

# Agenda

Advancing economics in business

## The Airport Charges Directive: is more regulation in the interests of passengers?

On January 24th 2007 the European Commission proposed what it calls a 'landmark' regulatory package for airports in the EU. Derek Holt, Oxera Director, discusses the likely implications of this for the future development of the aviation industry

In considering the European Commission's proposals for a new Directive on airport charges,<sup>1</sup> this article seeks to address the following questions:

- why have an airport charges Directive?
- what does the proposed Directive seek to do?
- how might it affect interactions between airports and airlines?
- what might be the effects on consumers?

### Why has the Commission proposed an Airport Charges Directive?

The aviation sector is making headlines for a number of reasons: it is in the front line of security issues in the post-September 11th environment; capacity constraints at many of Europe's leading airports are causing significant delays; and environmental pressures are having a significant impact on the industry in terms of both the debate on aviation's exemption from fuel duty by international convention, and the planned introduction of the sector to the EU Emissions Trading Scheme from 2011.

What does the proposed Directive do to enhance these areas? The answer is not much: rather, the genesis of the programme is linked to yet another of the ongoing debates in the sector, namely the gap between the performance of airports and that of airlines. Many airlines have, over long periods of time, failed to cover their cost of capital, despite various improvements in efficiency (such as fuel efficiency and costs per revenue-km). Prices have also fallen significantly for consumers, reflecting the intensity of competition and the emergence of the low-cost airline phenomenon.

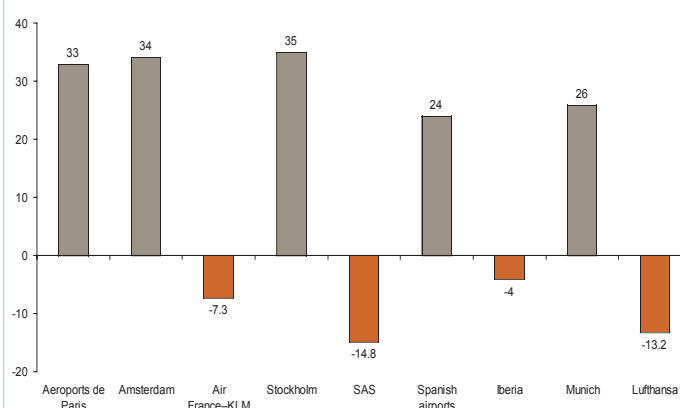
At the same time, average charges for airports have been increasing, as shown in Figure 1, reflecting the need for investment to maintain and develop capacity to meet the demands of the industry.<sup>2</sup> Unlike the situation for many network industries, incremental

costs of new airport capacity are often significantly greater than average costs, reflecting the fact that new developments often take place in an environment in which existing operations must be maintained and the logistics are challenging.

Regardless of the economic rationale for this direct comparison between airport and airline margins—and this is limited, given that both airline and airport returns should be considered in relation to the amount of capital invested and the risks facing this capital—airlines have used this contrast in fortunes to push for increased regulatory intervention in the sector. After all, from their perspective, airport charges account for a significant share of airline costs (4–8% for 'full service' airlines, and more for 'low-cost' airlines<sup>3</sup>), so tougher regulation of airports might help the airlines improve financial performance.

Of course, in a competitive market, reductions in the costs of access to infrastructure, so long as they are spread across all airlines, would be passed through to

**Figure 1 Cost per passenger among selected airports and airlines (% change, 2001–05)**



Source: Speech by Giovanni Bisignani, Director General and CEO, International Air Transport Association (2006), 'Regulate Europe's Airport Monopolies', April 7th.

