

# ACI EUROPE submission to ART

## Consultation on proposed models for regulation of airports

(Brussels, September 2019)

### Introduction

Airports Council International Europe (ACI EUROPE) represents the interests of over 500 airports in Europe across 46 countries and has extensive experience in playing a constructive role in the formation of aviation policy. ACI EUROPE's mission is *"to advance the development of safe, secure, sustainable and efficient airports for the benefit of the travelling public and businesses, as well as local and regional communities throughout Europe"*.

In carrying out this mission, our General Assembly has mandated us to specifically focus on the interest of passengers and the development of air connectivity to support the economic development of airport communities. As such, we carefully follow developments in the economic regulation of airports in Europe and around the world, and seek to ensure that airport economic regulation fits current market realities and is truly focused on maximising positive externalities.

ACI EUROPE considers that:

- The European aviation industry needs to be regulated in a manner which reflects both the local and European business environment and market dynamics it is operating within.
- Only national regulators such as the Autorità di regolazione dei trasporti (ART) can ensure protection of end users i.e. passengers, which should be to the fore of regulators' considerations.
- Under-regulation undermines economic efficient outcomes, by introducing the risk of abuse of market power. Yet over-regulation is equally threatening, distorting the market and introducing potentially damaging disincentives. The regulator's challenge is to find the correct balance, which ensures effective protection and promotion of consumers' interest for affordable and varied connectivity.

Our experience with airport economic regulation across Europe and our institutional knowledge from other ACI Regions around the world have led us to consider that flexible regulation fits current market realities and is compliant with the principle of proportionality. Flexible proportionate regulations delivers the best outcomes for communities, passengers, airlines and airports.

## **1. ART's proposed Model A places the Italian regulatory system at odds with trends in economic regulation in the rest of Europe & globally**

ART's proposed regulatory Model A intrudes into all aspects of airport financial management. Factors such as depreciation rates, parameters for cost of capital, and efficiency targets all have multiple methods for elaboration and quantification - with many standardised reference sources.

The airport operator, as a business in its own right, should have the ability to choose how to handle its accounting and pricing, and discuss that information with users.

Model A replaces the commercial freedom of an airport operator to operate as a business in its own right with a rigid set of rules that will never serve all purposes adequately.

ART provides no justification for why such regulation should be applied to all Italian airports with more than 1 million passengers per annum.

The *SCHEMA di Analisi di Impatto della Regolazione* in fact demonstrates that the airline market is more concentrated than the airport market, and therefore that airlines have more power in their markets than airports. The document presents that the Herfindahl-Hirschman Index for airlines in Italy is greater than that for airports. This fact would suggest that air fares – and not airport charges – require regulation.

The impact assessment scheme correctly identifies that airports with less than 1 million passengers per year are quite likely unable to earn enough revenues to cover their costs. How can an economic entity that is losing money be said to possess market power? Therefore, ART proposes a special regime for airports in this category, regulatory Model B, recognising that commercial entities without market power do not need heavy regulation.

But, the application of Model A applies to any airport that has a passenger volume exceeding 1,000,000. On the lower side of & immediately below the threshold, the airport is clearly lacking market power - and with one additional passenger, the airport is assumed to have enough market power to require detailed prescriptive rules on how to consult users, what information to present, and how to calculate its costing and pricing. This is clearly not proportionate and not aligned with market reality & outcomes.

Such an approach is also at odds with regulatory practice around the world – and would place Italy in an awkward corner. Indeed, regulators elsewhere are stepping back from invasive involvement because regulatory involvement in a market that faces effective competition will crowd out normal business relations. For example:

- In Europe, research has shown that changes in the market have contributed to an intensification of the rivalry between airports, across all channels through which they compete. With many of these trends now being long established, the competitive pressures on airports, of all sizes, across Europe are highly likely to endure and continue

to develop, implying that regulators and government stakeholders will need to address this ‘new normal’.<sup>1</sup>

- In the United Kingdom, Manchester Airport (an airport with nearly 30 million passengers) was found to not have market power by the UK CAA in 2009 and de-regulated. It is free to set charges by its own determination, though it naturally still follows ICAO principles for consultation with users, transparency and cost-relatedness. The UK CAA also put in place a light-touch regulatory framework for Gatwick Airport, which has resulted in benefits for all parties since 2014.
- In Australia, the Productivity Commission in June issued a draft report which supports the continuation of light regulation of airport charges for Australia’s large airports, Sydney, Melbourne, Brisbane and Perth, noting that there is no sign that the airports are abusing market power, especially because of the strength of airlines.

