Regulators’ forum subgroup on consultation and cost of capital
Topics

1. Reaching the goal of the aviation strategy
2. Consultation
3. Cost of capital
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1. Reaching the goal of the aviation strategy
2. Consultation
3. Cost of capital
The European Commission’s Aviation Strategy calls for action

Goal of the aviation strategy is to improve competitiveness and sustainability of the entire air transport value chain

Boosting the efficiency of airport services through effective economic regulation and stimulating employment growth and connectivity
Key to a competitive aviation industry is effective regulation of airport charges

Airport charges can account for up to 25% (excluding fuel) of airlines’ costs.

EC’s mid term evaluation: ACD is a “step in the right direction” but significant issues and gaps remain

Within its Aviation Strategy, the Commission has given the Forum a clear mandate to:

- Provide recommendations on the use of market power assessments
- Consider the optimal regulatory approach
- Work on the transparency of information
- Effective airline-airport consultation
- Work on better implementation of the ACD
The effectiveness of the ACD was a focus topic at the 1st regulator forum

To recap “user’s view from the 1st Thessaloniki forum”:

- Effective economic regulation is needed to replace the lack of competitive forces at airports
  - This includes oversight by independent regulators with the duties and powers to carry out their responsibilities

- Current ACD is meant to provide safeguards for airlines and passengers on key principles:
  - Consultation
  - Transparency
  - Cost-relatedness
  - ISA
And key elements were highlighted as necessary to ensure a more complete approach for setting charges

1. **Single till:** Mirrors outcome of a competitive market more accurately than hybrid and dual till which lead to airport charges above the competitive level

2. **No Pre-financing:** Users should not have to pay for facilities that don’t exist and it is not a cost effective way of financing

3. **Investment planning:** Airports should be required to consult and agree on a masterplan supporting capacity growth and efficient infrastructure utilization with airlines

4. **Incentives:** Clarity regarding application of incentives is required

5. **Cost of Capital:** Rules on the allowable cost of capital are required, based on the actual risk encountered by airports

6. **Threshold:** Have a discussion about whether it is appropriate to lower the threshold of the ACD for smaller airports with market power (associations don’t have a common view)
We support the creation of working groups to continue the dialogue

- Ways of working should include ongoing dialogue and consultation with stakeholders
  - Cost of capital, consultation/transparency are the first step
  - This is part of a broader journey which includes dialogue on wider topics
- The Forum should also ensure that it has technical input from independent experts
- Findings need to be disseminated and appropriate follow up is required to ensure best practice is adopted
- It is essential for the Forum to now establish clear Terms of Reference, setting out objectives and how to achieve them
Topics

1. Reaching the goal of the aviation strategy
2. Consultation
3. Cost of capital
Key principles of consultation

- Airport charges should be based on efficient costs and investments that deliver the services that passengers and airlines require and are willing to pay for.

- The consultation process should be designed to achieve this:
  - Elements should not be pre-determined in the law or concession contracts.
  - The justification for airport charges should be openly discussed in a timely manner.
  - Airlines should be given relevant information to assess the efficiency of costs of services.
  - Users views are taken into account.

- Regulators should ensure that the consultation process meets these principles.
Consultation process

The consultation process should ensure that the following elements are addressed:

- Agreed timelines & topics to be discussed
- Provision of the right information
- Consultation discussions
- Effectively taking users’ views into account

Role of the Independent Supervisory Authority (ISA)
Agreed timelines and topics to be covered

- A consultation process starts before charges are discussed (i.e. masterplan)
- Pre-agreed dates & topics to be discussed with the provision of appropriate information in advance
- Consultations to occur regardless of whether there is a proposed change in charges

Role of the Independent Supervisory Authority (ISA)

- Oversight of the process timelines
- Ensure essential topics are covered
## Examples of structured consultation

