

## Remedies Available to ISAs to Address Potential Misuse of Significant Market Power by Airports

### 1. Background

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- 1.1 The goal of the Aviation Strategy<sup>1</sup> is to strengthen the competitiveness and sustainability of the entire EU air transport value network. Tackling limits to growth in the air and on the ground, in particular by boosting the efficiency of airport services, is one of the three key priorities that the Commission has identified.
- 1.2 The Thessaloniki Forum of Airport Charges Regulators is tasked with 1) working on and making recommendations for a better common implementation of the Directive 2009/12/EC on Airport Charges (the ACD) and 2) promoting best practices in economic regulation of airports.<sup>2</sup> The ACD requires Member States to assign responsibility for supervising the setting of airport charges to Independent Supervisory Authorities (“ISAs”).
- 1.3 In this paper, the Forum discusses the range of remedial measures that could be made available to ISAs in seeking to address any risk of misuse or misuse of market power by operators.<sup>3</sup> The definition of Significant Market Power (SMP) used by this working group corresponds with the principles of EU competition law and rulings of the ECJ.<sup>4</sup> We also consider how remedies might vary according to the degree of market power.
- 1.4 This paper has been formulated by the Working Group of the Thessaloniki Forum on Airport Charges, taking into consideration the views of the airport and airline communities. Members of the working group are Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Switzerland and the United Kingdom.
- 1.5 This report has been adopted by the Thessaloniki Forum in December 2019.

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<sup>1</sup> [https://ec.europa.eu/transport/modes/air/aviation-strategy\\_en](https://ec.europa.eu/transport/modes/air/aviation-strategy_en)

<sup>2</sup> <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32009L0012&from=EN>

<sup>3</sup> Throughout this document: Airport refers to the Airport Managing Body or the Airport Authority. User or Airline refers to airlines operating or planning to operate at the airport during the period in which the charges being consulted on will be applicable (airlines planning to operate should formally notify the airport of this intention prior to the consultation). ISA refers to the Independent Supervisory Authority referred to in the Airport Charges Directive and designated by the individual Member State.

<sup>4</sup> The concept of dominant position is not defined as such in the Treaty but it is established by case law as: “[A] position of economic strength enjoyed by an undertaking which enables it to prevent effective competition being maintained on the relevant market by giving it the power to behave to an appreciable extent independently of its competitors, customers and ultimately of its consumers” Case 27/76, United Brands v Commission.

## 2. Caveats

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- 2.1 This report does not represent the views of the European Commission and does not in any way change the requirements of the ACD.
- 2.2 The scope of this paper does not include arriving at a position on whether the ACD should be reviewed.
- 2.3 This report should not be used as a limitation or constraint for Member States to apply their own methodologies, having regard to specific circumstances, regulation or other reasons.
- 2.4 This report will be kept under review and changed as and when deemed necessary by the Thessaloniki Forum.

## 3. Introduction

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### *Significant Market Power*

- 3.1 Formally, in order to identify Significant Market Power, the European Commission requires that “the undertaking’s decisions are largely insensitive to the actions and reactions of competitors, customers and, ultimately, consumers” over a period of time, even if some actual or potential competition remains.<sup>5</sup> Market power is not an absolute term but rather exists on a spectrum ranging from minimal to monopolistic. This is considered a market failure.
- 3.2 An airport that has (or is likely to acquire) SMP may misuse its dominant position to:
  - charge inefficiently high prices,
  - impose unfair trading conditions,
  - refuse to give access to specific services required by certain airlines,
  - offer special discounts to airlines who buy all or most of their supplies from the airport,
  - make the sale of one product or service conditional on the sale of another,
  - maintain levels of inefficiency,
  - achieve supernormal profits,
  - deliver lower capacity, and/or
  - offer a lower quality of service than airlines/passengers desire.

This list is not exhaustive and there are other ways in which an airport may misuse its dominant position. Misuse of market power results in a loss of consumer surplus and subsequent loss of economic activity.

