
- g) A meaningful consultation process must be established if there is to be any chance for the regulatory process to operate in a professional and business-like manner between the airlines and the airport. Effective and meaningful consultation can be defined as follows: "An open communication of a genuine statement of intention to implement a proposal not yet fully decided upon, listening to what either person has to say, considering the response and then deciding what should be done".
- h) In most cases, the regulator is the civil aviation authority or the responsible ministry. It is essential to have a politically independent economic regulatory process. This would normally be done by a body or panel, who should not be a part of the Government and who possesses the necessary competencies to deal with the airport. The panel would review any charges proposals and make recommendations to the regulator. The panel would accept evidence from all concerned parties and the reports of their deliberations and recommendations to the regulator would be public documents. Independence from Government would be even more critical for autonomous public sector entities wholly owned by a State or in which a State has a majority share or interest in order to provide more objectivity to the rate-setting process.

Transparency should be ensured by the regulator to the users concerning the rationale for the selected regulating formula and the method for determining the values used in the formula.

There should also be an appeal body, independent of the regulator, to which both the airport and its users can appeal for arbitration in the event of a dispute.

5. External Audits

- 5.1 It would also be essential to require professional external audits to ensure that the service provider adheres to the principles established by the regulatory framework.

6. Action by the Conference

- 6.1 The Conference is invited to:
- a) note that economic regulation can be an effective tool in improving airport efficiency and in countering potential abuse; and
 - b) recommend that ICAO guidance material appropriately include guidelines for effective airport economic regulation.