

Agenda

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Light touch or right touch? An international review of airport regulation

A recent review by Oxera compared the economic regulatory regimes at seven international airports, looking at their incentives for investment and financing, the extent to which they promote consumers' interests and competition, and the regulatory burden. What were the main findings, and what are the implications of the Civil Aviation Authority's subsequent proposals for the future regulation of Heathrow, Gatwick and Stansted—three of the airports reviewed?

Airport regulation in the UK is in a state of change. For more than two decades, the UK Civil Aviation Authority (CAA) was required under the Airports Act 1986 to set ex ante revenue yield caps at all airports 'designated' by the Secretary of State for Transport. With the passing of the Civil Aviation Act 2012, this is no longer the case. Instead, the CAA has taken on responsibility for assessing which airports should be granted a licence and be subject to economic regulation, and has been given greater flexibility to tailor regulation to individual airports through their licences.¹ In particular, the CAA now has the freedom to replace fixed price caps with lighter-touch regulation where such a change is deemed appropriate. For the first time, the regulatory frameworks applied to regulated airports will differ according to the unique characteristics and competitive environment of each airport.

The new regime reflects the substantial changes that have occurred since the last periodic reviews were completed in 2008 (for Heathrow and Gatwick airports) and 2009 (for Stansted Airport). The largest of these changes has been the break-up of BAA through the sale of Gatwick to Global Infrastructure Partners in 2009 and of Stansted to Manchester Airports Group in 2013. On top of the changing industry structure, demand has not grown as anticipated, with traffic at each of the UK designated airports below the levels estimated in the CAA's settlement for the fifth regulatory period (Q5). For example, Stansted's traffic has been around 25–30% lower than forecast, falling from 24m passengers per annum in 2007 to 18m in 2011.²

Given the new competitive pressures, Gatwick asked Oxera to review how its regulatory regime compared with those of similar airports internationally.

The choice of airports

In order to undertake a meaningful comparison of regulatory regimes at international airports, the following set of criteria was used to produce a set of comparator airports with similar commercial and operational characteristics to Gatwick.

The airports should:

- be subject to some form of **economic regulation**, and that regime should be **transparent** in terms of the operator's revenues, service quality and prices;
- operate in liberalised airline markets with well-developed **customer protection** and **fair-trading** laws;
- have **passenger numbers** per annum within 20m passengers of that of Gatwick;
- have a material level of **private capital investment** in their infrastructure;
- face **similar commercial incentives** and thus have a similar percentage of aeronautical revenues as a proportion of total revenues;
- have a broadly **comparable mix of traffic**—ie, they should serve a range of long- and short-haul destinations, have a reasonable mix of airlines, and/or a large percentage of traffic should be made up of international passengers.

The final list of comparator airports comprised Auckland, Brussels, Copenhagen, Düsseldorf, Paris-Orly, Rome-Fiumicino, Sydney and Gatwick.³

This article is based on Oxera (2013), 'Regulatory Regimes at Airports: an International Comparison', prepared for Gatwick Airport, January 23rd, available at www.oxera.com.

Trends in airport regulation

Broadly speaking, regulation at the comparator airports can be divided into three categories.

- **Ex post price monitoring.** Two of the reviewed airports, Sydney and Auckland, have been granted commercial freedom in the price-setting process, subject to ongoing price and service quality monitoring. To determine the level of charges, airlines and airports negotiate according to a set of formalised pricing principles. If the negotiations break down, disputes are often resolved through arbitration.⁴ Although these regimes are predominantly ex post, some ex ante regulatory action is needed to ‘set the rules of the game’—ie, to establish the informational requirements and pricing principles that guide the negotiation process, and the possible sanctions in an ex post intervention.
- **Commercial negotiation with ex ante regulatory approval.** The regulation of charges at Brussels, Copenhagen and Düsseldorf airports is also characterised by commercial negotiation between the airport and its users. However, at these airports, the negotiated prices are subject to ex ante regulatory approval as opposed to ex post monitoring. For some regimes this comprises bilateral negotiations between the airport and individual airlines, while for others it involves multilateral agreements with all of the airport’s users. Statutory ‘fall-back’ provisions are in place in a number of jurisdictions such that, should the airport and airlines fail to agree on charges, the regime reverts to traditional incentive regulation, with the regulatory authority setting a price cap.
- **Regulator-determined, ex ante price caps** are a feature of regulation at Rome and Paris-Orly airports, as well as designated UK airports to date. These regimes involve an upfront regulatory determination of the maximum revenue per passenger that the airport is allowed to earn for a period of (typically) five years. These regimes are associated with the greatest burden for the airport and its regulator. In particular, the regulator is required to determine a reasonable cost of capital and an efficient level of costs. As these factors are not directly observable, the review process can involve intense scrutiny of the company’s capital expenditure (CAPEX) programme and general market data.

