

A New Agenda in Airport Regulation Enters Service

By Simon Morris, ICF

Abstract

The classic model of airport regulation in which a regulator imposes prices on an airport is becoming increasingly out of date. Instead, a new agenda for regulation has emerged based on commercial negotiation between airport and airlines with the regulator intervening only if absolutely required. In this new facilitation-based regulation agenda, the role of the regulator changes from 'What solution should we impose?' to 'How can we assist parties to reach their own solutions'?

The facilitation-based regulation agenda provides a far less burdensome regulatory process and has considerable advantages to airports, airlines, and other stakeholders by enabling them to manage the process and shape solutions to meet their needs, including capital expenditure, service, operations, and traffic development as well as prices. Investors are likely to prefer this approach, as it avoids the periodic risks associated with successive regulatory processes. The specific features of the facilitation-based regulation agenda vary among countries. The very different contexts of Copenhagen's and London's airport systems illustrate the facilitation-based agenda in practice.

A Changing Airport Regulation Landscape

Formal economic regulation of airports originally emerged in 1986 alongside the privatisation of airports in the United Kingdom. In line with privatisations in other industries, UK airport privatisation initially followed the now-classic utility model

of regulation: prices at major airports were set for successive 5-year periods by an independent regulator on the basis of a price formula linked to inflation—known then as RPI-X, with RPI being an inflation measure and X being linked to 'efficiency'. In the United Kingdom, this was developed into a model of heavy-handed airport regulation based on operating and capital cost forecasts less commercial revenue (known as the single till approach). Airlines were allowed to make submissions—almost invariably negative in tone—but were not involved in the final price setting.

While questions and criticisms arose concerning the details of the way in which the method was applied (e.g., Was the capital expenditure gold plated? Was the cost of capital too high?), this approach was frequently seen as the ideal to be aspired to by other countries—even if they lacked the resources, information, and expertise to apply it.

Despite this perceived ideal, a wide range of other regulatory approaches has emerged across the world. These approaches have been designed to deal practically with the circumstances in specific countries, and they rely much less on the intervention of an omniscient regulator. Most of the approaches have involved airports and airlines getting together in one way or another to set prices. They have required far fewer processes and less expertise to get things done and—equally importantly in many cases—they generally have been far less expensive.

Over time, these individual—and in many cases unheralded—developments have begun to evolve into a cohesive whole that we may now describe as the facilitation-based regulation agenda. The results of this agenda now look to be more effective in most circumstances than the old orthodoxy.

Facilitation-Based Regulation Agenda

The facilitation-based regulation agenda is concerned with finding workable, practical, and sustainable solutions secured through negotiations between the parties involved as much as possible rather than a regulator imposing outcomes on the parties.

The facilitation-based agenda can potentially cover a range of concerns. However, there are four central issues:

- Are formal price controls necessary in the circumstances of specific airports?
- Can prices and other regulatory concerns (such as service and capital expenditure) be dealt with through negotiations?
- How can price-setting approaches give room for commercial give and take?
- Can we find ways to deal with high-risk, long-term investments that do not fit into conventional regulatory approaches?

Taking each of these issues in more detail:

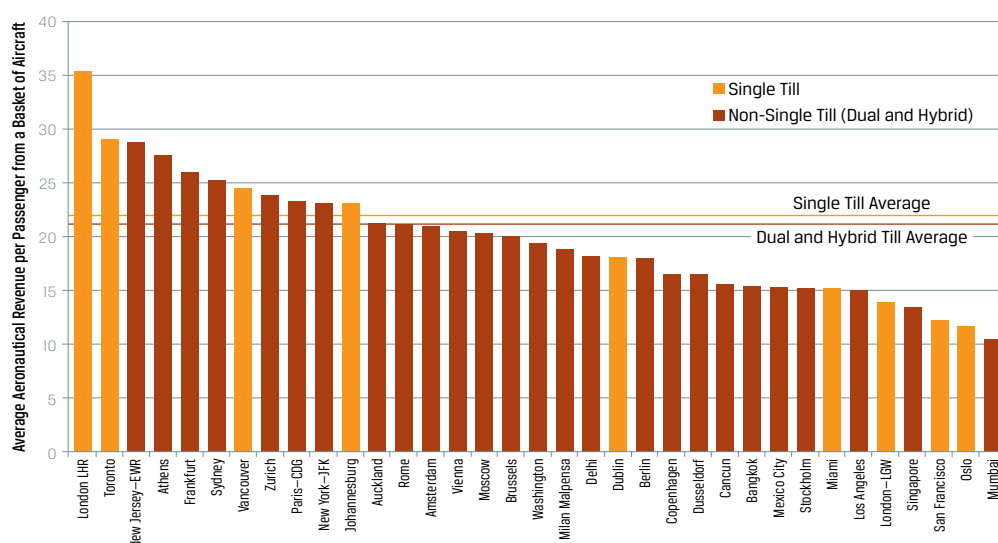
Deregulation where possible: There is increasing recognition that many airports face competition in a variety of forms, putting downward pressure on prices.

