

Attachment 6

**Statement by Thomas Charles Bass – Regulation – August
2001**

**Statement by Thomas Charles Bass – August 2001 on behalf of
Auckland International Airport Limited in response to the Commerce
Commission’s Draft Report (3 July 2001)**

I was employed by the UK Civil Aviation Authority from 1972 to 1997 in various capacities, starting as an Economic Adviser dealing mainly with airline issues and latterly as Head of Economics, Statistics and Airports Policy. In this role I was responsible to the Group Director Economic Regulation for airport regulation, including the last two MMC/CAA (UK) quinquennial reviews of the BAA London airports and of Manchester, and for the regulation of the conduct of these and the other UK airports. Since 1997 I have been an independent consultant, working mainly with the Macquarie Airports Group (formerly the Portland Group) on the regulation of airports and air traffic services world-wide.

I was asked by AIAL to assist in the preparation of its April 27 submission to the Commerce Commission and contributed to the sections on international regulation, including Attachment 6, “The Role of Airport Regulation and its Practical Implications.” In this Statement I offer comments on related issues in the Commission’s Draft Decision of July 3 2001. These comments are mainly, but not exclusively, from a UK perspective. The main points are

- 1) detailed sector regulation brings with it inefficiencies, costs and perversities which, although recognised in the Commission’s Draft Report, are all too easily understated ;
- 2) the detailed UK system was originally set up by the government which set the first five-year formula; the CAA (UK) then had several years to acquire the resources and do the specialised and detailed work for the second formula;
- 3) detailed regulation is in practice uncommon; only the UK uses detailed models, and then only for Heathrow, Gatwick and Manchester and the ideal is looser regulation;
- 4) once regulation exists regulators tend to become more rather than less interventionist;
- 5) the UK model uses what amounts to current cost accounting, not only for airports but for the regulated utilities in general;

1) Perversities of Detailed Regulation

The now prevailing model of ex-ante CPI-X regulation was designed specifically to avoid what were seen as the worst perversities of traditional rate of return regulation. (However rate of return regulation can be used to achieve particular objectives: the obvious example is the new airport at Athens (Spata). There the concern was to raise charges and, hence revenues, above their previous rates to a higher level that would be sufficient to finance investment in a project seen to be of national and strategic importance).

The key to CPI-X was that, because it was set ex ante, the regulated company faced strong efficiency incentives: it could gain by outperforming the assumptions set at each review and would lose if it failed to achieve them. At the same time users had the assurance that enhanced efficiency would be passed on to them when the next formula was set.

The case for CPI-X still holds sway for those industries where regulation is still seen as necessary. The UK government endorsed it in its 1998 paper “A Fair Deal for

Consumers: Modernising the Framework for Utility Regulation”, where it said that “RPI-X should be retained as the fundamental system of price regulation, so long as regulators continue to judge this is best for consumers”

But in practice CPI-X has perverse incentives of its own: the following examples have all concerned the UK CAA (UK) and other sector regulators:

- Deferral of cost savings until the next review.
- Over-forecasting of capital investment.
- Under-forecasting of secular efficiency improvements.
- Under-forecasting of traffic.
- Allocation of costs towards the regulated activities.
- Raising charges in non-regulated areas (for example office or check-in desk rents and coach/taxi fees).
- Introducing new charges in non-regulated areas.
- Diversion of resources/corporate energies to non-regulated or less regulated areas (eg off-airport retail, overseas airports).
- Reduction of costs through reduction in, or failure to improve, services standards.

In the UK various pressures (high political profile, capacity shortage, government threat of windfall tax, and 14 years’ experience) have moderated these tendencies. Nevertheless the CAA (UK) has become more rather than less interventionist in monitoring some of these activities and concern about the perverse incentives of regulation has led it to introduce assessments of airports’ performance between quinquennial reviews.

Ahead of the next reviews the CAA (UK) has also generated a major debate into fundamental issues such as the form and nature of the price cap, the single till, service quality, benchmarking and the treatment of capital expenditure. This shows inherent uncertainty as to whether the CAA (UK) is doing the right job. This fundamental review of the basic approach also imposes on airports and users additional costs over and above the already high costs of the normal five-year reviews. These costs include not only those of the MMC (now the Competition Commission) and the CAA (UK) but also the less measurable resource costs to airports and users. BAA and Manchester both appoint specialist teams for regulatory reviews and the process involves considerable commitment from their boards and top management.

