



March 14, 2018

**Ao Sr.
Rafael Pereira Scherre
Agência Nacional de Aviação Civil
Brasil**

SUBJECT: Consultation on Economic Regulation of airport concessions

As the global trade association representing the world's leading airlines, the International Air Transport Association (IATA) is pleased to provide a submission on ANAC's consultation paper mentioned above. IATA's membership includes some 280 passenger and cargo airlines comprising 83% of global air traffic and IATA's mission is to represent, lead and serve the airline industry.

In relation to the economic regulation at Brazilian airports, we would appreciate for ANAC to take into account the following key points:

1) The purpose of concessions

The introductory section of the consultation document mentions that the main driver of the previous concessions was to improve the airport infrastructure. IATA highlights that the past concession processes also focused on **maximizing income for the government**. The potential problem with the latter approach is that in the search for maximizing revenues, governments have created incentives that allowed winning bidders to earn excessive profits, out of which concession fees were paid. As a result of that costs for the value chain were significantly increased, in many cases in detriment to the consumer.

When the decision to privatize an airport is taken, the framework put in place must yield benefits to both the industry and its customers. **Privatizing airports should not be viewed simply as a short-term revenue raising option for governments. It must be construed as part of a long-term vision for economic development of the cities and regions it serves.** The success of privatization must be measured through the improvement of service levels, higher cost effectiveness transferred to customers, and the socio-economic benefits generated to the society, and not by financial gains for governments or investors.

Numerous potential risks need be addressed when a government embarks on privatization projects. Such risks are detailed in our fact sheet paper on privatization, which can be downloaded [here](#). It is therefore necessary that the motivation for carrying out concessions is the right one. The regulatory framework supporting a concession process must ensure that users benefit from efficient and timely build airport infrastructure, as well as services levels in line with users' requirements. All of the above should be delivered in the most cost-effective way so to stimulate the growth in traffic and potentiate the economic development and social welfare of the society.

This is the mindset that IATA urges ANAC to take for improving the economic regulation in the Country and for the upcoming round of airport concessions in Brazil, and is the baseline of the comments that we provide in this submission.



2) Information asymmetry & the cost-based vs. non-cost-based charging mechanisms

Section 3.1.1 of the consultation document touches on the issue of information asymmetry, the cost of regulation and the consequent non-cost based charging mechanisms. We address these below.

IATA agrees with ANAC that there is a significant issue of information asymmetry when dealing with regulated companies. However, IATA does not agree with the way ANAC is dealing with the issue. Based on our experience worldwide, IATA believes that the existence of information asymmetry in the context of airports with market power calls for necessary regulatory intervention rather than the loosening of it.

IATA sees with great concern ANAC's assertion that the costs of regulation at Brazilian airports are higher than the benefits of it. IATA would be pleased to jointly review this matter should ANAC hold evidence of such and be willing to share it.

While IATA believes that the regulatory remedies may vary according to the level of market power at airports (i.e. automatic determination of charges by the regulator vs. an appeal mechanism), IATA does not believe that, in a situation where market power exists, that the regulator should stand back from its duties to further the interests of consumers.

Regulatory decisions carried out by independent regulators lead to better outcomes to consumers than those proposed by monopoly airports and the costs of regulation are marginal in respect of these. For instance,

- United Kingdom (LHR): LHR proposed RPI + 5.6% for the Q6 regulatory period, whereas the UK CAA regulatory decision was RPI – 1.5%, which spared users from overpaying GBP 1.8bn.
- South Africa (ACSA): The Regulator's decision on ACSA's charges for the period 2015-20 led to users paying some USD 250m less than what ACSA initially proposed.
- India (BOM): Mumbai airport's proposals for the 2014-19 regulatory period included a 105% increase in charges, whereas the regulators determined that charges should be almost flat, saving users more than USD 700m over the period.

Based on the proposed reasoning, ANAC further mentions that the cost-based model was abandoned for airports under concession, and a non-cost based model on standard CPI-X price caps has been adopted, with "X" defined as a measure to share productivity gains with users.

Firstly, it is important to clarify that IATA believes the way ANAC calculates the "X" is different from the methodologies applied by the regulators previously mentioned. In all the previous cases, the setting up of price caps is linked to the "building blocks" methodology, with price caps based on forecasts of the relevant¹ efficient² costs underpinning the calculation of charges for a specific period of time – a regulatory period. This, in turn, includes a combination of "carrots and sticks", which provides the regulated company with the adequate incentives to outperform. Lower costs from outperformance³ are

¹ By "relevant" it is meant costs as per ICAO's building block approach (operating costs, depreciation, and a reasonable return on capital). No other costs should be included (i.e. concession fees or costs related to operations outside the regulated airport).

