Avoiding Pitfalls of Regulations in Airport Privatization

A Presentation

For

Sri Ajay Prasad, Secretary

Department of Civil Aviation

INDIA

Given By

Peter Bysouth

IATA Assistant Director Asia Pacific

<u>Avoiding Pitfalls of Regulations in Airport Privatization</u>

Nature of Economic Regulation in Airports:

Different levels of regulation covering all aspects of service provisions apply to airports:-

- (I) <u>Direct controls</u> include economic regulation, monopoly control, environmental and security controls;
- (II) <u>Indirect controls</u> include aero politics (bilateral), slot allocation, competition, planning restriction, Customs and Immigration

(B) The rational for economic regulation in Airport Privatization

Economic regulation has a number of functions:-

- to act in the place of the market,
- to protect airport users from profiteering/overcharge which can be incentivised by privatization,
- to encourage economic efficiency,
- to promote appropriate levels of investment to meet the needs of users,
- to ensure conformity with international obligations and
- to prevent broader monopoly abuse.

Meeting these needs does not necessarily require formal price control. Competition or other forces may operate effectively to meet the needs of users, without the need for Government intervention

C. Characteristics of economic regulation

- The best systems of economic regulations are judged by investors by their fairness to both users and providers, transparency, predictability and stability. This gives lower risks and high long term returns to airport investors.
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- Degree of economic regulation- Government has to choose between active and passive regulation. Active regulation is generally imposed in privatization process and management of airport operation.

D. Nature of Airport Charges

Airport charges are historically based on principle of:-

- **Non-discrimination**- Services are available to all users on same terms.
- **Cost recovery principle**- Recovery of investment incurred.

Ground rules for airport tariffs are laid down by superanational organizations.

ICAO states that users should bear full and fair share of using airport facilities whereas IATA insists that airport should recover reasonable costs.

(LETS DISCUSS IN QUESTION TIME ?)

E. The identity of the regulator

Regulation is normally undertaken by one of four types:-

The Courts (can be expensive cumbersome and unwieldy)

Government Department (danger of political interference)

Independent Industry Specific Regulator (needs wider com experience)

Independent General Regulator (needs industry specific knowledge

- Combinations of these are possible. In the UK the prime regulator is industry specific (the Civil Aviation Authority CAA). However CAA is advised by the Competition Commission (who can act as an appeal body).
- ***Airports are normally best served by a good independent and politically neutral regulator backed by a strong team but with clearly established provision for appeal.***

F. **Individual Vs. System Airport Regulation:-**

- • Economic regulation can be structured around single airport or whole airports system
- • Individual airport regulation is followed where airports serve different markets and demand for services is largely independent.
- • System regulation is appropriate where airport serves the same market and there is interdependence.
- • In individual regulation, users only pay for the investment from which they directly benefit. In system regulation cross-subsidization is also permissible between airports.

G. Quality of service provision

Economic regulation incorporate provisions to ensure quality of service by airports as better services are more important for airlines than price.

Quality of service provision may include :-

- (I) Service level agreements between airport operator and airlines with disputes resolved by the regulator.
- (II) Quality of service monitoring against set targets by the regulator.
- (III) Quality performance targets and allowing rebates if targets not met.

H. Different regulatory approaches

Methods of control are typically of 3 types:-

Formal price controls - normally limited to aeronautical charges and
Specific provisions to avoid monopoly abuse, for example:-

- overcharging or the imposition of unfair terms and conditions
- discrimination;
- unreasonable limitation of competition (especially operations run by the airport itself);
- predatory pricing

- **Normal market forces** - appropriate in competitive areas (especially in landside operations)

I. Alternatives to formal regulation

Formal regulation is not the only way of putting downward pressure on aeronautical charges. Other mechanisms:-

- – **Competition -** Airports may face potential competition for a wide range of their traffic
- – **Negotiation with powerful Airlines-** Airlines operate in a high profile, business and can often secure high levels of Government and public support. Airports are rarely as well regarded.
- – **Regulatory Threat** - Downward pressure on prices can arise from the threat that regulation will be imposed if the airport abuses its monopoly, or does not meet the reasonable needs of its users. Used for example in:-

  UK (Smaller airports), Denmark, Copenhagen, NZ

J. Approaches to Controlling Prices

Two basic approaches:-

Profit control and direct price control.

