

# Background: The Commission for Aviation Regulation

The principal function set out in Section 7 of the Aviation Regulation Act, 2001 (henceforth "the Act") of the Commission for Aviation Regulation (CAR) is to regulate airport charges and aviation terminal services charges in respect of airports having an annual passenger throughput in excess of one million passengers.

Under the Air Navigation and Transport (Amendment) Act, 1998 airport charges are defined as

- Charges levied in respect of landing, parking and taking off of aircraft...including charges for air-bridge usage but excluding charges in respect of air navigation and aeronautical communications services,
- Charges levied in respect of the arrival at or departure from an airport of passengers, or
- Charges levied in respect of the transportation by air of cargo, to or from an airport.

As so defined the potential to levy charges on the various service elements involved in the arrival/departure of aircraft, passengers and cargo is quite wide.

The CAR may provide for a different maximum level of airport charges at different airports. In the case of an airport authority, which manages more than one airport, the CAR may make a determination in relation to any one of the airports with reference to the aggregate of amounts levied by way of airport charges at that airport and amounts levied at the other airports.

The CAR must make a determination in relation to airport charges within 6 months of being established. Such a determination may provide

- for an overall limit on the level of airport charges
- the limits to apply to particular categories of such charges, or
- for a combination of any such limits.

The CAR's determination may operate to restrict such charges, or require reductions in them, whether by reference to a formula or otherwise and may provide for different limits to apply in relation to different periods of time within the 5-year price control.

In making a determination the CAR is charged with the aim of facilitating the development and operation of cost-effective airports, which meet the requirements of users. In pursuing this aim the CAR shall have due regard to the following factors:

- (a) the level of investment in airport facilities at an airport to which the determination relates, in line with safety requirements and commercial operations in order to meet current and prospective needs of those on whom the airport charges may be levied;
- (b) a reasonable rate of return on capital employed in that investment, in the context of the sustainable and profitable operation of the airport;
- (c) the efficient and effective use of all resources by the airport authority;
- (d) the contributions of the airport to the region in which it is located;
- (e) the level of income of the airport authority from airport charges at the airport and other revenue earned by the authority;
- (f) operating and other costs incurred by the airport authority at the airport;
- (g) the level and quality of services offered at the airport by its airport authority and the reasonable interests of the users of these services;
- (h) the cost competitiveness and operational efficiency of airport services at the airport with respect to international practice;
- (i) imposing the minimum restrictions on the airport authority consistent with the functions of the Commission; and
- (j) such international obligations as are relevant to its functions.

## The Nature of Airports

Airports are a complex concatenation of various services that enable passengers to engage in air travel. Airports produce many external benefits in terms of increased travel, trade and employment in the location in which they are located. They are also associated with some negative externalities including noise pollution etc. In addition to externalities that are a general nuisance, airports bring with them the potential for a catastrophic event (albeit at a low level of probability) in the areas in which they are located.

Starkie claims that airports are characterised by increasing long run costs at moderate levels of output<sup>[1]</sup>. Thus, in contrast with other regulated industries the natural monopoly position of airports is not due to the usual large economies of scale but rather from the scarcity of good locations and from economies of scope associated with established air services networks. This has implications for pricing, in that prices in excess of average cost may be warranted and prices based on a reasonable return on capital may be inefficiently low.

Airports provide airlines the infrastructure that enables air transport to function smoothly in an environment where there may be considerable uncertainty about future passenger demands and where they must allow a considerable lag between the time they decide to add new infrastructure and when this infrastructure is required. They do this while financially dependent on airlines, whose planning horizons are orders of magnitude shorter than theirs.

Airports have over the years moved on from providing purely aeronautical services alone. Most airports now provide a large range of services that enable passengers to carry out everyday transactions on the way to and from destinations.

These two sets of activities are complementary to each other. People come to airports (overwhelmingly) to fulfil a need to travel. In doing so they are happy to partake of various shopping facilities, dining opportunities etc. to fill in the time between their arrival at the airport and their departure[2].

