IATA ECONOMIC BRIEFING

MAY 2006

AIRPORT REGULATION AND CREDIT RATINGS

KEY POINTS

- A properly-functioning independent economic regulatory regime for airports can provide significant benefits to both the airports and to their airline users. If used correctly, it is **not** a "zero-sum" game where a financial gain to one side is equivalent to a financial loss to the other. Both sides can benefit from good regulation, in terms of greater efficiency and low financing costs.
- For airports, a key benefit comes from stable and low debt costs. A well-structured, independent regulatory regime is seen by credit rating agencies as a "credit positive", helping to boost credit ratings and lower debt financing costs. Fair and transparent regulation reduces – not increases – risk and uncertainty for airports. Less risk means that investors provide capital at stable and low rates, supporting investment for long-term growth.
- For airlines, the key-benefit comes from independent oversight to limit airport monopolistic power. Airlines will still have discussions (and disagreements) over some regulatory decisions, but overall will benefit from a fair regulatory regime that incentivises airports to improve efficiency and deliver investment in a timely and cost-effective manner.
- This argument provides additional support for IATA and member airlines' push for greater or improved airport regulation (especially in Europe). ACI adopts the view that "*increased regulation will not create better management or better business results; on the contrary … [it will] increase costs that must be passed through to airlines and to passengers*"[1]. This is wrong. In fact, good regulatory structures – providing better, rather than simply increased, regulation – can deliver improved efficiency and profitability on both sides.

DEVELOPING THE CASE FOR BETTER AIRPORT REGULATION

- IATA has recently highlighted the need for independent economic regulation at major airports. The case put forward has highlighted the inefficiency of several unregulated airports and the high and increasing user charges faced by airlines. In response, ACI argue that regulation merely adds complexity and costs, especially at a time when substanital new investment is required in the sector.
- Evidence from the credit rating agencies shows no sign that airports that face effective, independent economic regulation have higher financing costs. Both BAA and Manchester Airport have solid investment-grade ratings and a stable outlook (see Table 1). Both airports also have an operating cost per passenger of under €12. By contrast, Aeroports de Paris has a slightly higher credit rating (as public ownership provides de facto support from the French Government that lowers the risk of default) but also a much higher cost per passenger – a clear sign of inefficiency. The negative outlook for AdP reflects its move towards private ownership, not the prospect of regulation.
- Therefore, it is not the case that good regulation comes at the expense of higher financing costs and uncertainty, while it also helps to provide the benefit for both sides of greater efficiency.

Table 1: Airport Credit Ratings (November 2005)

Airport	Credit Rating	Outlook	Cost per Passenger (€)
BAA Plc	A+	Stable	11.9
Manchester Airport Group	A	Stable	11.6
Aeroports de Paris	AA	Negative	16.9

Source: "European Airport Credit Survey", Standard & Poor's, November 2005

[1] "Understanding the Airport Business", ACI, April 2006 (page 10)

CREDIT RATING AGENCY VIEW OF THE UK AIRPORT SECTOR

- Standard & Poor's adopt a broad view when assessing the credit rating of UK airports. As expected, the "monopolistic" features of airports, such as low competition and stable earnings are positive factors for lenders (see Table 2). Financiers are in no doubt that airports are in a position of strong market power that ensures a steady and predictable flow of revenue from their airline customers.
- However, the UK regulatory structure for airports is also seen as a positive factor, helping to boost long-term credit ratings. The regulatory regime is seen as supportive (as in fair and flexible, not biased towards airports) and transparent, reducing the risk of arbitrary political intervention or sudden financial changes. The incentive-based regulatory regime supports, not detracts from, stability of operations and delivery of investment to meet future growth.
- Indeed, regulation can also help to mitigate negative factors for credit ratings in the sector. The regularity of regulatory reviews provides important safeguards. It provides a clear and up-to-date information on costs, efficiency and outputs. It helps to provide sufficient liquidity for large investments, where efficiently delivered, and flexibility in the event of negative external factors.
- Airlines may still be opposed to some regulatory decisions (e.g. the cost of capital being set too high), but they have an open and transparent forum in which to argue their case.

Table 2: A Credit Rating Agency View of the UK Airport Sector (BAA and Manchester Airport Group)

Credit Strengths	Credit Weaknesses	Mitigants
• Supportive and transparent regulatory environment, reducing regulatory risk • Low competition • Natural monopoly position and high barriers to entry • Low-risk, predictable earnings and cash-flow generation • Solid operations • Continued growth prospects	• Major capex programme and increase in leverage • Customer concentration and dependence on lower-rated airline sector • Tariff resets • Increased bargaining power of airlines • External events (e.g. avian flu) • Credit quality deterioration following international expansion • Environmental restrictions on expansion • Potential break-up of BAA's London airports	• CAA allowing BAA to fund construction in a stand-alone approach, boosting financial profile • Strength of competitive positions and routes, maintaining traffic stability • Exclusion of the cost of capital from the constructive engagement process with airline users • Adequate liquidity and flexibility to defer capital expenditures

Source: Standard & Poor's presentation, London, May 2006

- The UK regulatory system is not perfect, nor should it be copied wholesale in other countries where there may be different structures and objectives for the airport sector.
- However, it demonstrates that an independent economic regulatory framework can provide both constraints on an airport's "monopolistic" power and a long-term boost to the airport's efficiency, growth and ability to raise finance. Indeed, the current Ferrovial take-over bid for BAA highlights that effective regulation does not reduce the attractiveness of investing in airports. Instead, it ensures that this investment is undertaken for sound financial reasons, not to exploit airline users through higher charges.

Mark Smyth
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E-Mail: economics@iata.org