Although the reviewed regulatory regimes can be classified into these broad categories, the precise nature of regulation at similarly classified airports varies in a number of ways. For example, in regimes focused on commercial negotiations, there are considerable differences in how the levels of service quality and capital investment are determined, if at all.

As well as the broad categories of regulation outlined above, several themes in international airport regulation emerge.

There have been significant changes in the type of regulation applied at airports within the last decade. Many of the reviewed airports have shifted towards ‘lighter-touch’ regimes. This has involved regulators setting the framework in which airports and airlines can negotiate, without actively intervening to set aeronautical charges. In contrast to this trend, the regulation of the designated UK airports (prior to the Q6 initial proposals—see discussion in the next section)⁵ has, over recent price reviews, seen the addition of a service quality regime and mandated constructive engagement with airlines alongside the regulator-determined price control (albeit Manchester Airport was de-designated in 2008, and thus ceased to be subject to economic regulation).

Airport regulation increasingly relies on engagement with airlines. Engagement and commercial negotiations with airlines feature in many of the regulatory regimes reviewed and have become a more prominent part of regulatory arrangements over the past ten years. As noted above, the greater emphasis on these arrangements has tended to be coupled with a reduction in regulatory intervention, although the extent to which consultation versus negotiation is required varies, as does whether the agreements require regulatory approval.

Regimes based on commercial negotiations between the airport and airlines tend to provide better incentives for investment and the promotion of users’ interests when there is the requirement to negotiate with airlines rather than merely to consult them on changes. In regimes where negotiation is required, the airport can negotiate individual service-level agreements with its airlines, which creates more flexibility to provide differentiated service levels and CAPEX on an airline-by-airline basis (rather than a one-size-fits-all approach). Thus, while transaction and compliance costs (ie, direct costs) could still be high in a light-touch regime, the impact of regulation on the degree of commercial flexibility of an airport (ie, the indirect costs) is likely to be less.

Negotiation-based regimes could, however, incur further costs if airlines and (current and future) passengers do not share the same interests.⁶ For example, it might not be in the interests of an airline to negotiate with the airport to increase its current capacity (to the benefit of passengers) if this means that other airlines are able to access that capacity and compete more intensely. The regulator may thus have a role in ensuring that the outcomes of negotiation are in passengers’ interests.

A reliance on commercial negotiations alone is unlikely to lead to optimal outcomes. On the evidence of the (small sample of) airports included in the review, light-touch regimes appear to perform better when they include ‘fall-back provisions’ in case agreements cannot be reached with airlines, and/or there is a threat of more intrusive regulation if performance is considered to be poor (eg, if prices are deemed to have risen excessively). As long as they are credible, these provisions increase the bargaining power of airlines and constrain the airports’ ability to exercise their market power. For example, arbitration has been an important part of the regulatory framework at Sydney Airport—indeed, Virgin Blue Airlines triggered arbitration proceedings in January 2007, which ultimately led to the airport making concessions in a negotiated commercial settlement.⁷

There appears to be some movement towards adjusted- or dual-till regimes. A number of airports have moved away from the single till: for example, Paris-Orly Airport has moved to an adjusted till; Brussels Airport is moving progressively to a dual till from an adjusted till; and Rome-Fiumicino Airport now uses a dual till. Despite this trend, the CAA has reiterated its commitment to a single-till approach.⁸

There does not appear to be a direct link between the potential for passenger and airline substitution faced by an airport and the regulatory regime applied. Economic theory indicates that the more competition there is, the less the need for regulation. However, based on the airports reviewed, there is evidence that the most light-touch regimes are applied at airports that are associated with the least potential substitution of passengers and airlines (Auckland and Sydney), while regulator-determined price cap regimes are applied at airports that are subject to greater potential for substitution (see Figure 1). One explanation for this is that policy concerns, as well as economic factors, have a strong influence on the regulatory process. In the international jurisdictions reviewed, there are various policy concerns, which may affect the type of regulatory regime and degree of intervention.