- **Profit control**: the original system for airport (and other) regulation. Used extensively at airports in North America. It has been used for BOTs, eg Athens, Budapest.
- **Direct price control** was used for pioneering privatisation of the BAA (British Airports Authority) in 1987. Becoming the dominant approach world wide.
- Used for example in:-
- - the UK; - South Africa;
- - Argentina; - Germany (Berlin).
- - Australia; ** - Mexico

K. Profit Control

- Sets the aeronautical prices permitted by the airport by determining the total revenue required from this source in order for the airport to meet a given financial target.
- Target normally either a return on capital employed, or (as in most US airports) the return required to meet a given level of debt service.
- Under profit control, prices can be set annually or for an indefinite period – with the operator being required to make an application to a regulator if it wishes to raise prices.

L. Direct Price Control

- **Sets prices directly on the basis of a price formula for a fixed time period -typically 5 years.**

- • Normally prices are set on the basis of an allowed revenue per passenger (or basket of prices) to allow a degree of flexibility in the price structure.

- • Generally, the price is related to annual changes in CPI but is expected to decrease each year by a given 'efficiency factor' (x) under what is known as a CPI-X formula.

- • Within this price formula, the airport is free to maximise its profits, by promoting efficiency and management flair., with the benefits shared with users at the next review.

(M) Relative merits of profit control and direct price control

- **Profit Control**

For:
– secure protection against excessive profits;
– can provide protection for lenders and other investors.

Against:
– no efficiency incentives (cost plus);
– potential incentive for 'gold plating' of capital expenditure;
– regulation tends to be reduced to legalised wrangling, rather than considering the best way to develop the company

- **Direct Price Control**

For:
– prices to users - their immediate concern- controlled;
– allows price planning;
– strong efficiency incentives;
– no incentives for 'gold plating'

Against:
– rising profits between reviews creates presentational problems;
– setting price formula dependent on potentially contentious forecasts of income and costs

R. Likely Pitfalls

1. **May discourage timely and efficient investment** if uncertainties are created about the level and adequacy of return. Inappropriate regulation may include following:-

   (i) Unreasonable low regulated rate of return;

   - (ii) Lack of clarity about the regulated asset base;
   - (iii) Cut backs in the level of approved investment due to second guessing of the airport company by the regulator.

2. **May produce excess and gold platted investment**:- Under profit regulation, over investment may result if the rate of return is reasonable or beyond. Gold platting is encouraged as there is no negative consequences.

3. **Consequent second guessing** of commercial decision by the regulator.

4. **Does not provide incentive for efficiency**:- Regulator may not be in the position to drive importance and efficiencies in the business. There is a need to provide appropriate incentives.

R. Likely Pitfalls (cont)

5. **Over regulation.** The power of two mechanisms namely; threat of regulation and countervailing power of airlines is underestimated and heavy handed approach is adopted resulting in over regulation.
6. **Too much emphasis of price determination** may result in reduction of quality of services by the company. There is a need to strike a trade off between price and quality. Regulator should take explicit action regarding quality and service.
7. **Cross-subsidization** through pricing in airport systems. This can have negative consequence in under-rewarding performing airports. Subsidy may be given to loss making airports through public exchequer.
8. **Lack of consistency and transparency in approach.** Significant changes in approach creates uncertainty & risk. Establish principles overtime.
9. **Some regulators apply their own thinking** to what they assess as a reasonable level of price. This may undermine the confidence of regulator.

Above pitfalls may be avoided while framing legislative or contractual proposals in the airport privatization process. The economic regulatory regime must be evolved by consultation with all stakeholders and peer review of the legislative proposal.