CONTROLLED TAKEOFF

How regulation can help airports to recover

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frontier economics

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EXEC SUMMARY

In 2020 all major airports have made huge financial losses, and the future remains uncertain. It could take years for traffic to get back to pre-COVID-19 levels. In this bulletin we highlight how adjustments to regulation can help to speed up recovery in the airport sector.

SIGNS OF A PICK-UP

The aviation sector is hopefully over the worst phase of the pandemic.

However, as traffic and revenue have fallen faster than costs, most airports are still operating at a heavy loss. The future remains uncertain: quarantine lists vary between countries and are subject to sudden alteration. Two main concerns for the public are:

- First, not all airports may be able to survive. When demand does return, some passengers may find that their local airport is no longer open for business.
- Second, passengers may face permanently higher ticket prices. COVID-19 may cause investors to attach greater risk to the aviation sector, raising the cost of financing future investments. This could lead to higher costs for airlines and to dearer tickets.

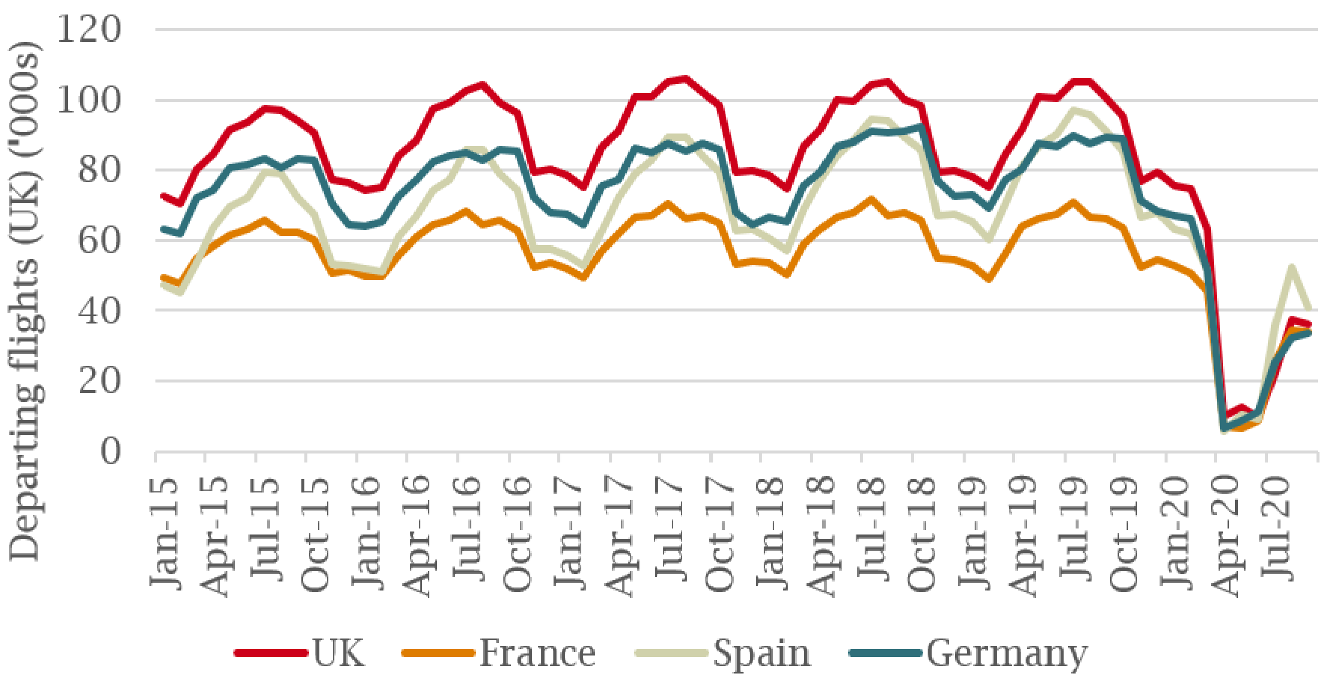
There are significant benefits to putting in place arrangements to help mitigate these effects, including a role for airport regulation.

REGULATION – HELP OR HINDRANCE?

Airport operators tend to be vocal about whether they should be subject to economic regulation. Many argue that it is unnecessary given the level of competition that they face from other airports and alternative modes of transport. Some airports are indeed subject to economic regulation without good evidence that they have significant market power (SMP), meaning that there isn't a clear economic rationale for regulation.

The nature of the regulation is contentious too, even more so in the current pandemic. In particular, there is a real concern that simple cost-based regulatory pricing models may suggest that airports should set high prices over the coming years to help recoup costs, but that they will find it impossible in practice achieve those prices. In simple terms, cost-based regulation sets a maximum airport charge per passenger by (i) identifying the airport's accounting costs; and (ii) dividing that sum by the forecast number of passengers over the same period. Clearly, dividing a large cost by a relatively low number of passengers implies a big charge to airlines, at precisely the time when the aviation sector needs just the opposite. If the airport is told by the regulator that it can charge a high price but fails to do so, the regulator may think it has done its job. But the reality is not only unrecoverable short-term losses for the airport, but also a significant increase in financial risk that inflates financing costs, exacerbating the problem.

FIGURE 1 THE NUMBER OF DEPARTURES IS BOUNCING BACK



Source: Frontier analysis based on OAG data

In light of this issue, many airport operators have called again for deregulation. But would deregulation help?

- If an airport does not have SMP it is the market, not regulation, that is constraining its prices. A deregulated airport will still face the problem that the average cost per passenger will be more than the market is prepared to pay.