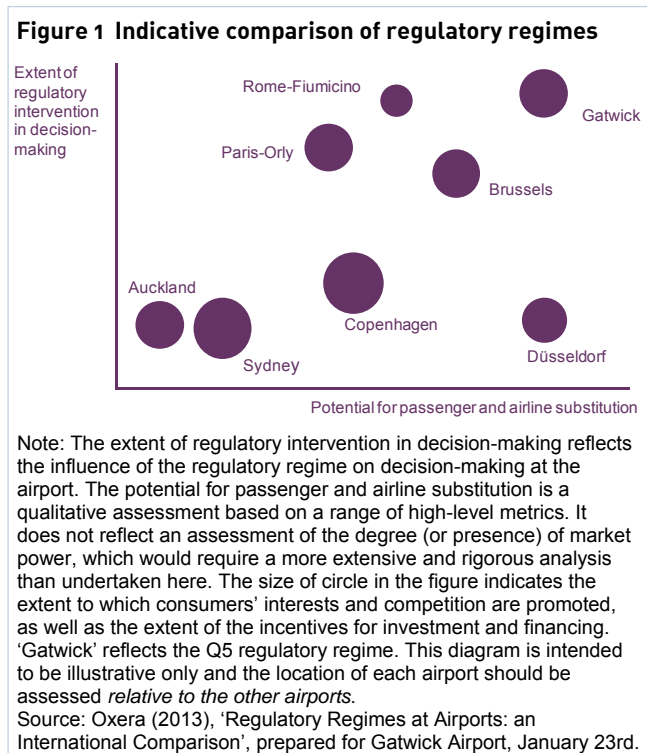
The ‘Q6’ proposals

Since Oxera completed its review in January 2013, the CAA has published its initial proposals for the regulation of UK airports over the next price control period—the CAA’s first proposals under the new Civil Aviation Act.⁹ Although the CAA has provisionally determined that Heathrow, Gatwick and Stansted airports should be licensed and continue to be subject to economic regulation, the proposed form of regulation varies significantly across the airports, to reflect their differing levels of market power.

At Heathrow, which was found to possess the strongest degree of market power, the CAA is proposing to continue to apply the existing approach based on the regulatory asset base (RAB), with charges changing at a rate of RPI – 1.3% per year over the control period. In the context of the review, this regime would be categorised as a ‘regulator-determined, ex ante price cap’.

As part of its market power assessment, the CAA concluded that, although there is a reasonable prospect that Gatwick will have significant market power in the next price control period, the airport appears to have less market power than Heathrow.¹⁰ As such, the CAA’s proposals for Gatwick acknowledge the potential for the regulator to move away from traditional RAB-based regulation, while allowing airport–airline discussions to play a greater role in the determination of prices and service quality. Gatwick has itself argued that regulation should take the form of commitments made with the airlines—including a price path (capping the average aeronautical yield) based on an initial price and an RPI + X formula for subsequent years—combined with bilateral contracts. Such a regime could broadly be categorised as ‘commercial regulation with ex ante regulatory approval’ (as defined above).

The CAA believes that the price and service quality commitments that Gatwick has proposed to date are unlikely to offer sufficient benefits to users, and therefore that they need to be revised to be considered acceptable. In particular, Gatwick’s price commitment



(to a growth of RPI + 4% per year over a seven-year period) is considered to be significantly higher than the CAA's view of a fair price. Should Gatwick not address the identified issues, the CAA has indicated that it will continue to adopt a RAB-based approach, with its initial proposals implying a cap on the growth in charges of RPI + 1% per year.¹¹

The most substantial changes in the CAA's initial proposals are at Stansted. The CAA has proposed that the airport move from RAB-based regulation to a price-monitoring regime,¹² in reflection of both Stansted's weaker market power and the regulator's lack of confidence in the airport's ability to project traffic growth and operating costs with sufficient accuracy (given current market uncertainties). The CAA has therefore proposed that Stansted be granted commercial freedom to negotiate prices and service quality with airlines, but that it will be subjected to a full investigation, and potentially tighter regulation, if prices do not fall in real terms over the five-year control period.

Moreover, a 'show cause' trigger will be introduced to provide a threshold for airport charges above which the airport will be required to explain and justify the price increase to the CAA. In such cases, where the CAA is not satisfied with Stansted's justification of the higher price, a full investigation could be launched. Under the initial proposals, the show cause trigger would be met if

Stansted's average price were to rise by more than half the rate of RPI inflation per year—that is, if RPI were 3% in any given year, Stansted would have to justify any price increase of more than 1.5%.

