

**IATA response to the Commission for Aviation Regulation Issues Paper of 29 October 2010 on the maximum level of aviation terminal service charges that may be imposed by the Irish Aviation Authority**

**1. Introduction**

1.1 IATA welcomes the opportunity to input to this Commission for Aviation Regulation (CAR) Issues Paper on the maximum level of aviation terminal service charges (ATSC) that may be levied by the Irish Aviation Authority (IAA) for the next control period or Determination.

**2. Approach to Regulation**

2.1 The IAA sharply increased the terminal navigation charge by around 33% from 1 July 2010. While we very much appreciated the “freezing” or status-quo in the rate for the first six months of the year a price hike of this magnitude is clearly unacceptable and undesirable. This has followed with a 14.6% increase in the unit rate from 1 January 2011. In the circumstances it should be queried if the current regulatory system is fit for purpose.

2.2 Ireland will presumably be obliged to adopt the EC Performance Scheme for terminal navigation charges (TNC) on 31 December 2014. It would be practical to consider earlier implementation of this scheme and to be consistent with the EC ANS Charging regulation and Performance Scheme rather than have a relatively short-term continuation of a national system.

2.3 IATA met informally with the CAR in July 2010 to outline our views and requirements with regard to ATSC structure including the proposal that these should be more site-specific and cost-related in future determinations.

2.4 We believe that charges should be cost-related, non-discriminatory and equitably applied in line with ICAO and IATA charges principles, and that no group of users should be given special treatment with regard to charges. In this regard we believe that the TNC structure should be site-specific reflecting the costs of providing the service at each airport.

2.5 ICAO Document 9082/7 highlights that users should pay their fair share of costs (para 36) that the allocation of costs of air navigation services among users be carried out in a manner equitable to all and to ensure that no users are burdened with costs not properly allocable to them (para 40) and that any under-recoveries of costs properly allocable to the users concerned is not shouldered on to other users (para 41.v). In our view these references support the principle of site-specific charges.

2.6 Clearly the users of larger airports are unfairly cross-subsidising the users of smaller airports. Intuitively larger airports have the ability to spread their fixed costs over a much larger customer base resulting in significant economies of scale and increased productivity. Despite their bigger infrastructure and costs larger airports will therefore generally justify significantly lower charges.

2.7 We are aware that as a result of political pressure the EC ANS Charging Regulation 1794/2006 does unfortunately allow the operation of airport systems for charging purposes. It should be noted however that this is not a mandatory requirement (Recital 5) and that States are allowed to choose the number of TNC charging zones they believe appropriate.

2.8 Within Regulation 1794/2006 the EC asks for details within Annexes II and VI in order to provide transparency and explanation on any resultant cross-subsidies between airports. In our view this is recognition that charging on an airport system basis inevitably enables cross-subsidies that can also be regarded as discriminatory and anti-competitive.

2.9 In the increasingly competitive and de-regulated airline business we cannot support charges systems that permit unfair cross-subsidies. Users should only pay for the services and facilities that they need and use. Those operators and passengers using the cross-subsidised airports are receiving the service and facilities at a reduced rate. If national or regional authorities believe that subsidies are required at smaller regional airports for local social or economic reasons, then any such subsidies should be born by those authorities that believe they are necessary, and not unfairly carried by the users of the larger airports.

2.10 It should also be considered that application of a TNC system charge, in addition to distorting competition, is neither efficient nor transparent. Additionally, reduction of the apparent costs of the smaller airports can result in uneconomic investment decisions and conceal inefficiencies.

2.11 An initial step would be for the CAR to consider a separate charge for Dublin with another charge covering the significantly smaller Shannon and Cork airports.

2.12 Other eventual considerations in line with recent developments should be:

- Outsourcing of tower service as has been done in Germany and Sweden, and is being planned for smaller airports in Spain, to reduce costs through tender and competition.
- Introduction of remote and virtual tower service, as being investigated in UK and Germany, to reduce costs.
- Inclusion of approach and tower service costs into airport charges as a means of driving down costs – through ending of direct charging with the airport competitively deciding how much of the ANSP's costs to absorb or pass-on.

2.13 IAA is a monopoly provider of essential service for airlines who are operating in an ever increasingly competitive environment. With regard to volume risk it should be considered that airlines have a higher risk on traffic and that ANSPs are better placed to take this risk. In the event of traffic shocks or downturns airlines are inevitably forced to reduce fares and yields while still paying the same or increased charges to the ANSP.

