Economic Regulation

The case for independent economic regulation of airports and air navigation service providers (ANSPs) is clear. It improves efficiency and productivity throughout the aviation industry. It encourages timely and cost effective new investment. It benefits all stakeholders, from the regulated airports and ANSPs to passengers, other users and the wider economy.

IATA believes that independent economic regulation, where needed, should involve detailed cost efficiency targets and service quality standards. It should preferably be based upon price-cap regulation with single-till procedures. Such a system has been successful in improving efficiency where implemented and can be expanded and improved to meet changing investment needs. It can be highly effective in improving the aviation industry for the benefit of all stakeholders.

The Scope of Economic Regulation

All airports and ANSPs must be subject to ICAO principles in setting user charges, including transparency, consultation and cost-relatedness. However, more detailed economic regulation of user charges, cost efficiency targets and service quality standards is also required where market power exists and can be exploited. The need for good, independent economic regulation exists whether an airport or ANSP is publicly or privately owned.

For airports, detailed economic regulation should be imposed unless they are small operators in relation to the relevant market or, in exceptional cases, can clearly prove that they face significant market competition. As such, economic regulation should exist, unless:

(i) an airport falls below an agreed threshold level based on their size relevant to the market, or

(ii) in an exceptional case, an airport is above the threshold level, but a thorough market contestability test can clearly demonstrate the existence of sufficient competitive market constraints to prevent them from exploiting any monopoly power.

However, even in the case of (ii), it is also important to ensure that a clear process is established for the test to be reviewed, especially after a change of airport ownership, and for economic regulation to be re-imposed if conditions have changed.

The Mutual Benefits of Good Regulation

A well-designed and effective framework can provide benefits for both users and for regulated companies. An incentive-led process helps to improve efficiency and the business investment planning process, through consultation with users who can provide constructive help. Independent and transparent economic regulation can reduce uncertainty on both sides, helping to reduce investor risks and financing costs. The stability provided by an effective regulatory framework can also attract longer-term investment finance into the industry, avoiding the potential volatility in infrastructure asset prices driven by short-term speculative finance.

Key Principles of Independent Economic Regulation

Appropriateness: Regulation should focus on airports and ANSPs that have clear natural monopoly characteristics that allow them to exploit their market power in setting charges. The detail and complexity required for regulation should be considered on a case-by-case basis, in order to ensure that the cost of regulation does not exceed its potential benefits.

No cross-subsidisation: Regulation should be undertaken at an individual airport or ANSP level, with the decisions made on a basis appropriate to the key objectives in each case. System regulation, that sets a price cap for more than one airport or ANSP, can lead to sub-optimal decisions.

Non-discrimination: In accordance with ICAO policies, the regulatory structure should not distinguish between different types of users. The consultation process should be open to a range of stakeholders and the regulatory decisions should be applied on a non-discriminatory basis for users. Regulators should take into account the interests of existing users while safeguarding the rights for future potential users.
Key Recommendations for the Framework of Independent Economic Regulation

In developing an effective system of economic regulation for airports and ANSPs, governments and regulators should ensure that they meet the following key criteria:

**Independence** from direct control by governments or airport authorities. Regulators should be given clear objectives, or statutory duties, and then provided with the resources and operational independence to meet these principles.

**Transparency** of both the process for regulatory decisions and of the expenditure and investment plans of the regulated company. The detail required should be appropriate to each case, helping to minimise the regulatory cost.

**Full and timely consultation** with airlines users on operational and investment plans. This should include incentive and penalty measures designed to ensure that airports and ANSPs approach the consultation openly and constructively.

**Length of agreements.** Regulatory reviews should normally cover periods in the order of four to five years. This provides sufficient time for a regulated company to develop procedures, implement changes and extract cost efficiencies.

**Flexibility** to adapt to significant external shocks, appropriate to the level of risk the company can reasonably be expected to bear. However, this flexibility, if used, should not undermine the longer-term credibility of regulation.

**A neutral dispute settlement mechanism** for appeals against the regulator’s decisions. Typically the neutral body will be an appellate body or the national competition authority. This helps to minimize the risk that the regulatory body itself can reach sub-optimal decisions.

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**FULL REPORT**

For a copy of the full report and further economic analysis of the airline industry, please visit: [www.iata.org/economics](http://www.iata.org/economics)

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Key Recommendations for Regulatory Practice

The regulatory framework provides the platform for improvement, but an effective process also needs to be established. This helps to ensure that the appropriate incentives for cost efficiency, service quality and user consultation are in place and helps to minimise the risk of regulatory failure. IATA proposes that the following key criteria should be met:

**Cost efficiency targets and service quality standards.** The CPI-X mechanism, or a variant of it, is the most appropriate mechanism for incentivising improvements in cost efficiency and service quality. However, it must be designed to provide a balance between the risk of an excessive regulatory burden and the risk of setting charges on the basis of historic rather than achievable lower costs.

**Single-till regulation.** A single till approach determines the level of revenue and return required and the user charges to be set on the basis of all services at an airport, irrespective of whether they are aeronautical or non-aeronautical. Single-till regulation provides strong incentives for efficiency and productivity improvements.

**Regulatory benchmarking.** There will be many common aspects between the regulatory process for different airports and ANSPs. As such, a forum should be available for best-practice benchmarking, both in terms of revealing additional information for the regulator and for regulated companies and users to assess the performance of their regulators.

**Commercial negotiations for investment.** Airline users should be closely involved in the planning, design and timing of new investment decisions, with regulatory oversight to ensure discussions can proceed on a fair and transparent basis. However, while it is important to consult airline users, they should only pay for investment through charges levied on an as-used basis and not through pre-financing mechanisms.

**Cost of capital return.** The cost of capital needs to take closer account of actual financing costs and risk profiles. In some cases, the regulator has erred too much on the side of caution, allowing a cost of capital that exceeds the actual financing costs faced by a firm. This provides an over-generous return to the regulated company at the direct expense of users.

**Asset valuation.** It is essential that the asset base on which airports and ANSPs are allowed to earn regulated returns is set in accordance with the investment undertaken and the risk borne. Artificial increases in asset values should not lead to increases in charges, they simply hand a windfall gain to an airport or ANSP.

A regulatory structure that incorporates the recommendations set out above can improve the relationship between airports, ANSPs and users, to the benefit of all stakeholders in the industry.