### Agreed timeline

**AMS:**
- Kick-off meeting aimed at agreeing the schedule of the consultation process

**LHR/LGW**
- Constructive engagement process

**WAW**
- Pre-meeting do discuss timelines

### Pre-agreed topics & working groups

**AMS**
- Traffic, investments, Opex, WACC

**LHR/LGW**
- Constructive engagement process
Example of a comprehensive consultation process – LHR*

*This is a good example but not necessarily best practice
Information to be provided by airports

- Established and justified link between costs and charges
- Provision of appropriate level of information would include
  - Traffic
  - Operating costs
  - Capital expenditure
  - Asset base
  - Depreciation
  - Cost of capital
  - Non-aeronautical information regardless of the till applied
- Services in return for charges – link between cost and service
- Airports should be open to provide further information if requested

Role of the Independent Supervisory Authority (ISA)

- Preparation of guidelines on the appropriate level of information
Examples of appropriate level of information

<table>
<thead>
<tr>
<th>Content of information</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>AMS:</strong></td>
</tr>
<tr>
<td>- Detailed disclosure required by legislation.</td>
</tr>
<tr>
<td>- Completed financial information requirements sent by users</td>
</tr>
<tr>
<td>- Cost benefit analysis for some projects</td>
</tr>
<tr>
<td><strong>LHR/LGW</strong></td>
</tr>
<tr>
<td><strong>WAW:</strong></td>
</tr>
<tr>
<td>- Completed financial information requirements sent by users</td>
</tr>
</tbody>
</table>
Consultation discussions

- Consultation as a two-way discussion (no public hearing)
- All charges items will be openly discussed
- English as language for discussions to allow expert participation
- Allow airlines and associations to participate
- Minutes of meetings

Role of the Independent Supervisory Authority (ISA)

- Setting the “rules of the game”
- Attending consultations and provide guidance when necessary
### Examples

<table>
<thead>
<tr>
<th>Language</th>
<th>Open attendance</th>
<th>Meaningful discussions</th>
<th>Attendance of the regulator</th>
</tr>
</thead>
<tbody>
<tr>
<td>English language for documents and consultation: AMS, CPH, Swedavia, Finavia, WAW, BUD, Italy (ART airports)</td>
<td>BUD, UK, DUB</td>
<td>- LHR/LGW - AMS</td>
<td>- CPH, Spain, LHR/LGW, DUB, CDG, ARN, HEL, FRA, MUC, BER, ART airports, BRU, ZRH, GVA</td>
</tr>
<tr>
<td>Translation provided: FRA, BER, SOF, FCO, MUC</td>
<td></td>
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<td></td>
</tr>
</tbody>
</table>

Role of the Independent Supervisory Authority (ISA)
Effectively taking into account users’ views

- Open dialogue is not enough, as it doesn’t mean airport will action
- Airports must demonstrate how user’s views have been taken into account, and if not, to provide a thorough justification.

Role of the Independent Supervisory Authority (ISA)

- Ensure users views are heard and taken into account (mandated)
- A clear and transparent appeal process is in place even if the ISA determines/approves the charges.
- Allow for appeals even if charges don’t change
- Independent assessments
  - To validate information provided by airports
## Examples

<table>
<thead>
<tr>
<th>Open outcome / user’s views</th>
<th>Independent ISA assessments</th>
<th>Effective appeal process to ISA</th>
</tr>
</thead>
</table>
| No good example could be found. | - CPH (WACC)  
- DUB (opex, capex, WACC)  
- UK CAA (various aspects) | - CPH (not yet tested) |
|                             |                            | - UK CMA |

Role of the Independent Supervisory Authority (ISA)
Conclusion (Consultation)

- There are very few end to end consultation processes that can be labeled ‘best practice’
- Meaningful consultations mostly happen where there are mandated requirements or where they are regulator-led
  - These focus on achieving efficiency/value for money for airlines and their passengers
- Areas of improvement for the Forum to consider include:
  - Transparency of information (transparency guidelines)
  - Consultation on required service levels
  - Justification for charges
  - Ensuring timely and meaningful dialogue between airports and airlines
  - All consultations to be in English
  - Effective appeals processes
Topics