### *Competition Law and Economic Regulation*

- 3.3 The misuse or risk of misuse of SMP could be addressed by competition law or by

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<sup>5</sup> [https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52009XC0224\(01\)&from=GA](https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52009XC0224(01)&from=GA)

sectoral specific ex ante regulation.<sup>6</sup> Case law precedents show that competition law has successfully been applied in cases of “vertical exclusion” and discriminatory abuses. However, it is less clear in relation to excessive pricing or reduced service levels. In addition, competition law is generally applied after the fact, although there are some exceptions such as, for example, in relation to a merger.

- 3.4 Before introducing ex-ante regulation, the deterrent effect of remedies available under competition law, such as financial penalties and behavioural remedies, should be considered as part of a regulatory impact assessment. They could be dissuasive enough to discipline the market. These remedies may include binding commitments to change (or not change) behaviour, settlements, or directions by the relevant authority to correct an infringement. While financial penalties may be effective, behavioural remedies usually need to be monitored, with compliance assessed on an ongoing basis. However, as ex post competition law remedies can take time to implement and generally take effect after the fact, ex-ante regulation can be more effective in that it prevents the misuse of SMP before it can occur.<sup>7</sup>

#### 4. Principles of Economic Regulation

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- 4.1 The economic regulation of airports should be tailored to the degree of market power. Where an airport does not have and is not likely to acquire significant market power in the short term, extensive economic regulation is not required. We are not currently aware of definitions for specific degrees of SMP and the appropriate form of economic regulation for each degree. In the absence of such definitions, ISAs should be able to judge the degree of SMP and set the appropriate remedy from the regulatory toolbox.
- 4.2 There is a range of remedies to deal with different degrees of market power. Before implementing any remedy, the benefits, costs and risk of each form of regulation should be considered through a regulatory impact assessment.
- 4.3 As in the case of the electronic communications markets, ex-ante remedies to the market failure identified should generally be implemented when: i) there are high barriers to entry, ii) the market structure does not tend towards effective competition (having regard to the state of infrastructure-based competition and other sources of competition behind barriers to entry)<sup>8</sup> and iii) competition law alone is not sufficient or does not adequately address the identified market failure.
- 4.4 General principles of good regulation state that regulation should be<sup>9</sup>:

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<sup>6</sup> [https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:12012E/TXT\\_Articles\\_101-102](https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:12012E/TXT_Articles_101-102) of TFEU

<sup>7</sup> For further discussion see the following ICAO document:

[https://www.icao.int/sustainability/Documents/Doc9562\\_en.pdf](https://www.icao.int/sustainability/Documents/Doc9562_en.pdf)

<sup>8</sup> See Directive (EU) 2018/1972, Article 67 Market Analysis Procedure:

<https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32018L1972&from=EN>

<sup>9</sup> See for example OECD principles:

<http://www.oecd.org/fr/reformereg/34976533.pdf>

[http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?doclanguage=en&cote=OCDE/GD\(95\)95](http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?doclanguage=en&cote=OCDE/GD(95)95)

- Necessary: the regulatory remedy should be valid and relevant to the identified problem;
- Effective: the remedy should be appropriately targeted with assured compliance and enforcement;
- Proportionate: the remedy should be tailored to remedy the relevant issue only where the benefits of doing so outweigh the costs;
- Transparent: regulatory decisions should be supported by explanatory materials;
- Accountable: responsibilities should be clear under the regulation, with an effective appeals process;
- Consistent: regulation should treat similar situations in a similar way, without unjustified differences.

4.5 More specifically in relation to airports, regulatory activities should be carried out in a way which:

- incentivises the airport to improve efficiency;
- seeks to ensure that demands for airport services are met, where appropriate and efficient;
- furthers the interests of passengers regarding the range, availability, cost and quality of airport services;
- prevents discrimination among users by the airport;
- promotes the development of competition, where appropriate;
- enables the financeability of the airport;
- has regard to government policy, such as, for example, incentivising the starting up of new routes and the development of disadvantaged and/or outermost regions, environmental issues, or facilitating connectivity.