- If an airport does have SMP it may, in theory, be able to raise prices if released from the constraints of regulation. But that is not what is likely to happen during the recovery period. Thereafter, the prospect of an unregulated airport exercising unfettered market power is not attractive. In other words, abolishing regulation for such an airport would be ineffectual in the short term and unwelcome in the long run.

Therefore, in neither case is there a strong argument for complete deregulation. But there is a strong argument for reform. In that respect, regulation, often bemoaned by airports, may actually be able to help them in coming years.

SHARING THE PAIN

Regulation could be reshaped to protect revenues over the long haul. This would reduce financing costs in the short term, thereby lowering risks and costs in the medium to long run.

Two aspects of the regulatory contract offer a solution:

- Traffic risk-sharing mechanisms
- The ability to spread the recovery of costs over an extended period

TRAFFIC RISK-SHARING

Many regulatory contracts in other sectors (as well as some for airports) include a threshold for demand variation that caps the supplier's financial upside and downside risk. Prices are reduced if demand is above the maximum and increased if it is below the minimum.

In one plausible option, shareholders should be fully exposed to traffic variation of up to, say, ±10%, but protected outside that range.

In 'normal' times such a rule is relatively easy to apply: if traffic falls outside these tramlines, prices are adjusted in the following years. But these times are anything but normal and, as we have argued, immediate price rises are probably not feasible or desirable. Furthermore, sharing risk within agreed ranges does not deal with the problem of a long-run shortfall in demand. The tramlines concept is helpful to articulate how much traffic risk it is reasonable for the airport to bear. But with a persistent dearth of demand and no immediate prospect of price increases, an alternative long-run adjustment mechanism is called for.

RECOVERING COSTS OVER EXTENDED PERIODS

Regulatory precedent includes mechanisms that allow costs to be spread out and recovered over time. The crucial step is to take advantage of one of the key elements of most regulatory regimes: the Regulatory Asset Base (RAB). (Clearly, this option is available only to airports that are regulated, enjoy SMP and have an RAB, which is why calling for deregulation may be misguided.)

The RAB is a measure of the net value of the regulated assets invested in the airport on which investors can reasonably expect to earn a return (i.e. provided airport operators discharge their obligations reasonably efficiently). It is a mechanism that allows regulators and investors to keep a running score, as it records all the costs incurred that need to be paid for in the future.

There are two established ways in which the RAB can ease the problem described above. It can help to:

- adopt a system based on 'unit of output' or 'economic depreciation':
  - Applying depreciation to units of output (eg, passengers in the case of airports), rather than fixing depreciation over a given time frame, means that if traffic is low costs are deferred (from a regulatory point of view) until the airport recovers.
- adopt a flexible approach to the recovery of all expenditure by adjusting the relative run rate of operating and capital costs. This is sometimes described as the 'fast money/slow money' approach.
  - This approach is already used by UK regulators to smooth the price effects of major investment spikes. It goes further than 'unit of output' depreciation in that it can be

applied to all costs, even operating costs that would normally be expensed through the accounts in the year they are incurred. Costs treated as 'slow money' are capitalised in the RAB and can be recovered at a later date, but only when traffic can sustain them. Airports, with approval from regulators, can then decide how much of the RAB to recover through depreciation on a more flexible basis to help recoup costs spread over a greater number of passengers in future.

Using the RAB as it should be used – as a repository for regulated value – would reduce the risk of investing in airports because investors would know that the RAB would preserve the value of their investments. This in turn could help operators to mitigate COVID-driven increases in financing costs.

Such an approach would also temper the effect of cost increases on airlines. Rather than facing abrupt price hikes, at a time when traffic is most uncertain, airlines could plan future capacity based on modest increases in airport charges, signalled years in advance. In a competitive market, these costs would largely be passed through to passengers.

An important point to note is that no retrospective changes need to be made to the regulatory settlement. It can simply be put in place on a forward-looking basis from 2021. Moreover, there is nothing to prevent these approaches being used retrospectively to address this year's losses. While retrospection is usually best avoided in regulatory settlements, the sheer scale of the problem requires flexibility and exceptional treatment.

As mentioned, these approaches may be an option only for regulated airports that have a RAB and that actually enjoy SMP. If they do not have SMP, then although their regulation may imply that they 'should' increase prices in future, they could find that it is the market that sets their prices. If airlines are not willing to pay more, the airport will not be able to recover its costs whatever the regulator says.

CONCLUSION

In this paper we have argued that flexibility in the regulatory accounting of operating and capital costs, underpinned by strategic use of the RAB, could be used to partially mitigate the long-run financial impact of the COVID-19 crisis on airports. Setting tramlines for the variation in traffic has merits, with the airport taking the full risk within the agreed range while being protected outside it. However, mechanistic cost-based regulatory structures may simply offer airports virtually worthless compensation for increases in costs in the form of permission to raise price to levels that are impossible to implement.

Changing the run rate of operating and capital costs by adjusting the ratio of 'fast money' to 'slow money' in the regulatory accounts offers a partial solution to this issue, provided interim losses are accrued in the airport's RAB. But given the scale of the crisis, even if the price increases could be delayed in this way, they would still be very substantial.

The only alternative is for government to step in with direct support for airports now. Intervention would reduce losses and hence limit future price rises. It would also make it viable to operate what is vital infrastructure, hopefully enabling airports to make the best of the recovery phase. However, such an intervention should be undertaken in conjunction with a change in regulatory approach, which, by providing future protection, could reduce the direct cash injection the sector may need this year.

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