1. Reaching the goal of the aviation strategy
2. Consultation
3. Cost of capital
The importance of appropriately calculating the CoC

- It is a significant % of an airport’s cost base
- There is a large and inconsistent variation in CoC utilized across EU

Sample of WACC across a number of airports in Europe (airport proposals and regulator’s decisions)
Main areas of concerns with the current approach on Cost of Capital

**Airports**
- Airports tend to overestimate the risk of their business assuming competitive assets
- No justification is provided
- Cost of Capital based on pre-determined return targets by the owners
- Cost of Capital pre-determined in laws / concession contracts

**ISAs**
- Lack of compulsory involvement
- Final determination not by the ISA – just “feedback” on airport proposals
- Lack of resources or technical expertise within the ISA
Different models are available to determine the Cost of Capital

Determination of Cost of Capital is often based on the CAPM model to calculate the WACC, but

- There are different views on the validity of the CAPM model applied for valuation

- If CAPM is the model used, the parameters need to be objectively defined
Individual parameters that determine the Cost of Capital needs to be set at a reasonable level.

- Risk free rate
- Asset beta
- Asset base (RAB)
- Equity risk premium
- Debt premium
- Gearing
- Tax rate
### Key considerations for defining the risk free rate

<table>
<thead>
<tr>
<th>What to consider</th>
<th>Why is it important</th>
<th>Good practice</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reference country</td>
<td>• Country may be (or have been) in financial distress and therefore its bonds cannot be considered risk free</td>
<td>• Home country or alternative “safer” EU country when necessary</td>
</tr>
<tr>
<td>Bond maturity</td>
<td>• Yield curve changes over time which leads to different outcomes</td>
<td>• 10 year bond</td>
</tr>
<tr>
<td>Historic vs. spot rates</td>
<td>• Volatility of rates • Consistency with other parameters</td>
<td>• Historic view but excluding “extra-ordinary effects” • Take into account current market conditions (quantitative easing) • Consideration for changes in economic growth, inflation expectations</td>
</tr>
</tbody>
</table>
### Key considerations for defining the asset beta

<table>
<thead>
<tr>
<th>What to consider</th>
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</thead>
<tbody>
<tr>
<td><strong>Market Power</strong></td>
<td>• Riskiness of the business is linked to its exposure to competition</td>
<td>• Given the lack of exposure to competition, risks are low and should be reflected in a low asset beta</td>
</tr>
<tr>
<td><strong>Selection of comparators</strong></td>
<td>• Compare like-with-like</td>
<td>• Selection should be based on airports with similar characteristics</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Comparisons against other regulated industries (i.e. electricity)</td>
</tr>
<tr>
<td><strong>Methodological approach</strong></td>
<td>• A wrong approach on the calculation betas could lead to wrong outcomes</td>
<td>• Hamada approach *</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Do not consider Blume adjustment</td>
</tr>
<tr>
<td><strong>Analysis of the risks</strong></td>
<td>• Adequate link between risk and reward</td>
<td>• To consider traffic risk and existence of risk sharing mechanism, length of charges period, adjustments based on deviations</td>
</tr>
</tbody>
</table>

\[
\beta_A = \frac{\beta_E}{\left[ 1 + (1 - \tau) \times \frac{D}{E} \right]}
\]

* *
Key considerations for defining the equity risk premium

<table>
<thead>
<tr>
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</tr>
</thead>
</table>
| Historic or survey data? | • Need to ensure a robust approach is taken in order to determine the ERP.  
• What better reflects best the long term return in equity markets. | • Where available, usage of statistical historical data over long periods of time (DMS)  
• Survey data is not very reliable since it is unclear as what considerations respondents considered on survey data | |
| Arithmetic or geometric | • What best reflects the investment horizon? | • Consider this as a long term holding, therefore closer to the geometric average | |

