

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

ECONOMIC REGULATION OF AIRPORTS AS A PROXY FOR COMPETITION

(Presented by Albania, Armenia, Austria, Belgium, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Moldova, Monaco, Netherlands, Norway, Poland, Portugal, Romania, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, The former Yugoslav Republic of Macedonia, Turkey, Ukraine, United Kingdom)

SUMMARY

This paper outlines the purposes and aims of an economic regulatory system for airports. It provides information on different regulatory regimes, with some clarification on the use of price cap regulation. Recommendations for action by the Conference are contained in paragraph 13.

Introduction

1. The aim of this paper is to suggest some of the principles that might be used to determine the circumstances in which economic regulation might be appropriate and the form such regulation might take. It draws on the experience of those States that have a system of airport economic regulation, including various Member States of ECAC as well as other ICAO contracting States.

2. The term “economic regulation” is used here to mean powers exercisable by a body independent of the operators and users of an airport to regulate the level and structure of user charges. These may be active or reserve powers. The use of economic regulation may be in addition to other regulatory or economic instruments intended to deliver national, regional and local policy objectives. These objectives may relate to social and environmental considerations, or the wider economic impact of airports. Airports should also be subject to general competition law and policy.

Purposes and Aims of Regulation

3. An economic regulatory system for airports should have the principal objective of meeting the long-term interests of airport users. This may be achieved by:

- guarding against weak cost control or inefficiency;
- providing incentives to make the best use of existing facilities;
- ensuring that airports are able to fund necessary investment in facilities to meet future demand and, as far as possible, carry out such investment;
- prevention of discriminatory charges and other anti-competitive practices;
- ensuring user views are reflected in the setting of service standards.

Nothing in an economic regulatory regime should compromise an airport's ability to maintain proper safety and security standards.

4. In a fully competitive environment, negotiations between an airport and its users about the level of charges, airport investment programme, and quality of service, would have their own equilibrium. However, where competition between airports is constrained, an airport may enjoy a degree of market power that if left unchecked could allow it to behave in a way that does not take proper account of the reasonable interests of airlines, other operators of aircraft, passengers and shippers of freight. This could result in higher prices and lower levels or standards of output than would be the case under normal market conditions. Such a situation may come about where an airport, or group of airports, accounts for a substantial proportion of traffic within a local, regional or national market. Under these circumstances, some form of economic regulation may be appropriate. The nature of the ownership of airports, whether in the private or in the public sector, or the nationality of ownership, should not, of itself, determine whether airports should be subject to regulation.

5. In its simplest form, regulation might require no more than enabling users of airports to appeal about unreasonable charges and anti-competitive practices to a body independent of the managing body of the airport and of airport users. The body would possess the necessary legal powers to investigate a complaint, and to apply a remedy if one is shown to be required. But in other situations, direct control of user charges might be considered necessary to counteract an airport's dominant position in the market.

Styles of Regulation

6. The regulatory regime should be no more onerous than is necessary to meet its aims in the particular circumstances of the airport or airports in question. It can, for example, be made more or less intensive depending on the scale of dominance and should be kept under review. Voluntary agreements between airports and their users may be sufficient to avoid the need to consider external regulation.

7. Where external regulation has been introduced it is becoming increasingly the practice for the charges levied by airports on their users to be directly controlled. Two broad approaches to price control have emerged. These are cost of service, or rate of return regulation and regulation based on a price cap.

8. Rate of return regulation, which has been widely used in the USA, sets limits on the return on capital employed the firm is permitted to earn. Its aim is to prevent monopoly pricing and excessive profits while the firm has an incentive to invest. This form of regulation, while preventing the firm from earning excess profits, has the disadvantage that it fails to give it any strong incentive to reduce its costs. There is also a risk that the firm will over-invest or, if the return is set at the wrong level, the outcome could be under investment.

9. Under price cap regulation prices, or more typically maximum prices, are set by the regulator in advance for a specified period into the future. These are based on the regulator's view of demand, the scope for cost efficiencies and to allow a reasonable rate of return that encourages investment. In this way the firm is given an incentive to cost-efficiency during the period of the price cap in order to earn greater profits. At the end of the period, when the price cap is next reviewed, the regulator can take account of these cost savings when setting the price cap for the next period. Thus some of the efficiency gains from the previous period can be passed on to users.