#### *General Benefits of Regulation*

4.6 When a sector is subject to appropriate economic regulation, direct benefits will follow. The primary direct benefit is additional utility or welfare for citizens due to improved market efficiency, which may include improvements in the allocation of resources, improved service quality, cost savings, or a combination of these.

4.7 Regulation can also generate indirect benefits, such as spillover effects resulting from third-party compliance with, or influence from, regulatory remedies. Indirect benefits can also include wider macroeconomic benefits such as GDP increases, competitiveness and productivity effects or other non-monetizable benefits, such as social cohesion as a result of improved connectivity.

#### *Benefits of Regulation in the airport sector*

4.8 If the principles set out above are properly applied, the regulatory model will be more likely to lead to outcomes which mimic a competitive airport services sector.

4.9 This provides benefit to airport users as it prevents the misuse of market power in the ways set out in Section 3. Regulation improves users' value for money by

incentivising the airport to provide the required services in an efficient way.

- 4.10 Passengers also benefit from better value in airfares, both directly as a result of better value in airport services provided to the airlines and also indirectly through enhanced airline competition and enhanced connectivity as a result of marginal routes becoming viable.

#### *Costs and Risks of Regulation*

- 4.11 Regulation imposes direct costs on ISAs and stakeholders. These vary according to the remedy; in the case of a light touch approach, the costs are likely to be relatively small, whereas the setting of a price or revenue control is a significant and contentious piece of work requiring careful and detailed engagement between the airport, airlines and the ISA. It also benefits from the detailed engagement of other stakeholders.
- 4.12 If the regulator fails to abide by the principles set out in this section, it risks imposing undue costs on airport operators and the wider industry. If regulation is enforced incorrectly, it can stifle the development of competition, generate adverse effects or increase compliance costs unnecessarily. Unnecessary compliance costs would be passed on to air carriers in the form of airport charges, ultimately affecting end users through an increase in airfares.
- 4.13 Overly rigid regulatory systems risk hindering an airport's ability to adapt to a change in circumstances. In order to protect the interests of users and passengers, the airport and other stakeholders should have the ability to consult with the regulator to accommodate these changes.
- 4.14 The regulator must ensure that the interests of both current and future passengers, and potential future new entrant airlines, are protected. This is particularly important in the areas of service quality and the development or maintenance of infrastructure. It must be recognised that the interests of these groups will not always be aligned with the interests of incumbent airlines.

#### *Harmonisation in the Application of Remedies*

- 4.15 Harmonising the application of remedies would increase the uniformity of economic regulation across the EU. Harmonisation would increase the predictability of EU airport regulation and improve the functioning of the internal EU aviation market.
- 4.16 This consistency is aligned with other aspects of EU aviation policy and other EU sectoral regulation making it easier to ensure accountability of ISAs and Member States given a common framework to assess against.
- 4.17 The benefits of harmonisation need to be balanced against the risk of a less targeted approach. For further discussion on this point, see the Thessaloniki Forum paper on

the use of selective criteria in the economic regulation of airports.<sup>10</sup>

## 5. Remedies

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- 5.1 There is a range of potential regulatory remedies which should be tailored according to the degree of market power. Below we set out some remedies which could be implemented and the circumstances in which they are appropriate.