### Features of the proposed Directive

- **Non-discrimination**—Member States must ensure that airport charges do not discriminate between airport users or air passengers. This is a fairly standard requirement across many regulated sectors (and indeed any dominant firms in economic markets must also adhere to this).
- **Consultation**—the proposed Directive requires each airport to have a regular, formal consultation process, with changes to charging levels or tariff structures made in agreement. It requires the establishment of an independent regulatory authority to rule in the event of disagreement. Airports will also need to consult with airport users before investment plans for new infrastructure are finalised.
- **Transparency**—airports will have to produce a wide range of information annually to airport users, including method of charging, cost information, forecasts of charges, traffic and investment, and productivity of equipment. Airport users, for their part, will also have to provide information regarding forecast traffic volumes and fleet usage.
- **Quality standards**—airports will need to agree service-level agreements with users, and refer to an independent regulatory authority if no agreement is reached.
- **Differentiation of charges**—airports will be able to differentiate charges, such as providing tailored services in dedicated parts of a terminal for additional fees. Any airport user will have the right to access these particular services, with airports required to establish objective and non-discriminatory criteria for granting access to a terminal/part of a terminal when there is insufficient capacity to meet demand for the service.
- **Security charges**—these are to be set such that they exclusively meet security costs. A range of approaches may be taken by airlines to charge for this requirement.

consumers. The fact that, in some cases, lower airport charges would exacerbate problems at congested airports and reduce incentives for required investment, and in other cases encourage more flying and greater emissions, is of note, but it is not driving the debate where the Directive is concerned.

## What is the Commission proposing?

The first point to note is that the Commission is not proposing a precise set of rules by which airport charges should be determined, or even a standard regulatory structure to be applied across all Member States. It recognises that there is simply too much variation in regulatory models and ownership structures, as well as in fundamental airport characteristics—such as hub versus destination traffic; the degree of congestion on runways and in terminals; and catering to low-cost or full-fare airlines—to be able to identify a common model.

Instead, the Commission is proposing a set of binding principles to which all airports above a certain threshold (one million passengers per year or 25,000 tonnes of cargo per year) must adhere. The key points are noted in the box above. Interestingly, the Directive makes no reference to two of the most significant ongoing debates in airport regulation:

- whether a single-till model (in which airport charges are set after netting off any commercial income generated by the airport) should be used;
- whether regulators should adopt a ‘system’ approach in relation to multiple airports serving a single region, or should treat each airport separately in terms of assets, risks and the appropriate charging level to cover costs.

## What are the implications of the proposed Directive?

A wide range of issues emerge from a reading of the Directive, spanning the cost of establishing the independent regulatory authorities, the relatively low threshold for size of airport covered, and the emphasis on two-way information sharing between airports and airlines.

From an economics perspective, three of the more significant issues are how the non-discrimination test will be applied, particularly in respect of charging differentiation; the distinction between airlines and passengers as ‘users’ of the airport; and the fact that the proposed Directive provides impetus for the reliance on ‘form’-based intervention rather than an ‘effects’-based approach.

### Non-discrimination and terminal differentiation

As mentioned above, non-discrimination is a fairly standard provision in relation to charging structures for essential facilities including energy networks, rail infrastructure, and postal services. It does not mean that charges to all users must be the same; indeed, where the cost of services to different users (perhaps using different facilities or terminal space) varies, equivalent charges may themselves be interpreted as discriminatory. This issue may prove particularly difficult in the airport sector where most of the infrastructure costs are common to many activities, and where many airports may not have detailed cost breakdowns for specific assets used by individual airlines.

Airports will therefore face a challenge in predicting how the price discrimination test will be applied in practice. Will charges be set in proportion to marginal costs imposed? Will it allow for discounts from published schedules? And will different financial risks imposed by different airlines have to be taken into account? Moreover, how much emphasis will be placed on different trends in price levels for users, as opposed to rates of return.

Furthermore, as the low-cost and full-fare market segments begin to blur together (eg, many full-fare airlines have begun to charge separately for food or extra baggage on short-haul flights, an approach previously attributed to low-cost carriers), disputes may arise in relation to access to lower-cost facilities. All air carriers that wish to have access to lower-cost facilities at a lower cost are entitled to in principle. Thus the proposed Directive provides a basis for challenge by airlines that wish to vary the nature of the service provided. Given the duration of many airport assets (even excluding runways), this could ultimately expose airports to lengthy court cases or even stranding of existing assets. Furthermore, it could lead to perverse or inefficient outcomes, by preventing airports from using price as a rationing device for access to scarce terminal facilities.