Incidentally it is not open to the CAA (UK) to decide to remove price control from the designated airports: the law requires a price cap. In the current review the CAA (UK) has made it clear that this is a matter for government and therefore not for discussion in the absence of a specific government request. (In this respect its role is similar to that of the ACCC in Australia, which administers the price cap but does not make the decision on whether a cap should be applied).

The furthest that the CAA (UK) could go towards relaxing price control would be the suggested “default” price cap. The CAA (UK) describes the key concept underlying this as “ to provide a basic protection to airport users against significant monopoly power but to allow and encourage negotiated access and service provision which is independent of the default price cap”. The principle is that airports and users would be encouraged to negotiate as many of the individual airport charges as possible, leaving

the regulator to cap only those charges on which agreement could not be reached. Ideally the regulator would be left with little, and ultimately no, role.

The Commerce Commission's draft recognises that "price control cannot be relied upon to eliminate the **entirety** (my emphasis) of any inefficiencies." Nevertheless it goes on to imply that it could eliminate many of the calculated past and perceived future inefficiencies and it also appears to assume that the costs of regulation are limited to its directly identifiable resource costs.

I also believe that the draft may place too much reliance on the identification of past and short term (but very debatable) inefficiencies and too little on the issues that the regulator will have to face in constructing a forward-looking regulatory formula. Even if the formula is not worked in detail as in the UK model the regulator will still have to rely on his/her own view of future performance.

Unless ex -post profit control is introduced (and I assume that this is not envisaged), the control mechanism will be yield-based and therefore inherently unpredictable in terms of total revenue. The regulator also has the problem of information asymmetry and, like anyone else, fallible judgement. The examples of Manchester and, in the past, Gatwick show that the regulator may allow charges **higher** than the airport needs to levy in the event. The regulator is no more likely than other forecasters to forecast correctly: in the past regulators and others have persistently under-forecast aircraft movements and consequently revenue and rates of return. (Aircraft movements are especially difficult to forecast even where passenger numbers can be predicted with relative confidence).

The conclusion in para 11.72 of the Draft that the UK price caps have "achieved reductions" has to be seen in the light of the fact that the starting point was a highly profitable business which had a deliberately generous opening formula to facilitate flotation. It is highly debatable whether charges would have fallen at a slower, faster or the same rate if less intrusive forms of regulation had been used.

2) The First BAA Formula was set by Government, not the CAA (UK)

As in all the UK regulated industries except Manchester Airport the RPI-X formula for the BAA London airports was set as part of the public flotation of a previously nationalised company. Since among the principal objectives were to achieve a successful sale and to foster the idea of share ownership generally, the government itself set the initial formulae with low values of X. In the case of the London airports the lowest possible value was set: X was 1 for each of the first five years despite the fact that, as subsequently became very clear, the airports were highly profitable in a growing market. They also had considerable opportunities for productivity gains and for generation of more income outside the regulated charges but within the single till.

Thus the first formulae were not directed towards users, who received only token reductions in charges in real (but not current) terms, and the first BAA London formula proved to be excessively generous. The interests of users became paramount only at the second stage when the regulators rather than the government set the new formulae.

The effect of this was that the regulators then had over four years to establish themselves and gain the resources and expertise to develop the second wave of price caps. This was relatively easy for the CAA (UK) because it already existed as an aviation regulator and its airline regulation activities were already beginning to wind down.

The CAA (UK) also had board members with City and financial experience at very senior levels all the price cap decisions were taken jointly by the Group Director, Economic Regulation and a part time board member with private sector business and finance experience. They in turn had advice from the full CAA (UK) board, including a finance specialist. They also had the benefit of the six-month MMC reviews, where the MMC had its own specialists on the panel and on its staff. Nevertheless the CAA (UK) had to take on additional staff and, for the first review, to appoint an outside consultant on the financial aspects.

Financial skills and business experience are less important to a general competition regulator, where the issues and the remedies do not involve forward-looking price caps.

With the shift of emphasis towards users the CAA (UK) had to find a formula which would meet users' needs (including future capital investment) while setting charges no higher than necessary to achieve this. This could not be done without:

- a detailed understanding of the financial drivers of the business: in practice this involves developing an agreed financial model of the regulated part of the airport;
- the ability to question and where necessary to adopt different assumptions of these drivers, eg traffic growth, productivity, cost allocations, input costs, etc;
- the ability to deal authoritatively with financial and stock market issues;
- close understanding of users' needs for future investments and their scale, phasing and cost;
- the ability to weigh the differing priorities of airlines, eg between quality and cost, and to make a choice when these are equivocal *within* airlines (airlines typically press for lower charges in public and for increased quality and enhanced investment in private);
- confidence in the basic approach: (note the current CAA (UK) questioning of the fundamental principles which have guided it since 1986).