### Behavioural

- 5.2 This type of remedy requires detailed consultation between the airport and users in relation to the level and structure of charges, cost information, quality of service and infrastructure. It might also include a dispute resolution mechanism overseen by the regulator. This would be suitable for airports with moderate levels of SMP. We consider that the remedies set out under the Airport Charges Directive would come under this heading.
- 5.3 The Airport Charges Directive applies to airports serving over 5 million passengers per annum (mppa)<sup>11</sup>. For these airports, the ACD provides for a set of minimum regulatory requirements for setting airport charges; these relate to consultation, transparency and non-discrimination.
- 5.4 The ACD allows Member States to apply additional regulatory measures, including for airports with less than 5mppa<sup>12</sup>.
- 5.5 Therefore, for airports above a 5 mppa threshold, Member States may consider whether further tailored regulatory measures may be necessary to complement or enhance the requirements of the ACD, and also whether it is necessary to impose any type of economic regulation on airports with less than 5 mppa.

### Trigger Regulation<sup>13</sup>

- 5.6 Trigger Regulation or shadow pricing can be used to restrain the potential misuse of market power through the threat of regulation. In this case, the ISA does not implement a full ex-ante regime, such as a regulator-determined price cap, unless the airport has misused or is misusing its market power. This can be sufficient to discipline the airports behaviour.
- 5.7 Trigger regulation can also be used to monitor service levels. In this case, the regulator intervenes directly when service levels are deemed to be inadequate.

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<http://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail.groupDetailDoc&id=38501&no=2>

<sup>11</sup> The ACD also applies to the airport with the highest passenger movement in each Member State

<sup>12</sup> See ACD Article 1(5). *This Directive shall be without prejudice to the right of each Member State to apply additional regulatory measures that are not incompatible with this Directive or other relevant provisions of Community law with regard to any airport managing body located in its territory. This may include economic oversight measures, such as the approval of charging systems and/or the level of charges, including incentive-based charging methods or price cap regulation.*

<sup>13</sup> Referred to by ICAO Doc 9562 as "Fallback regulation".

- 5.8 The threat of more intrusive regulation must be credible, and therefore, the power to introduce full ex-ante regulation must be readily available. There should be a strong legal basis enabling the regulator to access information and it should be well-resourced, so it can efficiently set the trigger conditions.
- 5.9 The CAA's regulation of Gatwick airport has some similarities to trigger regulation. The CAA monitors Gatwick airport's performance, including comparing prices with its view of a fair price (which is lower than the formal cap on Gatwick airport's charges) and requires Gatwick airport to undertake a shadow regulatory asset base (RAB) calculation should the need for more stringent regulation arise.<sup>14</sup> During 2019, Gatwick airport and its airlines have engaged in negotiations over arrangements for the next regulatory period, with the CAA ready to play a more active role if there is no or only partial agreement. The licensing framework gives the CAA considerable flexibility in the measures it could take if Gatwick airport misuses its market power.
- 5.10 Trigger regulation is used for Copenhagen airport. The charges are agreed upon during negotiations between the airport and airlines with ex-ante approval from the ISA. Failure to negotiate these charges results in reversion back to traditional incentive regulation.
- 5.11 Similarly, major airports in New Zealand and Australia are regulated under such a structure. The regulators monitor the airports performance and price setting to ensure they are reasonable and efficient. They maintain the power to step in and regulate charges if they believe the airport is misusing its market power. The Australian Competition and Consumer Commission (ACCC) has most recently extended its current price notification agreements until 2022 in order to consult and review price notifications in the light of any findings from an inquiry into the economic regulation of airports.
- 5.12 To date, the ACCC and the New Zealand Commerce Commission have not been required to intervene and re-regulate airport charges. Under the conditions set out above, trigger regulation and shadow pricing can be an adequate solution where SMP exists and the risk of misuse is moderate.

### **Price and Revenue Controls**

- 5.13 When there is a substantial market failure such that the airport does not face any sufficient competitive constraints to effectively moderate its behaviour, it may be necessary to apply one of the price or revenue control remedies described below.
- 5.14 Price and revenue controls could be implemented through a cost orientation methodology. This is an ex-ante assessment where the ISA examines the airport cost and revenue structure, based on which it sets out the charging system and the appropriate controls. In principle the difference between controlling price or revenue lies in the transfer or the absence of transfer of materialised traffic risk to airport users.

