ACI EUROPE WORKING PAPER – "OFF THE GROUND"

Re-thinking Economic Regulation as a result of the COVID-19 traffic shock

Status: Public

Date: 5 June 2020

Information for governments and independent supervisory authorities

1 INTRODUCTION

1.1 Many airports in Europe operate under economic regulatory regimes whereby the prices that they are allowed to charge for use of the aeronautical infrastructure are approved or determined by an independent supervisory authority (ISA). The COVID-19 crisis has revealed the need for governments and authorities to modify the economic regulation for these airports to account for risk factors and market shocks.

1.2 The impact of the COVID-19 pandemic on the sector also raises questions as to whether current economic regulation of EU airports is fit for purpose. Economic regulation should not be applied to a competitive market, where airports are competing to recover airline customers, aircraft, routes and local and transferring passengers. The consolidation and power of airlines is an especially pertinent development for authorities to consider.

2 PROBLEM DEFINITION

2.1 The design of the predominant regulated asset base (RAB) approach to economic regulation will lead to sharp increases in airport charges as a result of traffic volume losses from the effects of the COVID-19 pandemic. RAB model regulation is based on a contract between the regulating authority and the regulated entity. The mechanics of the regulation limit or cap pricing on one hand during good times, but on the other hand protect against abnormal losses; in other words, the right balance between risk and return.

2.2 The stylised example in Table 1 demonstrates how price targets are calculated, in a very simplified explanation of the building-block RAB model. In this case, capital costs are fixed at 1/3 of total costs, and it is assumed that the airport has made herculean efforts to reduce airport costs (with Operating Expenses decreasing 6% for every 10% decrease in traffic volumes). Full year traffic is estimated to decrease in 2020 by nearly 60%. As a result, airport charges should increase by 90%.

TABLE 1. STYLISED EXAMPLE OF BUILDING-BLOCK RAB MODEL

Building blocks	2019	2020	% change	Comments
Airport Cost (OpEx + Depreciation + Return on RAB)	1000	760	**-24%**	Capital costs (debt payments & depreciation) account for 1/3 of total costs. OpEx is assumed to have an elasticity of 0.6 (on the high end of findings for CAA 2014 & CAR 2019).
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Traffic units	100	40	**-60%**	Traffic at European airports is estimated to decrease by 57% in 2020 (IATA: -55% RPKs)
	=	=		
Unit cost (airport cost / traffic units)	€10.00	€19.00	**+90%**	In building-block approach, total airport cost is divided by traffic units to create a unit cost.

2.3 The airlines' trade association IATA has long advocated that the optimal form of regulation for airports is the "RAB-based approach", along with a number of governments. IATA now refuses to accept that the RAB-based model, by function of its design, must lead to increases in airport charges *[IATA (2020), Potential financial and operational measures to mitigate COVID-19 impact related to Airports and ANSPs'*].

3 PROPOSED SOLUTION

3.1 A more reasoned, less entrenched discussion about models of airport regulation will require a shift in mind set.

3.1.1 Firstly, governments & airlines must recognise that airports are commercial players and businesses in their own right, operating in a competitive environment.

3.1.2 Secondly, governments should fully consider the aim of regulation and the role of regulation towards economic operators. Governments should be prepared to liberalise airport pricing, promoting competition between airports, and removing independent supervisory authorities (ISAs) from the mix, where the market is sufficiently competitive or tending towards competition in the long-run.

3.1.3 Thirdly, where regulation is demonstrably needed, governments, and their fully independent supervisory authorities, should ensure that regulation delivers the right outcomes for consumers, society & sustainability. The regulatory framework should not simply create a cycle of conversations on increasing levels of detail. Regulators should recognise that airports are subject to significant traffic risk, and therefore introduce mechanisms to address that risk. And regulators must fully consider the buyer power of airlines as a counter to airports' possession of market power.

In a RAB model regulatory framework

3.2 For airports where regulation remains relevant, the size of the COVID-19 shock means that ISAs should be prepared to open price determinations and amend price controls. It will be necessary to prepare for interim reviews of regulatory settlements.

3.3 Airports may be able to offer flexibility, if the ISA is able to permit this, so that the sharp rise in prices does not kick in immediately. In exchange for this flexibility extended by airports, ISAs and airlines must also accept the need for greater flexibility in the future.

3.3.1 These mechanisms will balance the need for beneficial investments and users' requests to reduce costs. These measures could include:

- Carrying forward losses due to the COVID-19 shock to be recovered in following years, for example by capitalising a portion of foregone revenues (deferring airport revenues) into the RAB so that it could be recovered in future years on rising volumes;
- Modifying the allowed depreciation profile (e.g. applying "unit-of-production" depreciation method);
- Allowing for changing circumstances by applying/introducing risk-sharing mechanisms;
- Defining/reinforcing investment incentive mechanisms, as many airports are already operating beyond terminal or runway capacity, and one such measure would be an additional factor in the weighted average cost of capital calculation to recognise the asset-specific risk faced by airports from pandemics;
- For airport managers operating via a concession contract, allowing instruments for the re-calculation of terminal values to incorporate "foregone revenues", deferral of payment of fees, and/or a one-off extension of contract duration upon an objective calculation of the period deemed necessary to recover the amount of deferred costs.

3.3.2 These measures have been used in the past at airports and for other infrastructure.

Thinking beyond the RAB

3.4 A RAB model is one of many potential schemes to regulate an airport, but it has to be sophisticated enough in order to meet the requirements above.

3.4.1 Governments should consider at this time the type of economic regulation and the aims of the regulation. Regulation today is often thought of from the perspective of airlines, "to protect users", but regulation models exist for other reasons. Regulation can set a profile for investment, encourage private capital to allow pricing signals to work, or to achieve certain quality standards. The objectives and forms of economic regulation should be given proper consideration.

3.4.2 Several airlines worldwide along with their trade associations already publicly stated that they will put airports in competition with each other as part of their recovery strategy and allocate their fleets to the airport where they receive the best offer on prices. It demonstrates again that airport charges should be determined by market-based mechanisms as opposed to intrusive economic regulation on pricing. This approach is an effective way to support both the financial sustainability of the airport industry and the recovery of the airlines.

3.4.3 Authorities must remain cautious in being drawn into adjudicating disputes between airlines over their relative cost position at an airport, and seek alternative mechanisms to resolve disputes rather than second-guessing accounting & financial models.

3.4.4 Authorities, working within the regime established by the government, should encourage in the months that come, commercial discussions between airlines and airports. Authorities should allow for the development of growth incentives, route incentives, and traffic risk sharing agreements - as well as the more flexible & commercially driven approach to airport pricing that they embody.

4 EXPECTED OUTCOME

4.1 For the airports under economic regulation, which this note addresses, implementing the proposals above would allow for more dynamic and responsive pricing by airports, proportionate economic regulation frameworks that facilitate essential investments that allow our sector to address climate change, and continued positive outcomes for airport passengers.

4.2 Appropriate reflection today about regulation can ensure robust frameworks during the evolution of the market following the impacts of the COVID-19 pandemic. There are more than 450 commercial airports in Europe vying for traffic, and only a dozen airlines that are actively shaping the air transport market. The continued development of competition between airports reduces the need for intrusive regulation.