### What is an airport user?

One striking feature of the Airport Charges Directive is that the emphasis lies squarely on the relationship between airports and airlines. Of course, both of these groups are ultimately in business to serve passengers (or users of cargo services). However, it is possible that some of the provisions in the Directive may not necessarily serve the interests of passengers. For example, requirements that airports seek agreement with airlines for the provision of new infrastructure raise the concern that airlines with a strong market position at an airport may seek to limit the scope for new investments at the airport, fearing that such capacity growth would provide opportunities for competitors to enter the market. It is unclear how this potential conflict would be resolved, although it may be the case that an independent regulatory authority with a wider set of responsibilities could more effectively represent the interests of all users.

A similar issue may arise in relation to the service-level agreements. While these are standard agreements in many areas of business and provide a good basis for ensuring that airports focus on providing efficient, good-quality service (potentially with financial incentives to match), again there is a risk that the emphasis on agreements with airlines will focus on their own interests, to the potential disbenefit of passengers. Of course, in many respects, both groups will have similar requirements: efficient security arrangements, for

example. However, whereas airlines may care more than passengers about turnaround times, passengers may place more emphasis on the quality of the terminal environment and retailing options. Whether the proposed Directive would distort the future development of airports through the risk of service-level agreements focusing on the needs of airlines remains to be seen.

### The form and effects debate

A recent debate which has featured in competition law is whether rules should be based on form, or whether policy determinations should be based on the effects associated with a behaviour (for example, the effects on competition). A separate article in this month's *Agenda*, 'Establishing predation? *France Telecom* and Article 82 reform', examines the recent developments in this area in more detail, but it is useful to note here that while the wider debate has emphasised the benefits of an effects-based approach, the proposed Directive does little to explain how the various provisions are likely to impact on fair competition.

### Conclusion: will the Directive fly?

While a number of significant questions remain, not least of which are those of access to low-cost facilities and the application of significant information burdens on smaller airports, the principles-based approach has at least the advantage of avoiding the imposition of a 'one-size-fits-all' regulatory straightjacket on the sector. Even so, the principles are rather heavy-handed in some cases, particularly for airports without a strong tradition in detailed regulatory practice, and it is interesting to contrast the approach with trends in the European Commission's views on competition policy—where effects-based policy has been gaining ground—and with its approach to telecoms regulation, where national regulators are required to undertake market tests for significant market power and to ensure that any regulatory remedies imposed are proportionate to the failures identified in the market.

Nevertheless, for economically regulated airports such as Dublin and Budapest, the principles set out in the proposed Directive are likely to be largely consistent with existing practice. At many other airports, where the tradition has been one of negotiation with government in order to establish rates, the Directive may prove to have a much more significant impact on the regulatory process. Of course, with the Commission's proposal being a Directive rather than a Regulation, it will be up to Member States' governments, rather than airports, to determine how the obligations will be met. Whether passengers will see benefits—such as improved capacity, better quality standards or lower fares—remains to be seen.

### Derek Holt

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<sup>1</sup> European Commission (2007), 'Commission Proposes a Landmark Regulatory Package for Airports', press release IP/07/78, January 24th.

<sup>2</sup> See speech by Giovanni Bisignani, Director General and CEO, International Air Transport Association (2006), 'Regulate Europe's Airport Monopolies', April 7th.

<sup>3</sup> European Commission (2007), op. cit.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email [d\\_holt@oxera.com](mailto:d_holt@oxera.com)

Other articles in the February issue of *Agenda* include:

- establishing predation? *France Telecom* and Article 82 reform
- flying in the face of regulation: lessons in liberalisation for airlines
- up for grabs: Endesa, E.ON, economic nationalism and EU law *Michael Grenfell, Norton Rose*

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