If a monopoly controls both the aeronautical and non-aeronautical elements of an airport it will exploit this complementarity by lowering the prices of aeronautical services. It is clear that in most environments aeronautical charges are set as low as possible to ensure that as many passengers as possible use the airport, and duty free sales enable the airport to compete with downtown stores for a wide range of goods in terms of the travellers disposable income[3].

Some commentators have argued that given the complementarity of the airport's offerings and the countervailing power of airlines, that the potential and incentive for an airport to abuse its monopoly power is limited. In light of this they argue that, as in New Zealand, there may be no real need for an intrusive regulatory regime. This may be especially true in jurisdictions where there is a strong body of competition law to police any potential abuses.

## Regulatory frameworks

The regulatory framework in Ireland is likely to be similar to that adopted in many other jurisdictions including the UK and Australia (though in Australia the regulatory system also deals with access issues). There is a clear trend towards implementing incentive regulation as it ensures that the airport operator will strive for operational efficiency (it will also ensure that the operator considers which activities are best provided through competitive outsourcing). The nature of the price control will determine how scarce resources are allocated amongst potential users, with the hope that the prices charged convey the correct information about scarcity to users and are used to inform investment decisions (which is the critical element in ensuring dynamic efficiency).

In common with many other regimes there is no explicit requirement that the CAR foster competition in the provision of airport services. However, it is clear that many of the choices that the Commissioner will have to make in coming to a determination will have implications for competition. Competition concerns can arise *inter alia* in relation to the nature of competition between airports, the potential for competition between terminals in airports and in competition for the right to provide some of the services that airports may rationally decide to outsource.

In this regard, it is well recognised that regulation can often be a poor substitute for competition, where competition is feasible. One of the main challenges that the CAR faces is to identify those services within the airports that are amenable to competition and those which are best provided by a monopoly due to scarcity of locations, economies of scale or scope, or network effects etc. The responses of the airport operator and the various users to the current consultation will no doubt throw considerable light on this issue.

However, unlike in many network industries/utilities there is no clear consensus about which areas

within an airport are best provided by a monopoly. In the UK, as part of the review of the regulation of BAA's airports in the London region, there is currently a consideration of whether there is a potential for competition between terminals within an airport. Previous experience elsewhere has shown that it may be possible to lose many economies of scope if there are competing terminals. However, it may well be that terminals that are constructed and run as joint ventures between the airport authority and the airlines provide the correct incentive structure to maximise efficiency. This view must be tempered with the potential that such an arrangement may have in terms of foreclosing access to the terminal to new operators.

## Competition and the need for price controls

In any proposed regulatory structure there is a trade-off between the economic effects of market power and the potential to introduce regulatory distortions in the regulatory framework. In the case of airports this trade-off works in favour of the regulatory regime the less competition that there is in the market.

For example, Starkie and Yarrow draw on the case of BAA in the London region as this raises questions about the potential to increase competition by de-merging the 3 BAA airports in the London region<sup>[4]</sup>. The case for increasing competition is strengthened if the airports under common ownership are able to lower aeronautical charges due to the operation of the single-till regulatory regime and the airport operator is able to use revenues generated throughout the group to lower charges at any particular airport. The UK Government recently decided not to proceed with the de-merger of BAA's London airports, though the question remains open as to whether such an ownership structure is, in general, in the public interest.

In the Irish context, it is currently an open question as to what is the extent to which the airport operator's airports are in competition with each other (and indeed the extent to which they are in competition with the other airports in the State and in Northern Ireland) and whether competition might be increased by selective de-merging of airport assets. There is also a question in relation to how the current ownership structure (and the regulatory decision to regulate the airports together or separately) may allow the potential for cross-subsidisation to the detriment of other airports within the State

## Capacity and the price cap

An important consideration is whether there is sufficient capacity that an airport, under a single-till regime, could choose to set charges below those mandated by the price cap. In this instance, it is natural to question whether the price cap has been set at an appropriate rate and whether a price cap is required in the current circumstances. It is also an important competition consideration as to whom such discounts under the cap are given. If there is no objective justification in terms of costs, it may be that such an outcome will tend to ossify the position of the largest carriers operating out of an airport. This may hinder the introduction of new carriers onto routes, notwithstanding any discounts given in the short term to new entrants.