As a result, normal price controls may not be needed at all in many situations under a facilitation-based regulation agenda. Alternatively (or in combination), the possibility of imposing tougher regulation in the event of abuse of dominant position can be enough to promote good behaviour. In Australia, for example, the main airports are regulated only through annual price and performance monitoring, coupled with periodic reviews of airport behaviour.

Use of commercial negotiations: In a facilitation-based regulation agenda, instead of imposed regulation, prices and other issues can often be set through commercial negotiation. Where required, the regulator can set the process for the negotiation and act as a fall back in the case of nonagreement.

Cost approaches that allow flexibility: The classic single till approaches supported by the International Air Transport Association (IATA), under which all commercial income is applied to reducing airport charges, are effectively cost plus systems. They provide little or no room for give and take in reaching commercial agreement without the airport ending with returns below its cost of capital. Dual till and increasingly hybrid¹ approaches—under which at least part of commercial income and costs are retained by the airport—mean that the airport has room to make concessions without becoming nonviable. Previously, it was thought that this flexibility would cause higher prices. However, there is evidence that the stronger incentives for efficiency in capital and operating cost expenditure under dual or hybrid till approaches may, over time, lead to charges that are similar to, or lower than, those under pure cost plus single till approaches. At the very least—as depicted in the accompanying bar chart—there is no clear evidence of a single till advantage with single till airports at both the upper and lower ends of the range.

EXHIBIT 1. AIRPORT CHARGES (US\$) AT SINGLE TILL AIRPORTS COMPARED WITH DUAL AND HYBRID TILL AIRPORTS



Source: ICF analysis with data derived from Leigh Fisher reports

¹ For further discussion see 'In Praise of Hybrids' R Sharp Journal of Airport Management Vol 7 Number 1, 2012.



More robust and long-term price setting processes for high-risk, long-term investments:

Many countries face the crucial issue of sustaining major expenditure in areas such as new terminals, runways, or new airports while trying to avoid the heavily front-end loaded charges required by traditional cost-based regulatory processes. These problems arise from the fact that costs of new facilities that have not been eroded by depreciation or inflation are highest at a time when the level of utilisation—and therefore the charging units over which costs can be spread—are at their lowest. The size of such developments is also likely to make them higher risk. Avoiding these problems requires the use of long-term approaches rather than typical 5-year reviews. The solution is likely to be outside the conventional regulation pattern, and to require commercial negotiation.

Overall, the facilitation-based regulation agenda is likely to create a much more commercial, market-orientated, and flexible approach to regulation than the traditional model.