² In this regard, only "efficient" costs should be acknowledged in the cost base. Otherwise, the regulated entity would have no incentive to become more efficient.

³ The idea of incentive regulation is for the airport to outperform its targets. Any outperformance (i.e. actual costs lower than those assumed in the calculation of charges for the period) can be kept during the period. But in the following period, the regulation should be using the lower costs as a baseline for setting charges and that period.



then taken into account in the setting of price caps in the following regulatory period. The proposal for the adoption of the building block methodology is in line with ICAO's principles on charges (DOC 9082).

Secondly, another challenge IATA sees with the method ANAC uses to calculate the "X" factor is the very fact that it is non-cost based, and therefore ignores the actual situation in the market. Non-cost based models could easily lead to a situation in which the regulated entity earns excessive profits. This is, for example, what is currently experienced in the concession of the Lisbon airport, where charges are not cost related and users are paying significantly more than what they should.

The need to apply a cost-based model is linked to the fact that it is not possible to foresee, throughout the duration of the concession, many key items that underpin the calculation of charges, such as traffic evolution, evolving investment needs (not only related to traffic but also related to aviation industry requirements), cost of capital, etc. IATA believes that such unknowns can be better solved through periodic revisions of costs, charges and service levels.

For the reasons above IATA believes that the benefits of having the necessary, robust form of regulation far outweighs the costs of implementing it.

3) Quality

IATA is of the understanding that ANAC will build the model for the next round of concessions based on the existing model, therefore adopting both the "X" and the "Q" factors. In regards to the latter, IATA is of the belief that the current upside to the "Q" factor only serves the purpose of the concessionaires, as it generates the opportunity for an extraordinary return to the investors. IATA is convinced that ANAC understands the market powers and especially the pressures from the society and the political environment for a competitive and inclusive sector. In that sense, and based on the dynamics of the aviation market, IATA believes that there is no willingness to pay by the side of consumers for a level of service that exceeds their needs. Moreover, it is counter-intuitive that the Regulator allows for an extraordinary remuneration for the improvement of the service level, which should, from the logical perspective, be one the natural drivers of a service entity. For that reason, IATA urges ANAC to revisit the definition of the bandwidth of the "Q factor" and remove its upside.

For the avoidance of doubt, a rebate mechanism should still be maintained if the regulated companies deliver a lower than targeted service level. Users pay a price for an expected service level. If such service is lower than expected, it would mean that users paid more than what they should, and therefore should receive a rebate for having paid excessively in the first place.

In terms of the composition of the Q factor itself, IATA suggests that further enhancements are also considered. Currently, it mostly measures the level of satisfaction by the travelling public (measures that are mainly subjective in nature). There is a need to enhance the Q factor with an additional set of objective KPIs that measure the most critical operational components delivered to the airline users at a given airport. Such Q factor would also be updated through periodic reviews, firstly via consultation with users, and ultimately via ANAC if necessary.

IATA, ANEA and Infraero were part of a working group led by SAC to discuss the viability of the introduction of service level agreements (SLAs) at Brazilian airports. The document produced by the group can - as per IATA's opinion - be improved, but serves as a good reference basis for ANAC to elaborate on. IATA understands that in the case of SLA's "one size doesn't fit all", for which the determination of the critical elements to be measured and their corresponding KPI's should be left for discussion and agreement between a given airport and the airlines operators. IATA is ready to work in collaboration with ANAC to further develop such a concept. IATA's position on service level agreements can be downloaded [here](#).



4) Revenue management

In section 3.1.1, ANAC discusses the possibility of moving from a price cap to a revenue cap model. It would be important to clarify that in the economic regulation jargon, a “revenue cap” model is a cap that is not expressed on a per passenger basis, but on a monetary value, i.e. an allowed maximum level of revenue expressed in Reals. As per our understanding, ANAC provides a different definition for revenue cap, i.e. an average price cap for all regulated activities. Conversely, what ANAC refers to as a “revenue cap” is what is normally known as price cap in other regulatory environments: in the UK, the UK CAA sets a price cap - a maximum overall yield per passenger for regulated charges at LHR – and doesn’t set a structure *per se*, which is subjected to a separate set of rules.