The proposed regulation of Stansted is thus effectively a two-tier control with a shadow price cap of RPI – 0% (the breaching of which would lead to the launch of a full CAA investigation) and a price justification threshold of RPI minus half the rate of RPI.

The future of regulation at the airports

The CAA's initial proposals reflect some of the themes identified in Oxera's review of international airport regulation. There is potential for regulation at Gatwick and Stansted to move away from the ex ante price caps determined by the CAA, with a greater focus on commercial negotiation instead. As regulation moves towards monitored commercial negotiations, the more the CAA, and indeed other regulators that follow a similar path, will need to ensure that the outcomes are consistent with national policy goals and the interests of end-users (ie, passengers). In the case of airports, it will be important to ensure that negotiations between airports and their airlines do not result in a restriction of capacity and a resultant capacity gap similar to that in the GB energy sector.¹³

¹ HM Government (2012), 'Civil Aviation Act 2012', December.

² Civil Aviation Authority (2013), 'Economic Regulation at Stansted from April 2014: Initial proposals', CAP 1030, April.

³ Data from airports' annual reports and websites; ACI Europe (2012), 'Airport Traffic Report – December 2011, Q4 2011 and Full Year 2011', February 2nd; Leigh Fisher (2012), 'Airport Performance Indicators', October.

⁴ See, for example, Forsyth, P. (2008), 'Airport Policy in Australia and New Zealand: Privatization, Light-Handed Regulation and Performance', pp. 65–99, in W. Clifford and G. de Rus (eds), *Aviation Infrastructure Performance: A Study in Comparative Political Economy*, Brookings Institution Press.

⁵ Civil Aviation Authority (2013), 'Economic Regulation at Heathrow from April 2014: Initial Proposals', CAP 1027, April. Civil Aviation Authority (2013), 'Economic Regulation at Gatwick from April 2014: Initial Proposals', CAP 1029, April. Civil Aviation Authority (2013), 'Economic Regulation at Stansted from April 2014: Initial proposals', CAP 1030, April.

⁶ Oxera (2012), 'Buyer Power in a Regulatory Context: Myth or Reality?', *Agenda*, November.

⁷ Australian Competition and Consumer Commission (2007), 'ACCC Welcomes Commercial Resolution of Access Dispute between Virgin Blue and Sydney Airport', press release, May 24th.

⁸ See, for example, Civil Aviation Authority (2013), 'Economic Regulation at Heathrow from April 2014: Initial Proposals', CAP 1027, April, pp. 33–5. A single-till approach takes account of the costs and revenues of both aeronautical and commercial activities when determining the price cap by deducting the non-regulated commercial revenues from the total regulated revenue requirement. This means, in effect, that charges for aeronautical services are partly subsidised by non-aeronautical revenues. Conversely, under a dual-till approach, the regulator sets a price cap to cover the total cost of the regulated aeronautical activities without any offsetting adjustment for revenues generated from non-regulated commercial activities. An adjusted or hybrid till deducts a proportion of commercial revenues or certain commercial activities from the total regulated revenue requirement.

⁹ The discussion in this section is based on Civil Aviation Authority (2013), 'Economic Regulation at Heathrow from April 2014: Initial Proposals', CAP 1027, April; Civil Aviation Authority (2013), 'Economic Regulation at Gatwick from April 2014: Initial Proposals', CAP 1029, April; and Civil Aviation Authority (2013), 'Economic Regulation at Stansted from April 2014: Initial proposals', CAP 1030, April.

¹⁰ Civil Aviation Authority (2012), 'Gatwick – Market Power Assessments, the CAA's Initial Views', February.

¹¹ Civil Aviation Authority (2013), 'Economic Regulation at Gatwick from April 2014: Initial Proposals', CAP 1029, April, p. 15.

¹² Civil Aviation Authority (2013), 'Economic Regulation at Stansted from April 2014: Initial proposals', CAP 1030, April.

¹³ See, for example, Ofgem (2010), 'Action Needed to ensure Britain's Energy Supplies Remain Secure', press release, February 3rd.

If you have any questions regarding the issues raised in this article, please contact the editor, Dr Leonardo Mautino: tel +44 (0) 1865 253 000 or email l_mautino@oxera.com

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