

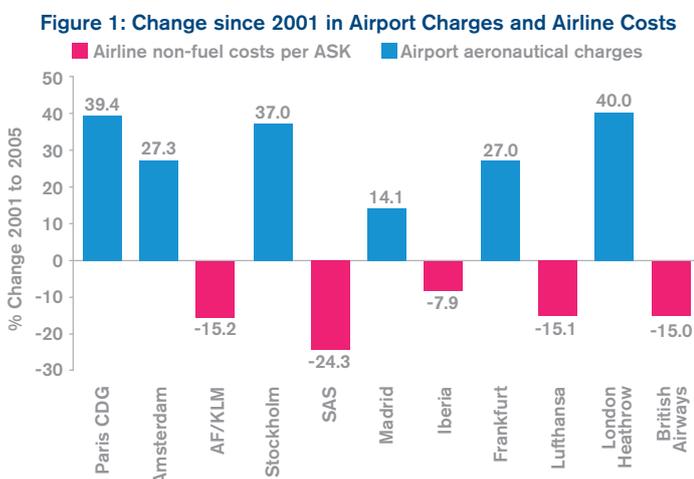
Economic Regulation

➤ The case for independent economic regulation of European airports 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 to passengers, other users and the wider economy.

European airports are, for the most part, natural monopolies with market power. They face very limited competition from other airports in their city or regional market, in terms of competition for airline customers and routes. Any competition between major hub airports for transfer passengers primarily reflects competition between the fares, service and routes provided by different airlines rather than between the airports themselves. Market power allows an airport to arbitrarily raise its prices, resulting in excessive and unjustified profits and/or the inefficient delivery of services. Economic regulation is both necessary and desirable to constrain this market power in order to deliver continuous improvements in cost efficiency and service quality.

The Need for Economic Regulation

European airports have the potential to exploit (and, in many cases, actually are exploiting) their natural monopoly position. Over the last five years, European airlines have significantly improved their efficiency and lowered their non-fuel unit costs. However, our infrastructure partners have, in general, not shared in this efficiency drive. Instead, as their costs have increased they have sought to pass this on to users through significantly higher charges (see Figure 1).



The need for greater infrastructure efficiency is clear. Infrastructure user charges represent a significant cost for airlines. For example, European airports received nearly

€12 billion in aeronautical revenues from airlines and their passengers in 2005.

Independent economic regulation acts as a powerful catalyst for improving cost-efficiency and delivering cost-effective investment. Regulation is a second-best solution to effective competition, but where such competition does not exist – as for many European airports – it is both necessary and valuable. An effective regulatory framework provides the platform for improvement but it must also seek to minimise the risk of regulators making wrong decisions (e.g. in allowing too high a cost-of-capital return) due to caution or an insufficient availability of information. The UK has a strong regulatory framework, but has seen a significant increase in user charges at Heathrow since 2001 (albeit from a relatively low level), with further large increases proposed. Though linked to investment, the size of the higher charges may also reflect a too generous settlement by the regulator.

The Scope of Economic Regulation

All airports 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 is publicly or privately owned.

For European 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. Economic regulation should exist for all airports above an agreed threshold level – based on their size relevant to the market – unless a thorough market contestability test can clearly demonstrate the existence of sufficient competitive market constraints (e.g. competition for seasonal leisure traffic, competition from other modes) to prevent them from exploiting any monopoly power. However, even where significant competition can currently be demonstrated to exist, it is important to ensure that a clear process is established for the test to be reviewed, especially after a change of airport ownership, and for detailed 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, often 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 Recommendations for the Framework of Independent Economic Regulation

In developing an effective system of economic regulation for airports in Europe, 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 the process by which regulatory decisions are made 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.

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.

Full and timely consultation with airline users on operational and investment plans. This should include incentive and penalty measures designed to ensure that airport representatives approach the consultation in an open and constructive manner.

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.

No cross-subsidisation. Regulation is undertaken at an individual level, with the decisions made reflecting the key objectives for each airport. System regulation of more than one airport can lead to sub-optimal outcomes.

Non-discrimination. The regulatory structure should not distinguish between different types of users. Regulators should take into account the interests of existing users while safeguarding the rights for future potential users.

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.

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 creating the right incentives for continuous 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. As such, a forum should be available for best-practice benchmarking, 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 mechanism.

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 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.



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