10. In a number of States there is a price cap based on the national rate of inflation (eg the Retail Price Index in the UK) minus an efficiency factor. Examples of states that have introduced some form of price cap regulation are the UK, Austria, Portugal, South Africa and Australia. In the UK price caps are applied to charges levied on airlines at Heathrow, Gatwick, Stansted and Manchester airports on a five yearly basis. In Austria charges at Vienna have been capped as have Lisbon, Porto and Faro in Portugal. Charges at airports owned by the Airports Company of South Africa, including Johannesburg, Cape Town and Durban, have been subject to a price cap while in Australia the airports brought within the initial price cap regime included Brisbane, Melbourne and Perth.

11. Where price cap regulation has been introduced the detailed formulation and composition of the price cap does vary between the regulatory systems. Some of the issues that have been relevant to the setting of a price cap and which partly help explain these differences are:

- i) The charges that are included within the price cap. Some price caps include, for example, check-in desk charges and ground handling charges while others exclude them. As a general approach, the charges to be regulated should be those levied by the airport for services it supplies directly on a monopoly basis and where there is little or no scope for competitive provision.
- ii) Whether the price cap is applied to the airport's income from the regulated charges ("revenue yield") or to the actual levels of the regulated charges ("tariff basket"). The revenue yield approach is currently used in the UK while Austria, South Africa and Australia have adopted a tariff basket. The benefits and disbenefits, including the different incentive effects of the alternatives, should be carefully assessed.
- iii) The extent to which an allowance for variations in traffic is built into the price cap. Some price caps are varied automatically as traffic levels change while others are fixed on the basis of forecasts made at the time the cap is decided.
- iv) The costs that airports are permitted to recover outside the price cap. In the UK and Australia the price regulated airports can pass through in higher charges certain additional Government-imposed security costs while in Australia some items of capital expenditure can be treated separately.

- v) How levels of service quality should be taken into account in the regulatory regime. None of the existing price caps are believed to include service quality as an express function yet this may be taken into account implicitly through the price setting process. Service standards may, however, be monitored and performance reviewed during the process of setting the cap.
- vi) The scope for price caps to be varied within the period for which they have been set. Incentives are maximized if the price cap is not varied once it has been set, other than through automatic, transparent mechanisms such as in (iii) above or in exceptional circumstances.
- vii) The extent to which charges are assessed against the "single till" principle in which all sources of revenue, both aeronautical and commercial income, are taken into account when fixing charges. It is not the purpose of this paper to examine the merits or otherwise of the "single-till" principle, which is likely to be the subject of separate discussion at ANSCConf 2000.

12. An alternative to direct price control by a regulator is the taking of reserve legal powers to introduce controls should the need arise. This is the position, for example, in New Zealand, and in the UK for airports above a certain size other than those already subject to an externally imposed price cap. In both cases any decision to introduce price control has to be taken by Government rather than the regulator.

Action by the Conference

13. ECAC notes that the Statements by the Council to Contracting States on Charges for Airports and Air Navigation Services (Doc 9082/5) do not currently address the issue of external regulation of charges at airports. It therefore recommends that the Statements should reflect the principles in this paper and suggests the following additional text for the section on airport charging systems:

"It may be appropriate to consider regulation of airport charges where there is a risk that an airport or airport system may exploit significant market power to the disadvantage of airport users. This may occur regardless of whether an airport is publicly or privately owned. Where there is regulation, a body separate from the operator and users of the airport should apply controls based on a recognized regulatory approach. The objectives of any system of economic regulation should be to meet the reasonable long-term interests of users through:

1. encouraging cost efficient airport operation;
2. ensuring effective use of existing airport facilities;
3. providing appropriate incentives for necessary future investment by airport operators; and
4. preventing discriminatory charges and other anti-competitive practices.

The system of regulation should be no more onerous than is necessary to met its defined aims."