- Other items for consideration:
  - Reference country for DMS values (EU average vs. DMS of a single country)
  - Consistency between time approaches between different variables (to avoid cherry picking)
## Key considerations for defining the gearing

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</thead>
</table>
| Actual or notional | • Identify the approach that incentivizes an optimal capital structure  
                      • Maximum use of tax shield | • Notional gearing to incentivize efficiency  
                                      • Informed by actual gearing and benchmarking |
| If notional, what reference to use for determining it? | • Key to achieve the incentivization goal | • Reference to credit rating agencies (i.e. What level of gearing is enough to maintain a solid credit rating?  
                                           • Extra care is necessary when comparing other airports since they may not have optimal capital structures |
## Key considerations for defining the cost of debt

<table>
<thead>
<tr>
<th>What to consider</th>
<th>Why is it important</th>
<th>Good practice</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actual vs notional</td>
<td>• Incentivizing an airport to achieve the lowest cost of debt</td>
<td>• Notional</td>
</tr>
<tr>
<td>References used for notional rate</td>
<td>• A wrong assessment could over/underestimate the cost of debt</td>
<td>• Regulated companies with strong credit ratings</td>
</tr>
<tr>
<td>State guaranteed debt</td>
<td>• State owned airports may have access to lower cost of debt than can be achieved in private markets</td>
<td>• Take it into consideration</td>
</tr>
<tr>
<td>Sense check</td>
<td>• Check results against actual and future cost of debt if calculation is reasonable</td>
<td>• Need expert analysis</td>
</tr>
</tbody>
</table>

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*References used for notional rate:*
- Incentivizing an airport to achieve the lowest cost of debt
- A wrong assessment could over/underestimate the cost of debt
- State owned airports may have access to lower cost of debt than can be achieved in private markets
- Check results against actual and future cost of debt if calculation is reasonable
- Regulated companies with strong credit ratings
- Take it into consideration
- Need expert analysis
### Key considerations for defining the tax rate

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<th>Why is it important</th>
<th>Good practice</th>
</tr>
</thead>
<tbody>
<tr>
<td>Notional vs effective tax rate</td>
<td>Cost base may overestimate tax payments</td>
<td>To analyze on a case by case basis depending on local circumstances</td>
</tr>
</tbody>
</table>
## Key considerations on defining the asset value (RAB)

<table>
<thead>
<tr>
<th>What to consider</th>
<th>Why is it important</th>
<th>Good practice</th>
</tr>
</thead>
<tbody>
<tr>
<td>What included in the RAB?</td>
<td>• Avoid risk of overinflating RAB with inefficient investments</td>
<td>• Monitoring &amp; independent assessment of investment costs</td>
</tr>
<tr>
<td>Dealing with artificial asset splits (hybrid/dual tills)</td>
<td>• Airlines do not support hybrid/dual till structures.</td>
<td>• Independent asset allocation which accurately reflects the usage of common space and how commercial objectives have affected airport design and passenger flows.</td>
</tr>
<tr>
<td>How do deal with investments outside an airport?</td>
<td>• Airlines shouldn’t be bearing the risks or costs of other ventures</td>
<td>• Eliminate them from RAB</td>
</tr>
</tbody>
</table>
Conclusion (cost of capital)

- Cost of capital should allow airports to earn a reasonable return, but not more
- Airlines should only pay for efficient costs
- Robust methodology required to
  - Prevent airports from charging excessively and making excess profits
  - Ensure consistency of approach
- Independent assessment is essential
Proposed next steps

- Agreed Terms of Reference for Forum
- Continuous stakeholder engagement essential
- Further in-depth discussions on:
  - Development of guidelines on information requirements
  - Role of regulator to ensure meaningful and structured consultation process
  - Cost of capital parameters
- Further meetings to discuss wider topics which are equally key to the determination of airport charges
Thank you