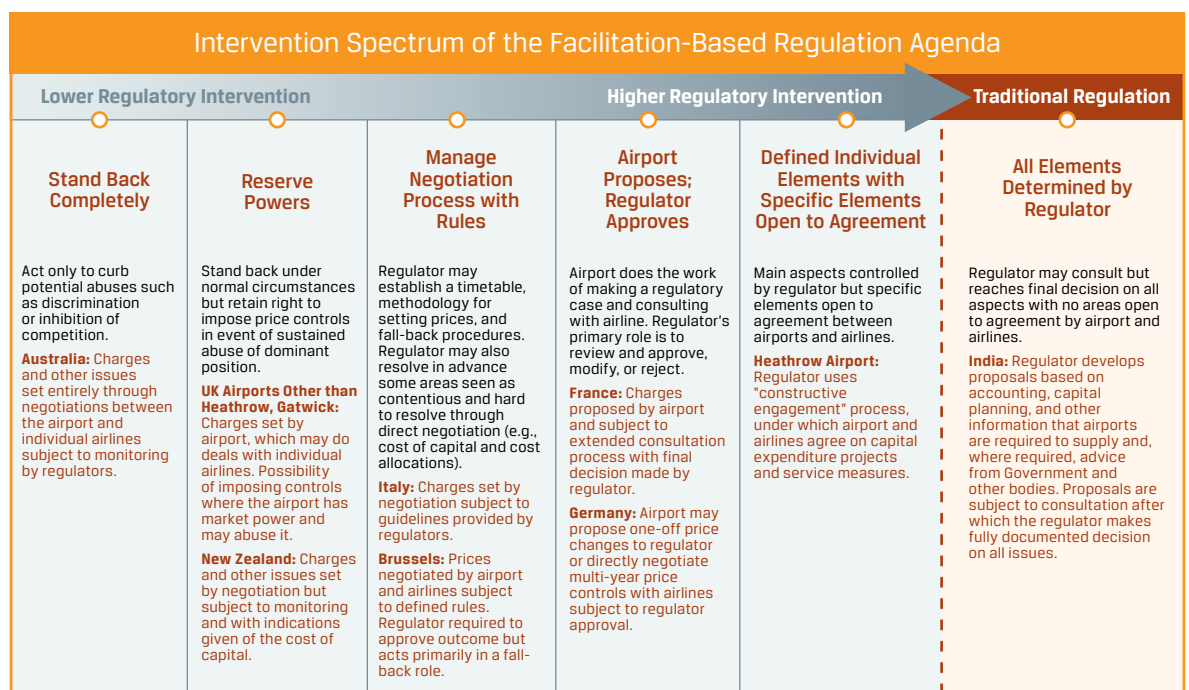
Issue	Facilitation-Based Regulation Agenda	Traditional Regulation
Are formal price controls necessary with deregulation?	<ul style="list-style-type: none"> May not be needed as competition and the countervailing power of airlines may put downward pressure on prices Threat of controls can also be used as effective deterrence to market abuse 	<ul style="list-style-type: none"> Perceived as needed to control airport
Can prices and other regulatory concerns (such as service and capital expenditure) be dealt with through negotiations?	<ul style="list-style-type: none"> Generally yes 	<ul style="list-style-type: none"> No
Do price-setting approaches give room for commercial give and take?	<ul style="list-style-type: none"> Of central importance for negotiation to work Favours hybrid and dual till approaches 	<ul style="list-style-type: none"> Not relevant
Can high-risk, long-term investments that do not fit into conventional regulatory approaches be addressed?	<ul style="list-style-type: none"> Requires innovative solutions that may not fit traditional models 	<ul style="list-style-type: none"> Outside the scope of consideration

New Roles for New Regulators

With the new, more commercial approach to regulation under the facilitation-based regulation agenda comes a requirement for a very different role on the part of regulators. Put simply, much of what regulators do will change from determining and imposing outcomes to assisting airlines and airports with finding collective solutions.

Not all facilitation-based regulation agenda approaches have adopted all aspects of the new agenda. Individual countries have selected points that reflect their own specific requirements along a regulatory intervention spectrum applying a range of approaches as portrayed in the exhibit below.

EXHIBIT 2. INTERVENTION SPECTRUM



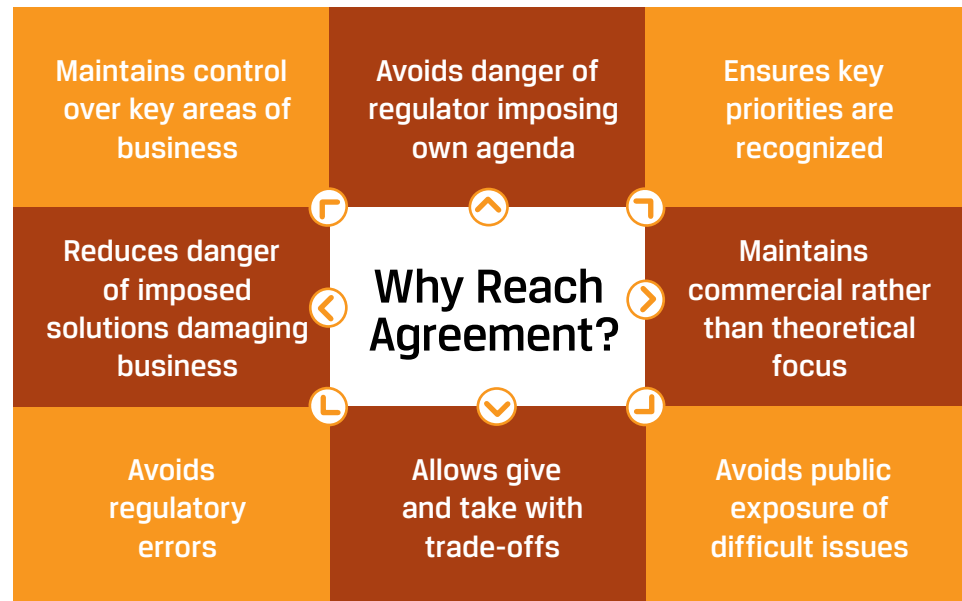
Regulators and Negotiations

Some regulators are careful not to become involved in negotiations in order to avoid compromising any final decisions, should they need to be made. Other regulators believe that the process of reaching agreement is better promoted by a more active management role. They may, for example, set agendas and sit in as observers on the formal consultation sessions—though there should also be scope for less-formal meetings (including one-to-one meetings with individual airlines), which may facilitate reaching a final decision.

