

## **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**  
**Agenda Item 5.2: Elements for consideration with regard to ICAO policy**

### **NEW CHALLENGES FOR ECONOMIC REGULATION OF AIRPORTS**

(Presented by the European Commission)

#### **INFORMATION PAPER**

#### **1. Current development trends**

1.1 The airport industry is currently going through a process of deep transformation. In the increasingly liberal and competitive environment of air transport, airport operations have also been changing in nature and there are today much stronger incentives for airport managers to behave commercially. This development applies not only to pure commercial activities such as the provision of retail services and other non-aviation activities, or to recently liberalised ones such as the provision of ground handling services. It also increasingly affects the core business of airports, that is the provision of airport facilities. Airports clearly have now a twofold nature. On the one hand they continue to be providers of a service of general economic interest, i.e. access to infrastructure necessary to carry out air transport operations, but on the other they have been developing a more commercial approach to the provision and development of such services.

1.2 Indeed cost containment, private finance, marketing and even acquisition strategies are increasingly characterising the airport core business. This does not concern only major hubs. Just as some innovating companies did in the airline industry, there are examples of smaller regional or downtown airports which are developing a low-cost concept and strive for attracting and creating new aviation business. Airlines increasingly negotiate attractive conditions with such airports, e.g. as part of the start up of a new service. Deep changes are affecting airport ownership too. Airport infrastructure is privately owned only in a few cases, direct national or local government ownership being the rule. However it is more and more common to find that airport managers, the companies running airports, are commercial enterprises whose shares are held by both public and private entities. The increasing number of privatisation and international acquisition operations witnesses the strong and growing interest of private investors.

## **2. The challenges facing airport management and the need for regulation**

2.1 At the same time airports are confronted with serious capacity, financial and environmental constraints, giving rise to potential discrimination between incumbent and new entry airlines. Concentration of operations exacerbates the problem at big hub airports, while there is spare capacity across the airport system, which requires a more commercial and efficient use. Expanding capacity requires financial resources that may well go beyond the capacity or the willingness of public budget to invest. Private capital investment is to be involved, but this implies that the right incentives have to be designed to attract private investors, in particular in the case of big airports.

2.2 Various public interest issues are connected with airports. Access to air transport services is of great importance to regional development policies, as it generates important economic and social impacts in terms of company location decisions, export trade and links to the rest of the world, tourism as well as employment and competitiveness. Airports impact on environmental issues too, mainly in terms of noise emissions, which is a major challenge to their social acceptability. Properly addressing the environmental constraint is an inescapable condition for the operation and development of airport facilities. Of course transport policy as a whole has a relevant stake, given the importance of infrastructure for the promotion of an efficient and competitive transport system. Indeed constrained access to airport infrastructure distorts competition as long as incumbent airlines are advantaged vis à vis would-be competitors. Hence the concern of policy makers for capacity scarcity, discriminatory practices and their commitment to expand capacity and eliminate discriminatory and/or excessive charges.

2.3 Cost and quality of service, which are frequently claimed to be unsatisfactory, are the main concern to airlines. They expect airports to be managed in a commercial way, which is a primary driver for the provision of cost-effective service. Development of capacity in order to expand their activity is also high on the airlines' agenda.

2.4 As long as airports are run by commercial enterprises, shareholders and investors are emerging as a new category of stakeholders in their own right. They expect a legal and economic framework encouraging the commercial operation of infrastructure so that investments can yield reasonable returns and they are encouraged to invest in new facilities. The importance of shareholders' interest might increase in view of current privatisation trends.

2.5 Sound economic regulation is appropriate to strike a balance between the demands and expectations coming from different stakeholders and to deal with the above mentioned constraints. The main tasks of regulatory action can be identified as follows: setting up a fair and efficient charging system for the use of airport infrastructure, which is not open to competition, and setting the incentives right to encourage investments and commercial management of the industry.

## **3. Fair and efficient charging**

3.1 Fair and efficient charging of airport infrastructure is instrumental to the achievement of a number of relevant policy objectives: prevention of distortion of competition between airport users and airports themselves; prevention of abuses of dominant position by entities running and using airports; efficient allocation of scarce resources; internalisation of external costs, in particular environmental externalities.

3.2 Ideally a charging system should be able to reflect the true costs of services provided, including a reasonable return on capital but excluding monopolistic profits. In this respect several approaches are available, but regulatory regimes targeting airport charges should continue to be based on the general principles of non-discrimination, cost relatedness and transparency, as laid down in the Statement by the Council to Contracting States on Charges for Airports and Air Navigation Services (DOC 9082/5).

3.3 Cost relatedness in a wider sense requires that charging systems be based on the "user pays" principle, meaning that all users of infrastructure should pay for the costs, including environmental and other external impacts, they impose.<sup>1</sup> This approach, known also as marginal social cost pricing, requires that all variable costs of using infrastructure are taken into account. Marginal cost components can include operating costs, infrastructure damage costs, congestion and scarcity costs, environmental costs. In the long run all costs are variable and therefore marginal costs include also investment costs for new fixed assets. This must be kept in mind when developing rules on pre-financing of investments in airport infrastructure.