Airports in Europe are required to build extensive additional capacity to meet demand for air services in the decades ahead. Airports seek to develop their facilities in the long-term and deliver an adequate return for illiquid and immobile investment with high intrinsic risk. Airports’ ability to plan for the future is being squeezed tighter and tighter, at precisely the worst possible time. EUROCONTROL’s *Challenges of Growth* report published in 2018 shows that Italy will have added more than 2,500 additional flights per day, with Italian airports having a capacity shortfall in all of EUROCONTROL’s forecast scenarios.<sup>2</sup> The financing of necessary capital expenditure remains a key impediment to delivering the capacity needed, which is essential to foster effective airline competition and allow air connectivity to develop.

Airlines will need to pay a fair share of the airport facilities they use, but airlines systematically oppose any increases in airport charges. Changes in airport charges are driven by capital expenditure requirement – investing in needed capacity and quality. Airlines can and do use the consultation process as a gaming opportunity to lower airport charges or delay changes to charges.

In many cases, economic regulation is ‘caught in the middle’ between airports and airlines. This ultimately distorts the optimal market clearing rate, raising additional barriers to the provision of much needed airport capacity.

The optimal solution, one that promotes the development of competition and where the costs outweigh the benefits, is to ensure **flexible & proportionate regulation**. In other words, we need to “normalise” the economic regulation of airports, not make it more prescriptive.

Independent experts who have looked at the airport sector share this sentiment. At a Seminar organized by the European Commission in May 2018, academic experts stated that it is time to

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<sup>1</sup> The continuing development of airport competition in Europe, Oxera for ACI EUROPE (September 2017) <https://www.oxera.com/publications/the-continuing-development-of-airport-competition-in-europe/>

<sup>2</sup> *European Aviation in 2014: Challenges of Growth*, EUROCONTROL (2018) <https://www.eurocontrol.int/publications/european-aviation-2014-challenges-growth-report>

“normalise the sector” by removing unnecessary sector-specific regulation. The best way to normalise regulation of airports is for the regulator to take a step back.

**ACI EUROPE calls on ART to put in place proportionate & flexible regulation that truly allows for improved consultations between airports and their users focused on delivering better outcomes for travellers.**

## **2. Airline dominance and countervailing power exists in the consolidating European airline market (measure 2)**

ACI EUROPE notes that airline consolidation in Europe results in a market where **more than 2/3 of all European airports have one or two airlines accounting for nearly 70% of all traffic**. This means that most airports are dependent on just one or two customers.

The current rules on consultation at Italian airports – maintained in ART’s proposed Model A – stipulates that 50% of the work-load units must vote in favour of the airport’s proposal for it be approved. This rule would, for many airports, continue to put their business decisions in the hands of just one or two airline. It can be seen clearly that this would pose problems for consumers and competition between airlines at the airport.

The rules should be amended to reflect the ability of airport users to dominate airport decisions.

Countervailing buyer power (CBP) is recognised as a strong commercial tool in European competition practice. In a market where one or two customers purchase a nearly all of the airport ‘services sold’, the airport faces a **nearly monopsonistic situation**. Intuitively, it is no surprise. In what other sector could a supplier be reliant on one customer accounting for up to half of its business, and have limited and contracting outside prospects for new customers?

This means that **airlines have enough negotiation power to ensure that airport charges are set dependent on the competitive market conditions**. Airlines are clear and transparent about their buyer power in their audited annual financial reports. A few examples demonstrate that airlines are aware of and exercise their power:

- “We are growing where the **cost and quality are right**. This is also why we are waiting until next summer to decide, **based on the development of the hubs**, where the new Boeing 777-9 aircraft will be taking off from as of 2020.” (Lufthansa Group [press release](#) 27 September 2018)
- “Air France - KLM has **significant leverage** via its procurement policy and purchasing volumes which it can use to encourage responsible practices across the supply chain.” ([AF/KLM Registration Document 2016](#))
- “As easyJet increases in size, the airline will drive further economies of scale from long-term deals with airports (...) **management continues to work with airports** that will reward easyJet’s commitment and growth with attractive financial packages. For example, despite 80% of outbound airports being regulated, **airport and ground handling costs decreased by -1.3% per seat at constant currency**”. (easyJet [Financial Statements FY17](#))

- “In absolute terms, airport and handling charges increased by 4%, from €830.6 million in fiscal year 2016 to €864.8 million in fiscal year 2017, reflecting the 13% increase in traffic offset by more competitive airport deals....” (Ryanair [FY 18 annual report](#))

Countervailing buyer power (CBP) is recognised as a strong commercial tool in European competition practice.