At first sight, it might seem that one or other parties involved in the commercial negotiations would be likely to see an advantage to triggering intervention by the regulators in their fall-back role. However, this would underestimate the benefits

perceived by both parties in managing their own destinies and ensuring that the issues of central importance to them are not vulnerable to the decisions of third-party regulators, who would inevitably have agendas of their own. Some of the benefits of reaching agreement between the parties are shown in the diagram below:

EXHIBIT 3. WHY REACH AGREEMENT



Benefits of the Facilitation-Based Regulation Agenda

In many cases, a facilitation-based regulation agenda may suggest that formal regulation is unnecessary and that competition—possibly backed by the threat of imposition of controls in the event of market abuse—may be enough. However, where regulatory involvement is necessary, the facilitation-based regulation agenda has substantial benefits for airlines, airports, regulators, and investors, as it:

- **Addresses** all important issues to airlines and their passengers, potentially covering capital expenditure, service, marketing, and operational issues—not just price levels and structures.
- **Enables** proper prominence to be given both to establishing the investments needed by users and how very major projects—such as new runways, terminals, or entire airports—are to be financed over a substantial time period.
- **Reduces** regulatory costs substantially for all parties. Discussions between airports and airlines can be much more focused and cost effective without the series of dense and long (several hundred pages) documents that regulators in India or the United Kingdom, for example, have regularly produced as a matter of course.

- **Avoids** the need for substantial levels of specific expertise (and the bureaucracy required to support it) on the part of the regulator. The work done for the review can primarily be undertaken by the airports and the airlines with the regulator, if required, acting primarily in a reviewing role.
- **Decreases** both the likelihood of regulatory failure and its consequences, offering comfort to existing and potential investors. The parties are directly involved in the issues with which they are dealing and therefore have strong interests in providing robust, workable solutions. If the results do eventually cause problems, the parties can quite reasonably be expected to bear the consequences of their own negotiating decisions rather than of settlements imposed on them by third parties.
- **Encourages** positive commercial attitude between airports and airlines. Normal trading agreements between established suppliers and customers offer a process of give and take between parties. This process reduces the likelihood of negative public posturing that appears to be characteristic of parties in the course of standard regulation based on a 'zero-sum' outcome, which inevitably reduces the likelihood of future trust and cooperation.

Case Studies

Copenhagen

While other examples, such as Australia, have been more widely heralded, Copenhagen has a long tradition of operating under what we would now describe as a facilitation-based regulation agenda, which has been evolving over time.

Under the revised approach established in 2009, charges are primarily set between the airport and airlines, though with the possibility of the regulator (the Danish Transport Authority) acting in a fall-back role in the event of a sustained failure to agree.

Key aspects of the Copenhagen system include the following:

- The airport and airlines are required to agree on price controls over a period of time, with a default position of 4 years (in the initial setting under this system, the airport and airlines effectively agreed on a 5.5-year formula).
- Reaching agreement follows a timetable specified by the regulator. This commences with the airport making a proposal supported by a prescribed information package covering historic and forecast traffic, costs, income, and capital expenditure, together with price and efficiency comparisons.
- In the event of failure to reach agreement, the regulator will set charges using a fall-back procedure.
- No methodology is specified for setting agreed prices between the airport and airlines. However, a move to fall back will require the adoption of a closely specified regulatory approach. Inevitably, the perceived likely outcome of a possible fall-back approach will have an important bearing on



the expectations of the parties and on the negotiation range for the final agreement reached.

- The price methodology in the fall-back position is based on a hybrid till approach with the airport charges subsidised by a proportion of the non-aeronautical revenue less all costs including the cost of capital. The level of this contribution is between 10 and 50 percent, with the level chosen depending on whether the airport has been able to maintain the competitiveness of charges against comparable rival airports.
- To assist the parties in assessing the possible outcomes of a fall-back approach, at the outset of the consultation process the regulator specifies the cost of capital and the asset and cost allocations that would be applied in a fall back. The asset and cost allocations are made following a review of the airport's own estimation methodology and the results of the review.