### **3. Quality of service**

3.1 Along with flight efficiency, delay performance is the most important component of service quality for the airlines. Providing the benefits do not outweigh the costs we would therefore like to see flight delay metrics that directly reflect airlines' and

passengers' needs by incentivising delay reduction. The CAR may be aware that our recent customer consultation process with UK NATS as part of the en route CP3 price control review resulted in the current weighted average delay metric being replaced with three core delay terms that better reflect the impact of early and lengthy delays which have a much higher economic impact on the airlines:

- T1 – Average delay – expressed as the average delay per flight.
- T2 – Impact of individual delays – expressed as impact score.
- T3 Variability of daily average delays – expressed as a daily excess delay score

3.2 The most appropriate source of data for the metrics would be CFMU delay figures, particularly as these will presumably also be the source for any SES II metrics. In our view the only requirement is for penalty incentives. Given that we are already paying through our charges for the agreed minimum level of service any bonuses would be inappropriate.

3.3 With regard the potential amount at risk it is recognised that any amount is not intended to compensate airlines for their delay costs. The purpose of the incentive is to focus IAA management attention on one of the two most important service quality components. The most appropriate source of data for the CP3 metrics should be CFMU delay figures, particularly as these will presumably also be the source for any SES II metrics.

3.4 Along with delay performance, flight efficiency is clearly one of the two most important service quality elements for airlines. Our understanding is that the EC Performance Scheme is only recording this element in terms of horizontal flight efficiency and that there is merit and consideration to including a vertical flight-efficiency element to avoid unintended or perverse incentives. However, the airlines also face the reality of inclusion in the EU Emissions Trading Scheme in 2012 and therefore prefer for a flight-efficiency financial incentive metric to be included in any regulatory settlements.

#### **4. Traffic forecasts**

4.1 We are generally happy with the EUROCONTROL/STATFOR medium term movement forecasts. Our own IATA forecasts are passenger based but historically show a very close correlation with the movement forecasts.

4.2 Given the recent unacceptably high increases in Irish TNC unit rates we cannot believe that IAA would be incentivised to under-forecast to achieve higher unit rates. Additionally we could assume that their priority is to forecast as accurately as possible for capacity planning purposes.

4.3 In the case of UK NATS we supported continued use of the correction factor one-year in arrears and believe that the application of the asymmetric interest rate should be sufficient to prevent NERL understating its traffic forecast. However, as we no longer have confidence in NATS traffic forecasting we requested the Regulator to apply an asymmetric rate to sufficiently discourages NERL from erring on the side of under-forecasting traffic for the year ahead.

4.4 It is generally accepted that capacity in terms of movements and time in the system, rather than weight, are the main cost drivers for ATC provision. So while charging formulas frequently include a weight-related element as a proxy for the “ability to pay” reflecting the relative productive capacity of different aircraft sizes, we do not generally support this policy.

4.5 However, we do recognize that aircraft size and associated weight turbulence is a consideration for airport approach and departure separation. Although any change to the weight element redistributes costs rather than reduce them, it results in fairer and more cost-related charges with non-airline users including general aviation and business jet operators paying a fairer share of the costs.

## **5. Operating expenditure**

5.1 From experience with other regulated entities it is evident that operational expenditure is one of the major areas for potential efficiencies. We rely on the CAR’s robust scrutiny on key potential areas for further improvement and efficiency savings. Staff costs, representing some 46% of total IAA TNC costs, are clearly a major area for such scrutiny

5.2 Over the last ten years, including the recent economic and traffic downturn, the airlines have been obliged to take robust efforts to reduce costs and increase efficiency against the background of increasing competition and changes to business models. This has enabled a 15% average reduction in airline fares over the same period, while in comparison ANSP costs and charges have steadily increased. As the independent regulator the CAR must ensure IAA is managing its business as efficiently as possible and to set operational expenditure projections on the basis of equally stretching efficiency improvements.

5.3 IAA should be incentivised to be more flexible and efficient at managing changing workloads. Intuitively, and particularly when compared to the airlines achievements, there is an opportunity for significantly more challenging operational expenditure efficiency. Non-regulated businesses, including airlines, operating in competitive industries, are obliged to successfully manage all such risks.

5.4 In theory we can understand the benefit of the rolling investment mechanism that should incentivise IAA to continue to pursue continued improvements throughout the Determination period and ensure that customers share the benefits earlier than they would otherwise. We are however also concerned at the possibility this mechanism can be gamed, including the restating of costs, and the lack of transparency on which benefits have been identified. We therefore welcome the CAR intention to fully consider the appropriateness of the RIM for the next Determination.

## **6. Capital costs**

6.1 There is clearly a need for meaningful consultation with IAA together with the CAR on the capital investment plan proposals to cover the Determination period. While the based airlines are best equipped and motivated to be involved in this consultation we would welcome the opportunity to participate.

