



International Civil Aviation Organization

WORKING PAPER

CEANS-WP/49

8/9/08

English only

CONFERENCE ON THE ECONOMICS OF AIRPORTS AND AIR NAVIGATION SERVICES

Montréal, 15 to 20 September 2008

Agenda Item 2: Specific issues related to airport economics and management

2.2: Cost basis for charges

Agenda Item 3: Specific issues related to air navigation services economics and management

3.2: Cost basis for charges

RELATIONSHIP BETWEEN RISK AND RETURN

(Presented by the International Air Transport Association (IATA))

SUMMARY

There are great differences in market conditions for individual service providers. Regardless of the methodology to calculate the rate of return, there should be a stronger focus on the relationship between the risk and the allowable rate of return.

Action by the Conference is in paragraph 5.

1. INTRODUCTION

1.1 The rate of return of providers measures the profitability of an asset over a specified period and is calculated by dividing the operating surplus by the total capital. WP/9 submitted by the ICAO Secretariat discusses a method to determine a reasonable rate of return on assets for both airports and air navigation services providers (ANSPs).

1.2 One missing element in WP/9 is the relationship between the risk of doing business and the rate of return. This paper tries to focus on that specific topic.

2. DISCUSSION

2.1 As mentioned in Paragraph 2.1 of WP/9, "it is important for regulators, in performing their economic oversight functions, to have a clear definition of what is a *reasonable* rate of return on

assets for the service providers, together with a methodology to assess it". In addition to this statement, there is also a need for a clear definition on the allowable value of these assets.

2.2 A reasonable rate of return must be set at an appropriate and realistic level that ensures the most cost effective method of financing of the airport or ANSP. It must reflect a fair balance between risk and reward for the regulated company, maintaining close relation to the actual financing costs.

2.3 There are a series of methodologies for determining a rate of return. A standard, and widely used methodology is the Weighted Average Cost of Capital (WACC). However, regardless of the methodology adopted, the principle for determining the return should remain the same. A reasonable rate of return allowed for airports and ANSPs should reflect the risks these face.

2.4 For instance, airports or ANSPs under a full cost recovery system face a significantly low risk. This is due to the fact that any unforeseen additional costs will be passed on to airspace users. As such a reasonable return should be fairly close to the "risk-free" rate. A commonly-used approximation of a "risk-free" rate is the cost of government bonds. EUROCONTROL is currently recommending this approach¹. Airports or ANSPs where shareholder equity is at stake (i.e. those under a price cap regulation) and therefore facing a relatively higher risk should be compensated accordingly.

3. CONCLUSIONS

3.1 There are great differences in market conditions of individual providers. Regardless of the methodology, the principle for determining the rate of return should remain the same. There should be a clear relationship between the risk and the allowable rate of return.

- a) States should set a reasonable rate of return in their economic regulation based on the level of risk of their providers. A commonly-used approximation of a "risk-free" rate used for service providers is the cost of government bonds.
- b) For those airports or ANSPs where shareholder equity is at stake (i.e. those under a price cap regulation) economic regulation should allow for compensation in line with the risk.

3.2 In addition, the following changes to the conclusions in the ICAO Secretariat's WP/9 (shown in a track-change mode) should be made:

- a) In performing their economic oversight function, States should, where necessary and in light of the local circumstances, clearly define what is a reasonable rate of return on assets *and a reasonable value of such assets* for their service providers.
- b) ICAO should develop additional guidance material regarding possible methodologies to assess a reasonable rate of return on assets *and a reasonable value of such assets* for service providers. The development of such guidance material would, in due course, be the basis to determine whether ICAO should develop additional policies on the subject matter.

¹ "Guidance on the Rules and Procedures of the Route Charges system", Paragraph 65. Eurocontrol, October 2003.

4. PROPOSED AMENDMENT OF POLICIES

4.1 IATA recommends the following text to amend paragraphs 22 and 28 of Doc 9082 (shown in a track-change mode):

Paragraph 22 vii)

Airports may produce sufficient revenues to exceed all direct and indirect operating costs (including general administration, etc.) and so provide for a reasonable return on assets at a sufficient level to secure financing on favourable terms in capital markets for the purpose of investing in new or expanded airport infrastructure and, where relevant, to remunerate adequately holders of airport equity. A reasonable rate of return should reflect the risks the airport faces. If the airport faces significantly low risks (i.e. under a guaranteed full cost recovery system), then a reasonable rate of return should be close to the “risk free” rate, such as the cost of benchmark government bonds, avoiding any double counting of inflation.

Paragraph 38 v)

Air navigation services may produce sufficient revenues to exceed all direct and indirect operating costs and so provide for a reasonable return on assets (before tax and cost of capital) to contribute towards necessary capital improvements. A reasonable rate of return should reflect the risks the provider of air navigation services faces. If the provider of air navigation services faces significantly low risks (i.e. under a guaranteed full cost recovery), then a reasonable rate of return should be close to the “risk free” rate, such as the cost of benchmark government bonds, avoiding any double counting of inflation.

5. ACTION BY THE CONFERENCE

5.1 The Conference is invited to:

- a) review and adopt the conclusions (including the changes made to the conclusions in WP/9) in paragraph 3; and
- b) adopt the proposed changes in paragraph 4 to Doc 9082 (paragraphs 22 and 38).

— END —