Two major agreements between the airport and airlines have now been reached under this system covering, successively, a 5.5- and a 4-year period. In addition, a separate agreement deals with the charges for the use of a low-cost pier. In each case, agreements were achieved between the airport and airlines after tough negotiations, without the need for intervention by the regulator—though the regulator was present at formal consultation sessions. As in some cases elsewhere, the agreements have covered capital expenditure, operational issues, service, and price structures in addition to price levels. As a consequence of the agreements, the airport has achieved a sustainable basis for its investment in the future and strong incentives to continue to improve its efficiency, while at the same time protecting the interests of airlines and passengers. Prices at Copenhagen continue to be low compared to its Northern European peers.

Although there were areas where the airlines or the airport could complain that the outcome did not meet all their aspirations, the approach appears to have operated successfully and robustly in practice. In most good commercial negotiations, the expectation is that each side gets something, but neither gets everything.

UK—Major South East Airports

Until the last 5-year regulatory review ending in 2014, the major airports in the London area (Heathrow, Gatwick, and Stansted) were all operated by BAA and regulated using a traditional, heavy-handed, regulatory approach.

However, two developments had a major impact on the way these airports have been approached by their regulator, the UK Civil Aviation Authority (CAA):

- The breakup of the former BAA with both Gatwick and Stansted being sold to other parties in the interests of promoting competition, leaving Heathrow Airport Holdings Limited as a successor company.
- The passing of new legislation giving the CAA considerably more flexibility on regulation; under this new legislation, price controls in any form are considered only when the airport fails a market power test—effectively where there is a prospect of abuse of a dominant position.

The additional freedom provided to the CAA has enabled them to move substantially away from their 28-year historically traditional regulator-imposed methodology. The result has been to create a nuanced approach for the three airports that reflects many facilitation-based regulation agenda issues:

- **Stansted**, which had recently agreed upon deals with its main suppliers (easyJet and Ryanair), reflecting its competitive environment, was moved out of price controls. The CAA saw it as facing substantial airline countervailing power in a competitive market. The absence of price controls has brought Stansted into line with other airports in the South East region, such as Luton and London City.
- **Gatwick**, which had unilaterally produced a set of guarantees on prices and other issues and declared its intention of negotiating price agreements with its airlines, was also moved out of price controls. However, its pricing has been made subject to monitoring by CAA to ensure prices remain low, with the clear threat of reimposing price controls if the airport does not act appropriately.
- Only **Heathrow**, where capacity is highly constrained (98 percent of available slots year-round are used) and where the airport is seen as retaining substantial market power, remains under conventional price controls. These are essentially a continuation of the previous single till regime.

The CAA has specified that when, following a decision by the UK Government, a new runway is specified for Heathrow or Gatwick, the airport concerned should seek to reach a long-term agreement with its airlines. This agreement would cover charges and other relevant provisions over the lifetime of the asset. The CAA would review the agreement to ensure that it was in line with the public interest (and would presumably act as a fall back if no agreement was achieved) but would not be directly involved in negotiations.

From having three traditionally regulated airports, the UK currently has only one. It remains to be seen whether even this will continue into the long-term future, especially given the proposal discussed above for negotiating charges associated with any new runway. It is significant that Gatwick and Stansted, now released from heavy-handed controls, handle 39 million and 21 million passengers per year respectively—much larger than many airports throughout the world where regulation has previously been thought to be necessary.

Conclusions

The facilitation-based regulation agenda represents a more grown up view of regulation, which has powerful advantages over the old orthodoxy. Airports in countries around the world have shown that the facilitation-based regulation agenda can be thoroughly workable. It also allows settlements to be reached between the parties who have most to gain and lose—and who most of all will need to live with the outcome once it has been reached.

About ICF

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The new task is to learn systematically which facilitation-based regulation agenda approaches work most effectively and when. To encourage that learning, we need a general understanding that the facilitation-based regulation agenda is not a second best for those airports with problems implementing an orthodox ideal. Facilitation-based regulation should now become the default option, offering the best outcomes for airports, airlines, regulators, and investors alike.

About the Author





Simon Morris has more than 20 years of experience in the aviation industry, and his expertise primarily lies in business planning. He leads the London Airport team in projects worldwide, building on work in due diligence and comprehensive business and strategic planning for owners, investors, and private-sector interests.

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