***ART’s models take no account of the gaming of airport charges consultations by sophisticated pan-European airlines to distort market outcomes for their sole benefit.***

### **3. Financing investment & risks of incorrect WACC determination (measure 13)**

ACI EUROPE is of the opinion that a more flexible regulation better serves the need to attract financing into the illiquid, immobile and very costly airport sector. The recent era of low interest rates and the possible result of a weighted average cost of capital (WACC) that is too low should be especially concerning to a regulator focused on the long-term interests of passengers.

This is important, because it is widely recognised that **the negative costs to social welfare of setting WACC too low are greater than setting WACC too high**. There is a continuing need for investment in the airport industry to meet future demand, modernise and improve quality as well as ensure (increasingly) sustainability and environmental protection. The European airport has now taken the bold step of committing to achieve Net Zero carbon emissions by 2050 – with several Italian airports having individually formally undersigned this commitment.<sup>3</sup> This will require significant investment in decarbonisation. Against the background of an airport capacity crunch and decarbonisation, the social costs of deferred investments are greater than the potential social costs of higher prices.

Airports need to remain incentivised to deliver adequate investment in capacity in the years ahead, and this requires aviation authorities at all levels, European and Italian, to tailor economic regulation to the current competitive state of the industry. It is incumbent upon authorities such as the ART to ensure that its policies support efficient market outcomes, which take full account of the long-term sustainability of the industry.

It is well documented that there is a shortfall of investment in airport infrastructure in Europe, which is leading to capacity shortages and unmet demand. In our view, this requires flexibility by regulators and willingness to take new approaches to ensure that planned capital expenditure takes place. In recent years, we have noted a trend of actual capital expenditure falling below,

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<sup>3</sup> Over 200 European airports to deliver Net Zero CO2 emissions by 2050, <https://www.aci-europe.org/component/downloads/downloads/6103.html>

plans, which indicates that there is a mismatch between the needs of airports, and what the financial and regulatory conditions allow.

***When reviewing the proposed regulatory Model A, ACI EUROPE urges ART to ensure serious reflection on the specific parameters and variables of the calculation of the cost of capital. We urge ART to ensure that it has properly allowed the transparency needed to define the correct level of the cost of capital to protect the needs of future users.***

#### **4. Treatment of ancillary revenue & the regulatory till (Measure 19 and 42)**

The proposed Measure 19 for the treatment of profits from ancillary activities is an inherently **politically motivated decision** to depart from a dual till approach and force a significant transfer of revenue streams from one side of the airport business (non-aeronautical) to the other side (aeronautical).

This is a backward step, which seems to be motivated by a political urge to de facto use airports as a way to subsidise airlines. Here again, ART is going against the trend followed in Europe – where many other regulators have recognised the benefits of the dual till form of regulation which is demonstrated by the increase in number of large airports (> 25 million passenger per year) operating with a dual till since 2010.

*The mandatory transfer has no justification*

The proposed measure is a political arbitration that has no justification provided in a detailed assessment of the market. The Illustrative note aptly summarises the positions of IATA and ACI EUROPE, and we thank ART for considering our paper.

ART recognises that the single till is “*not suitable to configure incentive profiles for interventions aimed at increasing airport capacity*” and that the “*pure dual till regime tends to provide an adequate price signal to the market with particular reference to the case of airport capacity close to saturation*”. Looking at incentives to commercial activity, ART also recognises that dual till provides stronger “*incentives for the operator also for interventions aimed at increasing commercial revenues.*”

Nonetheless, ART’s proposal for the pricing mechanism would transfer, in some cases, a significant proportion of commercial activity margins to the aeronautical till. The mechanism for the transfer uses the ratio of total incentive costs to total revenues, because “*a direct correlation was found between the level of incentives for voluntary activity and the amount of margins related to ancillary activities*”. This justification clearly follows the argumentation for single till made by the airlines, that there is a ‘tight link’ between the passengers brought in by an airport’s incentive scheme to airlines. But this logic that a share of the non-aeronautical revenues that passengers

generate should be reverted to the airlines is a distributional argument with little if any merit. For example, the United Kingdom's Civil Aviation Authority (UK CAA) has rejected this argument long ago, saying it is not a compelling argument and has the likelihood to create undesirable distortions and undesirable market outcomes.<sup>4</sup>

As with all industries, aviation has multiple parties, all of which are mutually interdependent. Selecting this particular relationship as a justification for transferring rents is arbitrary and without foundation. It amounts to a worrying pro-airline bias and airport discrimination.