This could not be achieved without:

- a reasonable set-up period (about 12-18 months) for the financial model;
- the internal resources (staff with financial modelling expertise to establish, agree, maintain, use and interpret it);
- staff with the expertise to understand and interpret the relationships between the financial, economic and policy (mainly user) issues;
- outside financial consultancy: during the set-up period (CAA used several months of a former Cooper bros. (now PricewaterhouseCoopers) partner);
- board members with business/financial experience at top level.

The CAA (UK) also receives advice from the Competition Commission, which conducts a six month enquiry into the charges and conduct of the designated airports. In the absence of such advice the CAA (UK) would almost certainly require further resources, even if it operated under a dual till system (ie dealt only with airport charges and not other airport costs and revenues).

Without these resources, and given the natural imbalance of information and the inevitable regulatory gaming, the regulator would simply not be equipped to present an effective challenge to the airports' submissions. In particular the CAA (UK) would not have had the confidence to set formulae which were regarded at the time - and not just by City commentators - as over-tough. (Two years later they were regarded by many of the same commentators as naively over-generous).

Given these needs and their associated costs it is not surprising that the UK model is unique since, as the UK government and the CAA (UK) have recognised, these costs would be disproportionately high for smaller airports.

3) Detailed Regulation is Uncommon and not being Extended

As noted in the AIAL submission, detailed regulation on the UK model is not fully used in any other country. While an increasing number of countries have some form of CPI related system, these are mainly either:

- a) "political" formulae designed to give the assurance that airport charges will fall in real terms (the first UK government formulae could be so described), or
- b) productivity trackers, using the CPI link to give a productivity target to the airports.

In both cases the value of X is likely to be low. Neither need involve the thorough and predictive models now used in the UK.

Even simple CPI-X models can be insufficient to deal with major issues. Part of the problem is the difficulty of accommodating longer-term objectives within a three or five-year price cap. For example both the Australian and South African systems take major capital investment outside the formulae and capex continues to give difficulties in the UK.

The Vienna formula appears to have originally been calculated quite closely, but the process was not transparent and even it has been rolled forward rather than reassessed after the initial period.

CPI-X is also not used for the majority of UK airports. Only the three BAA London airports and Manchester were originally designated for price control, and Stansted only because of concerns that under BAA ownership it might set unfairly **low** charges relative to Luton.

The UK government has said that in deciding whether to designate other airports for price control it would take into account

- the market position, including the extent of competition from other airports and other modes;
- prima facie evidence of excessive profitability or abuse of a monopoly position;
- the scaling and timing of investment, and their implications for profitability;
- efficiency and quality of service.

There has been pressure from powerful political forces for the designation of the BAA Scottish airports and, more recently, from easyJet, for the designation of Luton. In the first case BAA offered or was persuaded to offer an informal RPI-3 cap. However the government sought and took the CAA (UK)'s advice and decided not to designate Luton. In recommending against designation of Luton the CAA (UK) said, inter alia:

“Designation implies regulatory oversight over an airport which is likely to entail significant costs and may create distortions of its own. As such it is not to be undertaken lightly. Given the detailed oversight entailed by designation, the CAA considers the test to be met should be stronger than establishing the existence of some market power”

In accepting the CAA (UK)'s advice the Transport Minister commented:

“The addition of a cap would be a very major step, involving additional regulation and cost. I believe that this should be a last resort, requiring strong evidence of abuse or potential abuse by an airport of a dominant position”

It is important to note that these statements were made in a country which is comfortable with sector-specific regulation and which, by virtue of the history of specialist aviation regulation, the designation of BAA London and Manchester (and also now of the regulation of National Air Traffic Services), has existing resources and expertise.

Finally, and in a different context, it is worth reiterating that the Netherlands government considered some form of CPI-X regulation for Amsterdam Schiphol but recently decided to rely on general competition regulation.

4) Regulators are Naturally Interventionist

A common criticism of regulators and governments is that once given powers of control they are inclined to overuse them and are reluctant to loosen their grip. I recognise the syndrome, although my own experience in the CAA (UK) suggests that it is not always the case: the CAA (UK) was the first and a leading force in airline deregulation. Its culture has always been to look for ways of minimising regulation.

Nevertheless the current consultation on the regulation of charges at London and Manchester shows that because regulation brings its own perversities the regulator is inclined to widen his/her supervision even if he/she comes from a liberalising tradition.