For purpose of this submission, we will use ANAC’s definition of revenue cap. It is our understanding therefore, that ANAC proposes the adoption of a cap (yield per passenger) as the average revenue of the regulated activities, while leaving changes in the charges structure to be decided by the airport. ANAC further introduces concepts of peak pricing, differential charges among different groups of users and activities.

While it is the case that in many regulatory frameworks the caps are set on the overall level of charges, and not necessarily on individual charges, regulators also have a duty to prevent any discrimination being applied among users. In this regard, the proposal put forward by ANAC allows the airport to determine its own charging structure. IATA understands that, even if the airport was to provide a cost-benefit analysis, the result of such discretion could end up in a situation in which the regulated airport could abuse its market power to favor a certain groups of users and discriminated against others. It is an IATA established position that there should not be differential charges among different types of users, unless they are justified on a cost basis (please refer to IATA’s position on the matter [here](#)). Moreover, the proposed practice would contradict one of ICAO’s main charging principles: non-discrimination. Rather than being a tool to promote a more efficient use of the airport, IATA anticipates that this may be utilized by the airport to “divide and conquer” the airline community.

IATA favors a general reduction in the level of charges for all carriers, rather than granting incentives to a limited number of users. No group of users should be given special treatment with regard to charges, particularly, if those users not benefiting from them end up paying for it, which would be the case as being proposed by ANAC.

Furthermore, IATA is concerned about the peak/off peak example provided by ANAC in its consultation document. IATA opposes peak or congestion charging as it arbitrarily redistributes costs between different airline users and has a discriminatory nature. Peak charging is largely ineffective in addressing the congestion and capacity shortfalls it is supposed to resolve. It can even make matters much worse by introducing distortions in the overall air transport system.

- Airlines have little opportunity to adjust to peak charging in an efficient way due to the complex task of scheduling operations. The challenge is to maximize aircraft utilization and optimize aircraft rotation within the constraints of airport curfews, opening hours, increasing environment restrictions, crew availability, and many other factors. In addition, the market dictates airline scheduling, as schedules are constructed in response to passenger and cargo demands.
- Finally, peak/off-peak pricing constitutes a challenge to ICAO’s key charging principles of non-discrimination and cost-relatedness, which must be complied with. ICAO’s guidance also indicates that the effectiveness of peak pricing in redistributing traffic is limited.
- As an example for the above, please refer to ANAC’s attempt to introduce congestion pricing at Guarulhos in the latter part of the past decade. As demonstrated during meetings with ANAC’s Directorate, such a proposal would not have yielded the expected results, with airlines being left to pay the additional cost due to their inability to redesign their network to avoid such the charge,



affecting their bottom lines. Lastly, a congestion pricing attempts to, in principle, circumvent the obvious problem: lack of available infrastructure to deal with the passenger demand.

- IATA's position paper on peak/off-peak charging can be downloaded [here](#).

Finally, and while not specifically mentioned, but for avoidance of doubt, IATA is strongly against any bilateral deals between an airport and any particular user. This would, as described above, lead to a position where a user is given an unfair advantage over another, despite the fact the same level of service is provided. Charges should be published and applicable to all in the same conditions to ensure fairness and non-discrimination.

Lastly, the setting of an average price cap for regulated revenues at the airport is a common practice and therefore it is accepted by IATA (i.e. it is much more practical to impose efficiency targets on the overall activities rather than per activity). However, our concern is currently linked to the way ANAC is proposing how the structure is to be set (as described above). We believe that ANAC's main objective should be to ensure that the tariff structure is applicable to all and does not discriminate among any user.

5) Decentralization

Section 3.1.2 talks about decentralization of regulatory functions to public authorities as well as through user-airport discussions. These are addressed in turn.

a) Decentralization to local public authorities

ANAC mentions that in the context of federal concessions, it is not possible to pass on decision making to local authorities. For the avoidance of doubt, we do not believe that it would be wise to pass on responsibilities for economic oversight to more than one entity. Any authority with regulatory powers should be independent and have the skills and resources to carry out its responsibilities. Moreover, such responsibilities need to be carried out in a consistent manner across all regulated airports in a country. There are cases in Europe in which countries have more than one regulator (i.e. Germany, Italy), which have led to inconsistent approaches towards the regulation of charges.