Were this argument to be accepted, it would be equally valid to suggest that rents be transferred from airline profits to the tourist boards and local businesses of cities/regions who 'brought the passengers to the airline'.

*The mandatory transfer would be counter to practice at other airports*

The proposed levels for the mandatory transfer of the margin from ancillary revenues in model A is a significant departure from the regulation of other European airports and appears to be entirely arbitrary.

Austrian, Belgian, German and Spanish airports operate under a dual till, with a strict audited separation of aeronautical and non-aeronautical costs and revenues.

It is true that a few other countries have recently changed their national aviation strategies to require some contribution from the non-aeronautical till to the aeronautical till. But none have done so to the extent proposed by ART and not without providing safeguards.

The Netherlands, for example, changed legislation to require a mandatory contribution. The Dutch Aviation Law states, that "*in determining the contribution, account must be taken of the continuity of the company and the financeability of the investments of the airport operator. This may include investments planned for the longer term. The airport operator will subsequently determine how the contribution is to be spread over the years within the relevant charges period.*"<sup>5</sup> Such a safeguard is completely missing from the revision of the ordinance.

Moreover, the mechanism penalizes airports that carry out investments on new capacity. The level of the transfer is directly proportional to the spare capacity and the formula does not take into account that, in the short term, the new capacity will not be fully utilized.

The Danish Government also published a new National Aviation Strategy and a new regulatory model for the airport based on this strategy. The cross-subsidy was fixed at 35% for 2019 to 2022,

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<sup>4</sup> The 'Single Till' and the 'Dual Till' Approach to the Price Regulation of Airports - Consultation Paper - December 2000, United Kingdom Civil Aviation Authority (London).

<sup>5</sup> English translation of the Dutch version of the 'Besluit exploitatie luchthaven Schiphol 2017'. Amsterdam Airport Schiphol Operation Decree 2017.

and increased to 40% after 2022, subject to a review in 2021<sup>6</sup>. One severe consequence of this was that a long-term shareholder sold its holding<sup>7</sup>. Such practice is clearly not incentivising investments in airports and tends to keep private investors at bay.

*Mandatory transfers from the commercial business means airlines never pay the full cost*

An airport must deliver efficient services, quality facilities, adequate capacity and sustainability/decarbonisation. Ensuring adequate capacity requires the ability to decide on the investment strategy and make sure that the investment into developing new infrastructure will provide a reasonable return. Forced decreased pricing for aeronautical services will result in an underinvestment into aeronautical infrastructure. This was also recognised by authorities in setting up dual till systems for airports. With mandatory transfers from the commercial business to the aeronautical business, airport users will never pay the full costs of the facilities and services they use.

The mandatory transfer goes against the principle of ‘cost-relatedness’, the same principle upon which Model A relies. Cost-relatedness is one of the backbones of the ICAO guidelines for airport economics, and also in line with the principle that the user should pay for the infrastructure used as a foundation of the EU’s vision for the transportation sector. A dual till structure allows an airport to meet these principles and to provide transparent information about the full cost of providing the aeronautical services.

Such mandatory transfer is now also at odds with the EU’s ‘user pays’ principle – which the European Commission is reassessing and reinforcing in the light of the new EU Climate action policy. The ‘user pays’ principle requires that the infrastructure user pay for both internal and external costs generated by their activities and the use of the infrastructure. Mandatory transfers from the airport’s commercial business is now increasingly considered to be at odds with the ‘user pays’ principle. This is the same principle which is now leading the European Commission to abolish tax exemption on aviation fuel.

***ACI EUROPE asks that ART maintain its commitment to the principle of the dual till, which ART describes in the illustrative note. Enforced subsidisation of airport charges with commercial margins may please airlines, but it is neither efficient nor sustainable, and in the long-run is damaging to passengers.***

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<sup>6</sup> Statement of the Board of Directors of Copenhagen Airports A/S, Company Announcement Copenhagen, 19 December 2017 <https://www.cph.dk/en/about-cph/investor/announcements/2017/12/statement-of-the-board-of-directors-of-copenhagen-airports/>

<sup>7</sup> <http://cphpost.dk/news/business/danish-pension-fund-buys-major-stake-in-copenhagen-airport.html>