I also note that the Australian Productivity Commission has written to the minister to confirm that the liberally inclined terms of reference for its review of airport price caps are “not intended to preclude from consideration price cap arrangements of the general form of CPI-X”.

I suggest that these examples should cause some concern that a decision to regulate AIAL’s charges, even if taken on a narrow balance of argument, might be difficult to reverse once the perceived need for it was no longer apparent. This is of itself an argument against introducing price control in an otherwise liberal environment.

5) Inflation Accounting and UK Regulation

There has been a long debate in the UK about the deficiencies of Historic Cost Accounting and the strength of the case (particularly to economists) of CCA. In this context I use CCA to describe the various methods which have been used to account for business performance in a way which deals effectively with the realities of inflation and relative price changes.

CCA was used for some years in the private as well as in the public sector, but fell out of use in the private sector because of the well-recognised problems of finding a generally acceptable approach. However CCA, or variants of it such as Modified Historic Cost (MHC), remain the preferred approach of the MMC and for sector regulators generally.

The UK government has encouraged sector regulators to develop common approaches to issues. This is being done partly through the Centre for the Study of Regulated Industries (CRI), whose Research Report 9 “Accounting Requirements for Regulated Industries” discusses the subject in some detail, and partly by meetings of regulators. In the direct context of airport regulation the Competition Commission has resolved the long-standing issue of asset valuation by taking a particular starting point (1991 in BAA’s case) and rolling values forward by RPI.

The history of current cost accounting in the airports industry was set out in the 1992 MMC Report on Manchester (para 219). Up to 1988/89 BAA used CCA. This was replaced by MHC which was similar to CCA, with annual revaluations but without adjustments for monetary working capital or gearing adjustments to the P&L. The MMC observed that the effect of the change was not large and was “likely to be a good proxy for the current cost results.”

The use of inflation accounting, in its MHC form, was not of itself controversial to the CAA (UK) or to the MMC but particular difficulties arose over the valuation of construction. In short BAA had used a construction index when this was running ahead of RPI but wanted to use RPI when the reverse was the case. The CAA (UK) told MMC that this was the greatest single cause of forecasting error in the second quinquennium and it asked the MMC to seek a more stable method of valuation for the third and subsequent quinquennia.

The MMC prefaced its decision to go for RPI-indexed roll-forward with the following comments (para 2.152)

“The recent decline in construction prices has now introduced an additional and exceptional degree of uncertainty to the valuation of BAA’s capital base. Hence, in our view, it would be appropriate to establish a more stable regulatory value that may not correspond to the valuation of assets in the accounts, but being adjusted by the RPI is less susceptible to capricious and unpredictable movements in construction prices and reflects the value of investment made on behalf of shareholders.”

In the following year the MMC followed the same logic for Manchester, where it also decided in future to roll forward asset values by the RPI. At no stage did the MMC question the appropriateness of quasi-CCA approaches to the base valuation of the assets or to their forward projection. As it said in para 2.145 of its 1996 report on London, the MMC regarded “ a main criterion for establishment of airport charges... as being the generation of a reasonable rate of return on assets over a reasonable period which, over time, would also provide a return equivalent to the cost of capital on new investment”.

More particularly, BAA's accounts for the individual airports future development was value land held for future development in the same way as free standing completed properties let to and operated by third parties held for long term retention - ie at open market valuation. So far as I know this was not questioned by users, an active constituency in the UK, nor by the MMC.

However the CAA and the Competition Commission will roll these assets forward by RPI on the same basis as the other operational assets. Land held for future development remains significant: for example in 1999/2000 it accounted for £55 million of Stansted’s total assets of £884 million.

The first conclusion from the Financial Framework section of the CRI report is:

“ Historical cost accounting cannot adequately take account of the effects of inflation or factors such as the discount on assets at privatisation. Current value systems of accounting are therefore required”

The report goes on to show how the principles of CCA can be applied in practice and to describe their application in water, electricity, and telecommunications, and in parts of the railway and gas industries. In this context its main significance is to show that pure HCA is not generally regarded as appropriate for the UK regulated industries, where even nominally HCA accounts are in fact MHC.

HCA remains the norm in Europe and in the US, so it is natural to question why sector regulators and the Competition Commission (formerly MMC) should use CCA or its close equivalents. However the UK is probably the only country which has a **transparent** system of airport price caps set with direct reference to rate of return. If other systems have been developed successfully on the basis of pure HCA returns they have yet to be revealed.