It is due to the facts highlighted above (independence, skills required and consistency) that it is prudent to keep regulatory powers within a single entity.

b) Decentralization via participation of users

One of ICAO's key principles in setting charges is consultation between the airport and its users. These should be two-way discussions (i.e. user's views need to be taken into account during the decision making process) and the airport should provide adequate level of transparency in order for users to be able to formulate informed views on their proposals. If airports and users can agree in the level of charges and services, then it would certainly reduce the need for regulatory intervention.

However, in the context of an uneven level playing field (i.e. one of the parties – the airport – holds significant market power), such outcomes rarely happen, and therefore while constructive engagement between the airports and users should be a cornerstone of the charges setting process, regulatory intervention would, in many cases, be required.

Such intervention should happen at different stages of the charges setting process. For instance, setting the rules ahead of the process (i.e. the framework for setting charges, consultation requirements, transparency requirements, among others), ensuring the regulated company follows such rules, and having the regulator setting charges if necessary. More specifically, in order for a consultation process to be meaningful:



- There needs to be a genuine possibility to influence charges, nevertheless, this is linked to the regulatory model that governs the concession. If, for example, charges (or parameters underpinning the calculation of charges) are pre-set in the concession agreement, there is little chance that a positive outcome could be achieved through consultation. IATA has too often witnessed consultations that are meaningless in the context of airport concessions where parameters are pre-determined. Put simply, it is extremely rare that the regulated company will price below its pre-determined cap.

If, for instance, charges are determined on 5 year periods, based on a building block approach, then a constructive engagement approach could work, provided regulatory intervention is envisaged at the end of the consultation process if necessary – be it via the automatic determination of charges, or via an appeals procedure (as detailed in section 6).

- Need to establish transparency requirements: In the context of airports holding market power, there is a natural incentive for them to provide as little amount of transparency as possible. A low level of transparency significantly limits the possibility of a successful constructive engagement process. It is therefore of paramount importance that ANAC determines guidelines on what is the level of information that should be shared with users, and enforce that such level of transparency is actually provided. IATA would be delighted to work alongside ANAC to help develop such guidelines.

In summary, it is desirable and necessary to foster constructive engagement among the stakeholders, and ANAC should encourage that. However, constructive engagement does not replace required regulatory intervention, as there are a number of “rules” that need to be established in advance for discussions to be fruitful. In this regard, the involvement on ANAC in setting such rules (and enforcing them) is of paramount importance.

IATA understands the challenges of designing and executing a concession contract that can be as long as 25 years. Aviation is a very dynamic business with a high degree of correlation to the economic development of a country. In the event of continued sustained growth, decisions to accelerate CAPEX might be required, and IATA strongly supports that this is done in close collaboration between the concessionaires and the users. The State, as one of the partners to the contract, will enjoy “additional returns” from the business growth and the derived contributions by the concessionaire and expanded taxation base.

Conversely, when the country experiences an economic downturn, all partners to the contract need to carry their fair share of the burden and generate conditions for their businesses to remain afloat. This, as well, needs to be done in a concerted manner. A rebound of the regional or local economic activity can be intrinsically linked to its connectivity to the remainder of the country. In that sense, the potential reduction of services undermines efforts for recovery. Under this scenario, IATA encourages that mechanisms are put in place to allow for a constructive dialogue between the State, concessionaire and airlines so to maintain the connectivity, including extraordinary measures around a timely limited reduction of contributions and royalties towards the government.

In terms of representation at consultations, unlike other regulated industries, there is unique situation in the regulation of airports charges, insofar as airlines are a well-organized user group whose interests are aligned with consumers (airlines compete for passengers, and therefore a key for their survival is to consistently meet their needs. This is why airlines consistently survey their passenger satisfaction, etc). As such, it can be expected that airlines voice the consumer needs at consultations and therefore can adequately represent their needs at the charges setting process.



6) Regulation of airports under concession agreements

The previous sections have provided our views on the regulatory mechanisms needed in order to improve the economic regulation of airport concessions. This section summarizes the main principles and elements that IATA believes need to be the basis of a robust framework that would ensure that charges are set in accordance with the principles of efficiency and reasonability