6.2 We fully support the principal of milestone capital allowances but given the relatively large investment costs for major projects such as airport towers we believe consideration could also be given for a more symmetrical system including trigger penalties for reductions in charges.

6.3 With regard the asset lives for depreciation purposes we are unclear on why buildings have only 5 years while airport towers have 20. EUROCONTROL Principles for example recommend between 20 to 50 years for freehold buildings including related works services, or over the period of the lease for leasehold buildings.

6.4 With regard to gearing, we understand there are rumours the Government is planning to separate IAA service provision with a view to possible sale and privatization. In preparation it would be helpful to know if the CAR has any intention to introduce gearing targets and caps to protect users or to ring-fence provisions to protect the regulated business from operations elsewhere in the group and keep important assets in the regulated business to ensure continuity of business.

## **7. Cost of capital**

7.1 The Principles allow an ANSP to recover its costs related to net assets employed. They also reinforce the ICAO requirement (Para 6.36 of ICAO Doc 9161) that the cost of capital should take into account the very low financial risk of providing ANS and taking the Government bond rate as a guide.

7.2 In our view all ANSPs certainly enjoy enviable low-risk characteristics including:

- Monopoly providers.
- Large and guaranteed income stream.
- Very efficient medium and long-term recovery rate of 99.8% (through EUROCONTROL).
- Full cost or determined cost recovery system backed by late payment penalties and enforced recovery.

7.3 In any normal and competitive business the cost of capital reflects the opportunity cost of funds for investment in organizations. In these circumstances if investments were expected to earn a return below their cost of capital other alternative investments might be considered. We recognize there may be an element of competitive demand for funds from other Government organizations and entities. However, not only is ANS provision a monopoly business, but the Governments have agreed an obligation in line with international agreement to provide this essential service. In these circumstances opportunity costs should clearly not be a consideration.

7.4 We recognize the justification for a reconsideration of the applicable cost of capital applicable to economically regulated ANSPs where the company is subject to the risks of price capping. It should be noted however that in these circumstances the cost of capital is a key regulatory parameter or lever to ensure continuous cost-effectiveness and improvement in unit costs from which the users benefit. Also, in the relatively few cases of ANSP that are independently regulated, the risks are also shared with the users through measures such as traffic risk-sharing mechanisms and a symmetrical performance bonus/penalty scheme.

7.5 Both the ICAO Document 9161 and the “Principles” recommend that the Government bond rate, or alternatively rates payable in financial markets by enterprises of comparable low risk, may be taken as a guide. However, it should also be noted that other infrastructure utilities such as water, gas, and electricity that have steady income streams but do not have the assurance of full-cost recovery, have average betas somewhat lower at 0.56.

7.6 We are aware that some ANSPs have used the cost of capital to build up reserves or profits. In our view ANSPs have no requirement to build-up any reserves to finance investments, which are already covered by depreciation and interest costs. Any such reserves could be regarded as pre-financing that can be considered as a “double-hit” for the users who finance the build-up as well as the normal investment costs.

7.7 We recognize that many ANSPs have a tendency to be overcapitalized with assets and cash, with the result that a small weighted average cost of capital (WACC) on a very large asset base can have a higher cost impact than a big WACC rate on a leaner balance sheet.

7.8 Against this background we believe that the cost of capital for ANSPs within the full cost or determined cost recovery regime should be at the level of Government bond rates, and that any difference above that level must be clearly identified and justified in terms of any real or additional risks.

## **8. Other issues**

8.1 The EUROCONTROL CRCO Overview of the data provided by the 23 EC–Member States for the 25 November 2010 TNC consultation provides some interesting comparisons. While the average National TNC costs for all States are for a decrease of -2% for 2010 and +3.1% for 2011, Irish TNC National costs by comparison are increasing +8.7% and +10.3% respectively. In particular it is observable that whereas the average European depreciation costs are +0.1% for 2010 and -0.1% for 2011, Irish depreciation costs are +19% and +26.7% respectively.

8.2 Similarly, while the average European cost of capital is +4.8% for 2010 and +3.1% for 2011, the Irish costs are increasing +19% and 26.7% respectively. It is noted that Irish depreciation and cost of capital each represent some 29% of total costs against the European average 11.7% and 4.8% respectively.

8.3 This would seem to indicate that the current economic regulation is not sufficiently bearing down on Irish TNC costs. Additionally, if the extremely large TNC depreciation cost increases are contributed to by significant individual investment projects this would emphasise justification for a more site-specific and cost-related TNC structure as well as asking the question whether project procurement and implementation is sufficiently cost-effective. Given the large cost and unit rate increases over 2010-11 it is difficult to have any confidence in the forecast 1.6% per annum Irish cost data from 2012 to 2015 provided for the EC Consultation.