## 5. Enabling airports to use incentives effectively (Measures 19 and 59)

The ART consultation documents make reference to European and Italian law and practice regarding incentives. A survey of airports conducted by ACI EUROPE in 2018, and shared with the Thessaloniki Forum of national airport charges regulators, found that:

- **98%** of all European airports offer incentive schemes
- **93%+** of all schemes are public
- **42%** of airlines at an airport benefit from schemes
- **46%** of passengers in Europe travel with airlines that benefit from schemes (however very few airports know if the airline actually passes on the benefit)
- **>70%** of airports offer more than one incentive

The granting rebates & incentives to attract and retain airline business are clear evidence of increasing competitive & pricing pressures upon airports - and themselves question the need for detailed regulation (save for cases of an airport having significant market power and being at risk of abusing such market power).

In the ART's proposal, incentives enter in different forms:

- Incentives contribute to the calculation of the regulatory till (discussed above).
- Disclosure to the regulator: the transparency requirements set out in Model A require the same level of disclosure for incentives financed with private and public sources.
- Disclosure with users: ART requires that, during the tariff consultations, airports disclose the total amount of incentives granted and the name of beneficiaries. This proposal has serious competitive issues.

From ACI EUROPE's perspective, disclosure of significant amounts of commercially sensitive business information about incentives to all airport users has competition issues and would effectively defeat the value created by incentives to all users.

The amount of disclosure required would reduce the scope of price differentiation possible, as each airline tries to match the lowest price. This would impede the ability of an airport to develop a robust pricing policy based on its own strategic objectives which are always focused & driven by air connectivity/traffic developments. Differentiated pricing policies in aviation are standard, today airlines are recognized as the most sophisticated commercial actors with their pricing policies. There is no reason to prevent airports from also using price differentiation, which leads to economically efficient outcomes.

A regulator that seeks to maximise welfare gains should encourage price differentiation; this is a recognised principle in economics and common business practice. Regulation that is focused on minimising deadweight losses should ensure that differentiated pricing is available to airports to use wherever it will drive consumer and connectivity gains, operational efficiency or

environmental goals. Incentives are a key way to differentiate airline customers based on the price elasticity, and maximise consumer welfare.

***ACI EUROPE calls on ART to allow airports to operate as businesses in their own right and negotiate their own business-to-business incentive contracts without having to disclose to all other users this commercially sensitive information.***

## **6. An appropriate efficiency factor (Measure 15 and 41)**

ACI EUROPE, noting its wide range of experience with airports in Europe, believes that the proposed methodology for calculating the efficiency factor is unreliable and non-transparent.

In principle, the stochastic frontier model (as in ART's proposals), or other benchmarking models, could be used to estimate the efficient costs of airports. The methodology, however, suffers from serious implementation issues, which make it unreliable in regulatory decision making due to the high risk of errors. The shape and the determinants of the long run average cost function are unknown ex-ante, and the estimated efficiency levels may vary significantly with the assumptions made. Importantly, airports are subject to both internal factors and exogenous heterogeneities which influence their costs but over which the airports have no control and the proposed methodology lacks consideration providing risks of incorrect judgement on levels of efficiency. Accordingly, the estimated efficiency levels from a benchmarking analysis are not easily explained and should be treated very cautiously.

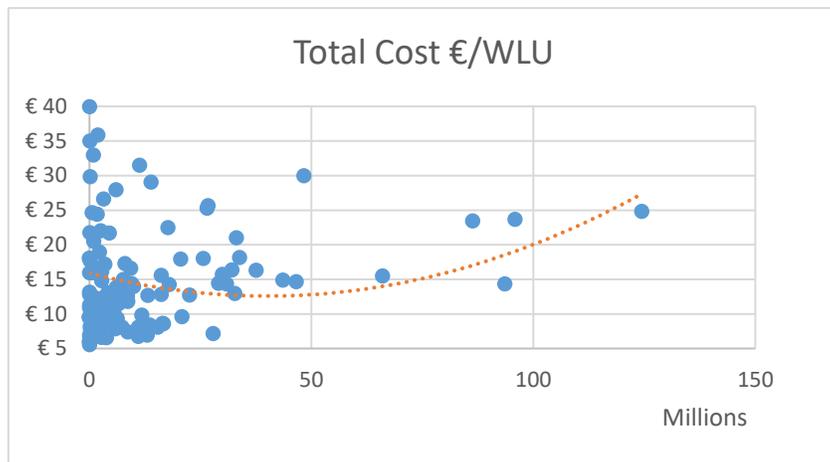
The proposed methodology is also non-transparent. The consultation document defines the methodology too vaguely, allowing for a variety of functional forms, model specifications and control variables. As such, the information made available is not sufficient to make a precise estimate of the efficiency rate applicable to each airport, whilst the adoption of a benchmarking method should guarantee that the airports can rely on the transparency of the process. Airports should be able to detect the efficiency by themselves and use this knowledge to further invest in their infrastructure to increase their efficiency.

