

CONFERENCE ON THE ECONOMICS OF AIRPORTS AND AIR NAVIGATION SERVICES

(Montreal, 19 - 28 June 2000)

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

THE PRINCIPLES OF THE ECONOMIC REGULATION OF AIR NAVIGATION SERVICE PROVISION

(Presented by 29 Contracting States, Members of EUROCONTROL¹)

SUMMARY

The current ICAO policy enables air navigation service providers to recover their costs in providing the service, including a pre-determined cost of capital.

This action paper describes a system of separate and transparent economic regulation of air navigation service provision as an alternative option to existing cost recovery practices.

The Conference is invited to recommend the amendment of paragraph 37 of the *Statements by the Council on Charges for Air Navigation Services* (Doc 9082/5) with a view to reflecting such a system.

1. Background

- 1.1 ICAO policy on cost recovery is articulated in guidelines produced in the form of Council Statements. Although these Statements have no legal force, there is a presumption that States' cost recovery practices will conform with them. The principles in the Council Statements include:

¹ The EUROCONTROL Organisation comprises 29 Member States in Europe and an Agency. The Member States are: Austria, Belgium, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Former Yugoslav Republic of Macedonia, France, Germany, Greece, Hungary, Ireland, Italy, Luxembourg, Malta, Moldova, Monaco, Netherlands, Norway, Portugal, Romania, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, United Kingdom.

- that air navigation service charges levied on international civil aviation are cost-based;
 - that the revenue from air navigation service charges may produce sufficient revenue to provide for a reasonable rate of return on assets (before tax and cost of capital) to contribute towards necessary capital improvements;
 - that the allocation of air navigation service costs among aeronautical users is carried out in a manner equitable to all users.
- 1.2 In addition, the Council Statements attach importance to providers consulting with users when any significant review of existing charges or the imposition of new charges is contemplated. On organisation, ICAO advises that, where it is in the best interests of providers and users, governments may wish to explore the possibility of establishing autonomous authorities to operate their air navigation services, with separation between service provision and regulation.
- 1.3 EUROCONTROL Member States believe that a system of separate and transparent economic regulation based on incentivising providers, as an alternative option to existing cost recovery practices, is consistent with the above ICAO general framework.
- 1.4 The note below is to be read in the context of economic regulation where the service providers are separate from the regulatory authority.

2. Purposes and aims of Regulation

- 2.1 The current ICAO policy enables air navigation service providers to recover their costs in providing the service, including a pre-determined cost of capital.
- 2.2 Air navigation service providers operate in a quasi-monopolistic environment. The ideal role of regulation is to provide incentives through the charging mechanism to encourage an efficient and effective service at the lowest possible cost. Amongst the various methods of promoting performance, the possibility for the service provider to make a fair profit may in certain cases seem appropriate. In practical terms, the aim of regulation is therefore to align the motives of the provider with the objectives of the regulator to maximise general economic welfare, through the setting of the appropriate price (charges) level.

3. Objectives

- 3.1 The objectives of any system of regulation should include:
- furthering the interests of users;
 - encouraging efficiency and value for money in service provision;
 - encouraging investment in time to satisfy reasonable demand;

- ensuring an appropriate quality and level of service provision;
 - having regard to the financial position of the service provider.
- 3.2 The overall aim of an economic regulatory system should be to encourage the autonomous service provider to achieve in the short and the long term the best quality/price mix for users.

4. **Regulatory models**

- 4.1 The choice of regulatory model should be consistent with the objectives at para 3.
- 4.2 Various regulatory models exist but typically they will regulate the price that can be charged (e.g. cost of service, or rate of return regulation; pure price cap regulation; hybrid price cap/rate of return regulation; self-regulation, which may also co-exist with reserve legal powers to regulate more formally). Two broad forms of price regulation can be identified.
- 4.3 Price regulation based on the rate of return : Rate of return regulation, widely used in some States, while effective in preventing excessive profits, gives the provider less incentive to reduce its costs (since it knows prices will simply be set to allow a return on capital employed) and could lead to an incentive to over-invest (since the return is directly linked to the size of the capital employed).
- 4.4 Price regulation based on the price cap model: In such models, prices are set for a predetermined period of years (e.g. 5 years) on the basis of projected demand and costs (including the scope for cost efficiencies) and to allow a reasonable rate of return that encourages investment. Incentives are maximised if the price cap is not varied once it has been set. Service quality and an allowance for possible cost pass-throughs may be taken into account implicitly through the price setting process.
- 4.5 When economic regulation is adopted, it is considered that the price cap model best suits air navigation charges purposes because of its strong incentives on the provider to reduce costs and invest appropriately.

5. **Institutional structure for economic regulation**

- 5.1 There should be a credible and robust institutional structure for economic regulation; the regulator should be separate from the service provider and users, and should not be a direct beneficiary from the financial performance of either the provider or the users. The State should require its regulator to comply with its international obligations. The regulator's objectives and duties should be published, by the competent national authorities, at the time of implementing economic regulation and of any subsequent revision to his objectives and duties. The regulator should be required to demonstrate that he has acted impartially.

6. **Duties of the regulator**

6.1 The regulator's duties will reflect national and international transport policies and priorities as determined by States and/or competent international organisations. Duties specific to air navigation charges should include:

- promoting and participating in meaningful consultation between both the regulator and the service provider (jointly and/or separately) with users;
- setting standards for and ensuring provision of information (including financial and forward-looking) by the service provider;
- conducting periodic reviews of the provider's forecasts, actual costs and income, and ensuring that these are published;
- monitoring and enforcing service standards;
- setting the conditions which govern the maximum charge and allow an efficient service provider to achieve a reasonable rate of return, without excessively constraining its ability to finance the regulated activities;
- ensuring transparency of his own process by publishing his decisions and the reasons for them.

7. User consultation

7.1 States who opt for a system of economic regulation should recognise that user consultation, and the provision of information to users, is an essential part of the process.

8. Recommendation

8.1 The Conference is invited to recommend that the *Statements by the Council to Contracting States on Charges for Airports and Air Navigation Services* (Doc 9082/5) should reflect the principles in this paper. The following additional text (as sub-para 8) is suggested for paragraph 37 of the ICAO Document 9082/5 in the section on air navigation services charging systems:

“If air navigation services for which a State is responsible are entrusted to a service provider which adopts a commercial approach to the setting of prices, the service provider should be subject to economic regulation. In this case, an independent economic regulator separate from the service provider and users should apply controls based on a recognised regulatory approach.

The objectives of any system of regulation should include:

- furthering the interests of users;
- encouraging efficiency and value for money in service provision;

- encouraging investment in time to satisfy reasonable demand;
- ensuring an appropriate quality and level of service provision;
- having regard to the financial position of the service provider.”

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