# What is meant by airport capacity

Airport capacity is in many ways an inexact science. It is possible to measure capacity in any given element (for a given industry standard of delay, congestion etc.) but it is a difficult exercise to integrate the capacities of each element to arrive at a global capacity figure. Notwithstanding this, the airport must be incentivised under the regulatory regime to ensure that its assets are used as intensively as possible to ensure efficiency.

In relation to Dublin airport there has been much adverse press comment last summer in relation to landside capacity, notwithstanding the fact that new terminal infrastructure has since come on stream and there is now ongoing work to upgrade existing facilities<sup>[5]</sup>. At the same time the airport operator is currently conducting a public information exercise in relation to plans to build a second runway to increase the airside capacity of Dublin airport even further<sup>[6]</sup>. Given the difficulties in relation to planning it is probably prudent that the airport operator ensures that the process of obtaining planning permission is initiated well in advance of any plans to actually build.

Planning and environmental concerns are increasingly limiting the actual airside capacity of airports throughout Europe with Schipol in the Netherlands being a particular example. It can be anticipated that similar restrictions may be imposed on airports in the State going forward. This prospect will, in turn, influence the airport operator's decision on whether to build extra capacity.

It is important from the perspective of dynamic efficiency that the correct incentives are given by the regulatory regime to increase capacity in a manner that delivers capacity in an efficient manner as possible. As an airport is an integrated system of differing services, each with their own capacity, it is important that, whatever regulatory regime is chosen, it incentivises the airport operator to invest in those areas where capacity constraints are believed to exist.

## Single v. Dual-Till

The debate on the single-till versus the dual-till in aviation regulation has been played out recently in Australia and is currently under review in the UK. This debate has generated much research into the issue, which will help inform the thoughts of all interested parties in the current process. In both instances the starting point was the status quo at Sydney and the BAA airports (and Manchester) of the single-till approach.

Under the single-till approach airports have a natural incentive to exploit the demand complementarities between aeronautical and non-aeronautical activities. Such an incentive will exist no matter at what level the price cap is set at. The airport has an incentive to do this up until the point where capacity constraints emerge. It may be likely that a well-run airport which chooses to lower aeronautical charges below cost in the light of excess capacity, will recognise upcoming capacity constraints and invest accordingly. This, in turn, may provide an argument as to why airports should have the greater flexibility that comes with a price control on a basket of services. In this manner, if constraints begin to emerge in relation to a particular service the airport will be able to send out signals to users to economise through higher prices. These prices may then be set at levels approaching or exceeding their true costs, which may incentivise

the airport to invest accordingly.

However, the single-till may lead to over-investment in non-aeronautical activities that may distort competition, given the airports' incentive to ensure that the maximum rents are accrued from their non-aeronautical activities.

Starkie and Yarrow point out that in a situation where there is excess capacity at an airport the single-till approach can lead to a situation where the price caps do not bind (a factor that is likely to be exacerbated in a situation of strong countervailing airline power) which may cast doubt on the need for price cap regulation in the first instance. Starkie and Yarrow point out that such a situation existed at Stansted Airport in the early 1990's. In this instance the low charges were challenged as predatory by Luton Airport. In the end it was found that the low prices at Stansted had harmed Luton but that the low prices were reasonable given the excess capacity at Stansted. This decision, it must be noted, predated the introduction of competition legislation that mirrors that of the EU in the UK. It is not at all clear that a similar decision would be reached if the competition act had applied at this time

The final choice between the single versus the dual-till is, as is recognised by the CAA, an empirical question as to whether the single-till or dual-till results in better productive and dynamic efficiency. The answer to these questions differ across airports at any point in time and may well differ in relation to a single airport over time.