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<sup>14</sup> For each year, this involves adjusting the RAB for inflation, adding new capital expenditure and removing any disposed assets.

### *Rate of Return Regulation*

- 5.15 Rate of return regulation involves setting a price equal to the ex-ante assessed cost of production, plus the normative cost of capital.<sup>15</sup> The effect is to restrict the return that the airport can achieve relative to its cost base.
- 5.16 This method gives little incentive for the regulated entity to achieve efficiencies and may incentivise the airport to increase its cost base; in particular it can incentivise an inefficiently high level of capital intensity, meaning that the regulated company actively seeks capital project based solutions as opposed to operational solutions. It can therefore also lead to gold plating, also known as the Averch-Johnson effect, where projects are scoped at a higher level than that which is required by airport users. If the regulator were to include a capital cost in the rate of return calculation only to the extent that it is demonstrably efficient and necessary, this could mitigate the gold plating issue.

### *Price Cap Regulation*

- 5.17 Price cap regulation is the application of an ex-ante maximum price level(s) per passenger (or other unit of work) for a regulatory period taking account of potential productivity gains. Unlike rate of return regulation, price cap regulation creates incentives to reduce costs. An appropriately set price cap should lead to a high incentive to increase efficiency, as airports can be permitted to keep profits from outperformance achieved through the regulatory period. The benefits of this outperformance can then be passed on to airport users when the control is re-set for the following regulatory period. It is ideal when an airport has SMP, the risk of misuse is considered to be high, and the loss of consumer surplus associated with such misuse is likely to be substantial. The incentive is stronger for multi-year regulatory periods (e.g. 4 or 5 years).
- 5.18 A price cap may take a high-level approach to opportunities for productivity gains, or it can include a more detailed assessment of costs and revenues to identify what is achievable.
- 5.19 The following outlines an example methodology of how a price cap on airport charges could be set using a Regulated Asset Base (RAB) building blocks approach. Other approaches for defining a price cap are possible. Targets (or efficient levels) for the various regulatory building blocks over a certain time period are estimated. These building blocks typically include passenger traffic at the airport and the efficient level of operating costs to serve that traffic, and commercial costs and revenues (or margins) if a single till is applied.<sup>16,17</sup> Targets can take account of productivity growth, thereby increasing incentives for cost reductions.

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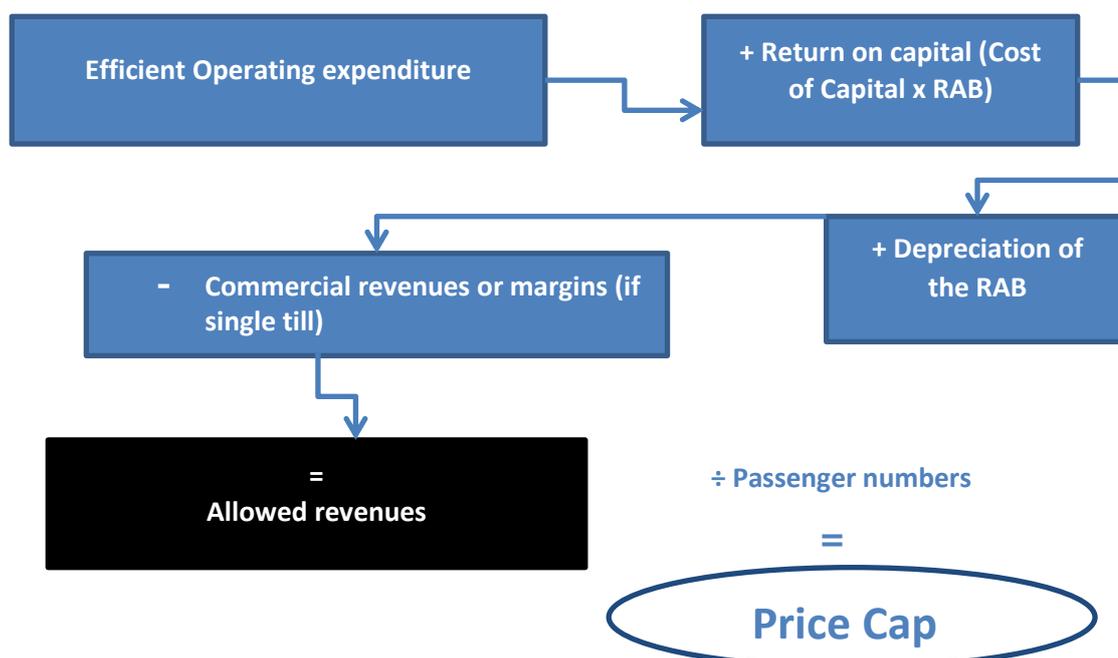
<sup>15</sup> Whether aeronautical costs only or total costs, depending on whether they are calculated on the basis of single or dual till.

