

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

Air Navigation Services (ANS) Economic Regulation

(Presented by the International Air Transport Association)

SUMMARY

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

1. Introduction

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

2. Traditional Cost Based Methodology

2.1 The traditional cost based methodology uses primarily the process of unit rate capping as the key element of control to restrict permitted unit rate increases between periodic reviews, usually not exceeding five years. It has been used with varying degrees of success for natural monopolies, in particular, public utilities and also airports. There are valuable lessons to be obtained from reviewing these practical experiences.

2.2 In the absence of an effective economic regulation, there exists no real incentive for a ANS provider to improve efficiency since any increase in costs can be passed on to the users.

3. Independence of Economic Regulator

3.1 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 ANS provider. 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.

3.2 Independence from Government would be even more critical for autonomous public sector bodies 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.

4. Transparency of Information

4.1 Regulatory formula and component values

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

4.2 Traffic forecast model

4.2.1 The traffic forecast model used should be transparent to the regulator and the users. The model used should consider various information including but not limited to user traffic forecast (especially major national users), air traffic flow plans, airport traffic forecasts and historically based trends.

4.3 Activity-based cost accounting system

4.3.1 A robust activity-based cost accounting system that conforms to international accounting standards and provides detailed cost per facility and service will allow for a higher level of transparency to be provided to the regulator and the users. Such a cost accounting system will help establish the proper baseline costs, possible efficiency gains, and ultimately the unit rate cap.

4.4 External audits

4.4.1 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.

4.5 Performance

4.5.1 Performance measures including financial indicators and service levels should be developed for the purpose of benchmarking against best practice. These measures should be developed in consultation with the users. Using these measures, the economic regulator would be able to assess whether a high level of service quality was being maintained in conjunction with cost reductions.

5. Consultation with Users

5.1 A minimum level of requirements should be defined concerning consultation between the regulator and the users as well as the service provider and the users. The regulator should consult with the users concerning the development of the regulatory formula and the method for determining the values used in the formula (including but not limited to the inflation index, actual and forecast traffic, cost figures, efficiency gains, unit rate cap and maximum rate of return).

6. Safeguard Mechanisms

6.1 There must be safeguards against the service provider generating unreasonable returns and allowing poor service standards. Lessons from other industries are particularly valuable concerning safeguard mechanisms.

7. Review Period

7.1 Although some airports have a five-year review period, experience in other industries has shown this to be too long. ANS providers themselves have often expressed to users the difficulty in developing meaningful five-year forecasts of cost, traffic and inflation, which are all basic components of economic regulation. The ideal forecast period seems to be three years (n+4). Having a three-year review period would also limit the necessity for adjusting unit rate caps between reviews.

8. Valuation of the Asset Base

8.1 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. ANS providers should not re-value their asset bases with the intention of charging depreciation on the new asset values, especially when the assets in question may have been already fully depreciated. Depreciation for charging purposes should be based on book value.

8.2 Including both assets in the course of construction, and the capitalisation of interest associated therewith results in double counting of the opportunity cost of capital. This should not be allowed.

9. Cost of Capital

9.1 The calculation of the appropriate cost of capital should remain according to ICAO recommendations (ICAO Doc 9161 - AT/724 paragraph 4.38-4.41).

9.2 For debt capital, this would be the actual interest paid to the providers of debt capital. For equity capital, the appropriate cost would be a “negotiated” rate approved by the State (or other national economic regulator) taking into account the low financial risk of providing air navigation services. The government bond rate (i.e. risk-free rate) should be used since any risk premiums (i.e. operating and financial risks) would be considered in the setting of the profit cap; in certain cases, rates payable in financial markets by enterprises of comparable low risk (i.e. other natural monopolies) could apply. The overall cost of capital based on a weighted average of debt and equity could then be included in the State’s cost base and recovered from the users.

10. **Profit Cap**

10.1 In determining a profit cap for the ANS provider, which would include the actual risk-free weighted cost of capital and any applicable risk premiums, due consideration should be given to ensure that it fits within the context of the average return of the airline industry and that the resulting unit rate cap is at an acceptable level in recognition of the low risk, monopolistic nature of ANS entities.

10.2 Targets and incentives should promote the required quality of service and cost effectiveness. In order to foster partnership between ANS providers and the users, a profit cap should safeguard against excessive profits while preserving incentives for cost reduction.

11. **Protection against falling Service Standards**

11.1 In addition to protection against excessive returns, there must be protection against falling service standards. This can be achieved through defining a minimum level of service, establishing performance measures including safety measures for the purpose of benchmarking against best practice (as mentioned earlier) 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 safety and quality of service.

12. **Action by the Conference**

12.1 The Conference is invited to:

- a) note that economic regulation can be an effective tool in improving ANS cost efficiency and countering potential abuse in the setting of charges; and
- b) recommend that ICAO guidance material appropriately include guidelines for effective ANS economic regulation.

— END —