## **Service levels, investment and low-cost operators**

A relatively recent innovation in terms of aviation is the emergence of low-cost point-to-point operators in the mould of Southwest Airlines in the US. These operators have pared costs down to a minimum by offering a basic service of point-to-point travel without many of the service elements that are common to most airlines.

Such airlines make much less intensive use of airport resources, having significantly lower turn-around times etc. and demand a much lower level of service than may be acceptable to traditional operators.

The emergence of these operators has been an important innovation in the airline industry and has delivered substantial benefits to consumers. It is important that the interests of these airport users (and their passengers) are met in the regulatory environment. This has implications both for pricing (there should be a menu of options that a low-cost operators should be able to opt out of) and for investment (the low cost operator may require a much lower specification in terms of terminal facilities than will a traditional operator). Whilst the pricing and service issue can be relatively easily addressed to ensure that low-cost airlines are not forced to consume services that they do not require (thus raising their costs) the issues around investment are much more problematic.

Given the vastly different planning horizons of airports and airlines, how can a low cost operator credibly commit to use facilities into the future, in a manner that will ensure that the airport operator has an incentive to deliver such tailored infrastructure? Given the paucity of low cost operators (relative to traditional operators) it may be that, given the potential cost of retrofitting a higher level of specification

is high enough, the airport operator may be unwilling to build tailor made infrastructure for low-cost operators.

This may be overcome by the building of competing terminal infrastructure or by some joint venture arrangement between the airline and the airport operator. These options would also raise competition concerns (in relation to access by new entrants) that would have to be addressed. This issue may be beyond the scope of the CAR, but this and other issues fall naturally into the ambit of the Competition Authority.

In response to the UK Government's decision not to proceed with the de-merger of BAA's London airports, the CAA is looking at ways to introduce competition in the provision of terminal infrastructure, through new investment or the lease of terminals. The CAA has identified the following potential benefits from increased competition between terminals:

- better service at reduced cost due to competitive pressures;
- increased innovation;
- improvements in service quality; and
- increased specialisation of terminals to different user groups.

These may arise at the cost of increase in a negative externality in airport operations and planning and a potential increase in transactions costs. Competing terminals may lead to a lessening of economies of scope in terms of pooling resources across terminals.

## A Competitive Mandate

It is a generally accepted principle in most regulated markets that once competition is introduced regulation should be applied to only the core monopoly elements and all other concerns should be dealt with under general competition law. However, aviation regulators, including the CAR, do not in many instances have a direct mandate to increase competition.

Notwithstanding the lack of a clear competition mandate many choices that the CAR will make may impact on the competitive process in the airports industry. In relation to this issue in the UK the CAA has stated that

“it does not believe that the lack of such a statutory duty (to encourage competition) should prevent it from pursuing competitive solutions within the Airports Act in some situations where these may be the best means of achieving its statutory objectives.”

As in the case of other regulated industries the Competition Authority has a mandate to investigate potential breaches of the Competition Act and has done so vigorously in the past. This is an important principle so that regulator, whilst being cognisant of competition concerns, does not have to involve itself in a detailed examination of all potential competition issues.

The goals of achieving productive, allocative and dynamic efficiency are best achieved by ensuring that, where possible, competition exists. The Authority hopes that the CAR will take a similar pro-competition

view to that taken by the CAA. Where potential competition issues arise the Authority stands willing to assist the Commission (and any other interested party) in its endeavours in this regard.

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[1] Starkie, D. *A New Deal for Airports*, IEA Lecture Series, <http://www.iea.org.uk/wpapers>

[2] It is likely that arriving passengers require less in terms of services but they may be intensive users of bureau de change facilities etc.

[3] The loss of duty free for travel within the EU has lessened the ability of EU airports to subsidise aeronautical activities.

[4] Starkie, D. and Yarrow, G. *The Single-Till Approach to the Price Regulation of Airports*. Paper submitted to the CAA's review of the price cap on BAA's airports.

[5] *Irish Times*, 9th September 2000.

[6] *Northside People East*, Vol. 14, No. 10 14<sup>th</sup>-20<sup>th</sup> March 2001