3.4 A new feature in the evolution of the airport industry is the emerging of a certain degree of competition between airports. Indeed, there may be some airport substitutability in situations where passengers have a choice between alternative facilities located in the same catchment area, or when airports operating as hubs compete to attract connecting traffic. However, despite the development of inter-airport competition, market forces still play a limited role in this industry, which keeps on being characterised by significant levels of market power. Regulation of pricing based on cost relatedness provides objective and sensible criteria for charge setting. This approach prevent exploitation of monopolistic market power and guarantees that airport users are not discriminated (charged different prices for the same service), with a clear benefit for competition among airlines.

3.5 Sound economic regulation can make a major contribution to the optimal use of existing capacity, both for runways and terminals. Charges can be modulated (peak and off peak charging) in order to take into account congestion and the different level of demand during the day. An especially important issue is the funding of new infrastructure development. A properly designed charging system has also a role to play in the development of new capacity. Investment costs in new facilities needed to satisfy additional demand can be embodied into user charges. The general principle that user charges contain a "pre-financing" element is to be accepted and supported. However this would apply only in cases where public approval to build the infrastructure has been granted and building permits, where needed, have been issued. In addition to that it is important for the users to be consulted on the changes concerning the level of charges.

3.6 Air transport is growing faster than technological and operational advances which reduce environmental impact at source. In particular noise emissions are of concern to airports, since they make airports increasingly little acceptable to neighbouring residents and seriously hinder any expansion plan. The charging system could be an effective tool to deal with noise related issue. First of all landing charges could be modulated so that airlines are rewarded or punished on the basis of the noise performance of their aircraft. In addition to that, if a marginal social cost pricing approach is adopted, user charges could include external costs.

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<sup>1</sup> The European Commission has been developing these concepts in a white paper on "Fair payment for infrastructure use" - COM(98)466

#### **4. Encouraging private investors involvement and commercial management of airport infrastructure**

4.1 Given the constraints on public finance and the search for efficient management practices, there is a tendency in several countries to develop the involvement of private actors in the provision of airport infrastructure in addition to already established self-financing practices. This can take the form of public-private partnership financing of new infrastructure projects, or of incorporation and privatisation of existing airports. However private initiatives in funding and managing airports have to be offered the right conditions and incentives if they are to be successful. This implies reducing some of the uncertainties facing private investors and promoting commercial management of infrastructure.

4.2 The sheer size and complexity of large airport infrastructure projects, and their long-lead times, means that the private sector will only participate if the extent of their uncertainty about a given project is limited. Political commitment to implementation from the public sector is one essential element of this, but the extent to which there are legal uncertainties about a project also needs to be minimised. While the private sector should bear commercial risks, those related to construction costs and future traffic flows, the public bodies concerned should bear non-commercial, or "public policy" risks. Public policy risks can entail project costs increases due to administrative or legislative delays, or unexpected changes in public regulation, e.g. safety or environmental standards. For instance, environmental protection consideration should be addressed in a strategic manner, at the earliest stage in the project planning and development process, in order to reduce uncertainties and public risks linked to environmental policy.<sup>2</sup>

4.3 For privatisation, in particular through foreign investments, to be successful, it is necessary to guarantee open access to international bidders for the market for airport concessions. It is desirable that a true global market for airport concessions develop, where actors can compete on an equal footing. This requires the identification and promotion of common practices on public procurement for airport concessions based on transparent and competitive bidding procedures. In this respect ICAO should offer guidance on how to bring about an appropriate legal and economic framework.

4.4 Evidence shows that when airports are run as commercial undertakings, their financial situation and managerial efficiency improve, whether they are publicly or privately owned. It is therefore desirable that commercial behaviour develop. National authorities should allow airports to be run in a commercial manner, by liberalising services that can be run as market activities but that are still unnecessarily regulated. An example of this is the liberalisation of ground-handling services.

4.5 Discounts on airport charges may be a major piece of commercial behaviour when they are used as an incentive for airlines prepared to start up new service on routes which are not currently served from an airport. Indeed from an economic and commercial standpoint it is sensible that airports and airlines share the risk entailed in developing new business. However such discounts should be designed in such a way that they do not distort competition by imposing on competing airlines different charges for the same service. Therefore they should be non-discriminatory, transparent, temporary and decreasing.

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<sup>2</sup> On these issues see the Communication of the European Commission on "Public-Private Partnership in trans-european transport network projects" - COM(97)453

## 5. Conclusions

5.1 The European Commission believes that fair and efficient charging systems must be based on the principles of non-discrimination, cost relatedness and transparency. However the transformation of the airport industry requires an in-depth debate on how to further develop the existing regulatory framework. The principle of social marginal cost pricing can make an important contribution to such a debate. Moreover it should be recognised the importance to promote:

- the efficient and commercial provision of airports services
- the consultation of users concerning development plans and the level of charges
- the optimal use of existing airport facilities
- an economic and regulatory environment encouraging private investments in airport infrastructure projects
- the establishment of an open and transparent global market for airport concessions.

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