<sup>16</sup> Single till implies that net revenues generated through non-aeronautical business at the airport (such as car parks and retail) are used to offset the level of required aeronautical revenues.

<sup>17</sup> A percentage of commercial margin can be applied if using a hybrid till.

- 5.20 It also includes establishing rules and/or assessing all elements of capital investment programmes to determine the appropriate level of expenditure to be added to the RAB. The RAB is effectively the sum of the value of airport assets which the regulator has determined should be paid for by airport users. The real value of the RAB changes over time as assets depreciate out of it, while conversely new allowed expenditure is added to it. The regulator also sets an allowed rate of return (cost of capital) on the RAB over the time period in question. Figure 5.1 provides a high-level example of a RAB-based price cap calculation.

Figure 5.1: Example of Calculating a RAB based price cap<sup>18</sup>



- 5.21 When properly set, price caps cover all efficient costs and provide remuneration for investment, ensuring that airport charges are no higher than they need to be to operate and develop the airport in the interests of airport users.
- 5.22 Price cap regulation could entail some potential shortcomings. For example, over time, if the ability of the regulated company to out-perform the cap is reduced, the company could be induced to reduce service quality; this needs to be avoided through careful monitoring of service quality. Also, since a price cap is usually set for several years on the basis of projected capital expenditure as well as on existing assets, the airport may have an incentive to overstate likely capital expenditure prior to the price cap being set and, subsequently, not undertake the full programme; in a multi-year price cap, this may result in the airport earning a short-term return on the assets without actually having to invest in them. This could be avoided through a number of regulatory tools, already adopted by some regulators, such as penalties within the regulatory period for delayed investments. It also requires the regulator to carefully assess the efficiency of any proposed investment, informed by the views

<sup>18</sup> The Price cap can include adjustments, for example, for inflation, service quality targets, capex delivery etc.

of airport users.

- 5.23 Price cap regulation requires a well-resourced regulator, with expertise available in aviation, economics, finance and law if the process is to work effectively. Ultimately the most powerful incentive of all for the regulated airport is to achieve the highest price cap it can in whatever way possible through overly conservative assumptions from the regulator, and then outperform the assumptions that underpin that price cap over the regulatory period. If the regulator is not well-resourced, the airport operator may focus its efforts on convincing the regulator that improvements or efficiencies are not possible, or challenging decisions, rather than focusing on achieving those efficiencies and improvements.
- 5.24 When an airport is under dual-till regulation, the question of how costs and assets are allocated is essential. The regulator requires detailed cost-allocation information from the airport operator and should impose some rules and/or standards on the allocation methodology. For example, allocation rules should be stable in time, transparent and verifiable.
- 5.25 Both Heathrow and Dublin Airport have been found to have SMP. Both airports are subject to a RAB-based building blocks approach to determine revenue requirements for the airport. They are also subject to a single till approach, subtracting predicted commercial revenues from the necessary revenue. The price cap is accompanied by quality of service targets to protect the interests of airport users.