The approach taken by ART is at odds with what we see around the world. The stochastic frontier model has never been used to impose efficiency targets as ART is now proposing. Regulators occasionally require benchmarks not to impose targets, but to ensure the reasonableness and transparency of the tariffs. Benchmarks typically involve partial productivity measures or quality indicators, where the airport operator can compare itself with a peer group of airports to improve its performance.

ART has also underestimated the complexities associated with managing the volumes of passengers when an airport reaches certain size thresholds. The 'idée fixe' of constantly decreasing cost curves for a firm over the long run seems at the roots of ART's approach and formulas. However, it does not hold for airports. Empirical evidence is clear that airport costs per

work load unit (WLU = 1 pax or 100 kg of freight) decrease to the volume of around 20 – 30 million work load units, but that after that volume operating cost per unit increase.

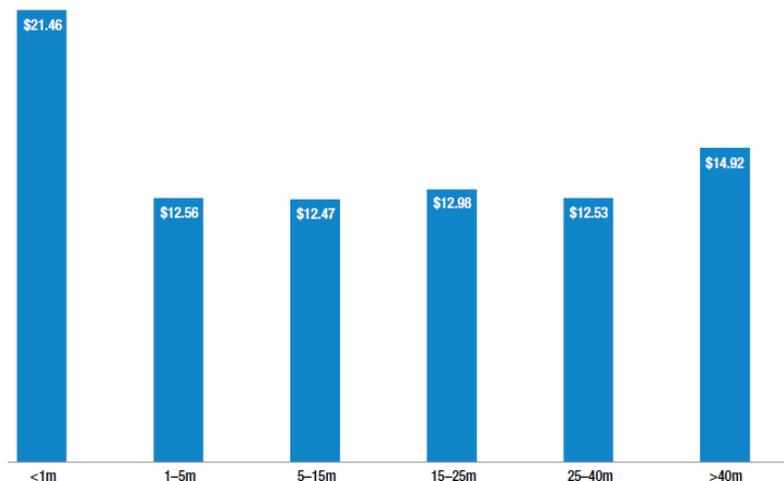
Figure: 2018 airport level data for European airports



Global and long-trend evidence shows that per unit operational expenditure can start to increase at a certain passenger volume, in the range of 15 – 30 million passengers a year. The chart below shows that the convex shape of the cost curve is empirically consistent.

Figure: Total Cost per passenger (Source: ACI WORLD Airport Economics 2019 Report, p 37)

Total cost per passenger (US\$) by airport size category (2017)



Source: ACI Airport Economics Survey (2018)

**ART’s proposed efficiency factor is unreasonable, non-transparent, and challenges empirical evidence. ACI EUROPE calls on ART to revisit the conclusions on allowed operating costs and the efficient productive frontier using this lens.**

## **7. Conclusion: Putting in place proportionate and flexible regulation to address the needs of airlines, airports and consumers.**

ACI EUROPE welcomes the opportunity to comment on the proposed regulatory models to ART.

More than €43 billion in investment is being planned by the top 50 European airports alone over the next 5 years to meet demand expectations. And this is not accounting for the additional investment that will be required for decarbonisation purposes – as per the European airport industry pledge to achieve Net Zero carbon emissions by 2050. At the same time, significant shortfalls of capacity are forecasted at Italian airports even in EUROCONTROL's most cautious scenario. Meanwhile, ART's new proposals outline a far less adequate regulatory discipline than that set forth in the currently applied frameworks to offer protection to the needs of infrastructure development.

It is therefore critical that regulation allow the conditions to finance this investment need.

ACI EUROPE urges ART to rebalance its proposed regulatory models. The proportionality and burden on airports should be better tailored. For larger airports, the rules should consider the impacts on financing of investment programs, alongside the impacts on air fares, and provide greater clarity to airports on the key factors that impact future investment plans. The resilience that the regulation allows the airport through preparing for economic shocks has a key place in the framework. Finally, the commercial space given to an airport to operate as a business in its own right should be expanded, especially when it comes to determining price differentiations.