- Charges should be set on the basis of ICAO's building block methodology, on a single till basis.
- Incentive (price cap) regulation is the favored approach for regulation, with regulatory periods of 4 or 5 years.
- The building block methodology should not include any concession fees to avoid possible pass-through effects.
- All elements underpinning the calculation of charges (and service levels) should be adequately consulted by the airport with users.
 - o ANAC should issue guidelines on what would constitute adequate transparency and facilitate the process of consultation itself (should there be issues during it). As per above, IATA is willing to support ANAC in establishing such guidelines.
- The regulatory framework should include provisions that ensure that airports consult on the various stages of capital expenditure projects (masterplan, expansion options, etc).
- The pre-determination by ANAC of minimum expansion requirements for infrastructure and the deadline for its commissioning at a given airport as a contractual obligation has not proven to be an adequate mechanism. In most cases, CAPEX expansions were far beyond the actual need to meet demand. As such, concessionaires expanded their facilities and are now left with "white elephants", which need to be paid for. This imputes strains on both the concessionaires and the airlines operating at these locations. IATA advocates for a proper development of a masterplan in consultation with the user and a joint determination of the required CAPEX to meet the services attributes determined by ANAC. In summary, ANAC should not establish what needs to be built, but rather what the output – in an acceptable timeframe – is expected to deliver. This very much supports the concept of the "X" and "Q" concept, as well as the proposed SLA under "Quality" above.
- For medium/large airports, ANAC should determine the charges applicable to an airport under concession on the basis of:
 - o Forecast efficient costs (i.e. operating costs and depreciation costs linked to necessary and efficient capital expenditure projects).
 - o A reasonable cost of capital.
 - o Forecast contributions from non-aeronautical activities (Single till basis).
 - o Service levels that will be delivered to both passengers and airlines.
- For smaller airports, it may not be needed for the regulator to automatically determine the charges, but rather act when there is an appeal from users to the airport's decision (in such appeal case, ANAC would determine the charges on the basis of the principles highlighted above for medium/large airports).
- A "Q" factor should link the level of charges with the levels of service. Such a factor should also include objective KPIs, and with links to the level of charges should the expected level of service not be met.
- There should be adequate governance arrangements so that only capital expenditure projects that are deemed necessary by users are implemented.
- The framework should contain provisions on how to deal with underperformance (non-delivery of capital projects and projects delivered over budget).
- The tariff structure should be set in a non-discriminatory basis.



- The framework should have adequate provisions in order to avoid the regulated airport from raising non-regulated charges (for activities related to aviation).
- The regulation should foster competition in areas of the airport where it is possible (ground handling, catering, open access for fuel suppliers, etc).

We recognize that it may be difficult to enforce a number of the key principles highlighted above at existing concessions. However, we would appreciate to work with ANAC in finding out opportunities on how some of these provisions could still be included (i.e. transparency).

For future concessions (new or renewal of existing contracts), we request ANAC to incorporate them in full. In its discussion document, ANAC comments on the potential issues of having different frameworks at different concession contracts. However, if a modified framework would be in the interest of consumers, then we believe that ANAC should incorporate them. Moreover, since there are so many concessions in Brazil, the country is in a unique situation of testing new models in order to see what provides the most efficient outcomes and better value for money for consumers.

7) Airport networks

The considerations set out in section 6 equally apply to the proposed concessions of airport networks. Moreover, airport networks bring additional challenges which need to be addressed by ANAC from the start.

For instance, there is a difference between operating as a network and charging on a network basis. On the former, there may be some benefits of operating as network in the sense that there is a possibility of sharing overhead costs. However, charging as a network (i.e. same charges at all airports in the network, or higher than justified charges at one airport to subsidize costs at others) is a matter of great concern.

Charging as a network implies that users at certain airports would be paying for costs of facilities and services at other airports they do not use. IATA strongly opposes cross-subsidization – as it clearly and directly contradicts ICAO's user-pays principle and reduces the incentive to achieve efficiencies at smaller airports. Government support should be the first mechanism for providing aid at smaller airports, rather than users at other airports.

In that sense IATA envisages a system whereby the concessionaire could be compensated for up to a certain amount after demonstrating the efficient use of capital and operations. A single till framework would be easiest way to analyze such scenario, accompanied by the disclosure of a minimum set of data to be determined by ANAC for the sake of easily and transparently calculating the ratios. Monies to compensate for such shortfalls would originate from FNAC, in line with the recent attempts by the Federal Government to expand the capillarity of that air transportation system. IATA is willing to sit alongside ANAC to help develop such model.

If ANAC insists on the adoption of network charging, then, at the very least, a single till framework, accompanied by the required regulatory disclosure of a set of financial information and an appropriate appeal mechanism, would be required. The above, coupled with external oversight pressure from the public opinion and the financial markets, would help yield operational and cost efficiencies, as well as the required levels of service.

As highlighted above, the sheer number of concessions in Brazil provide ANAC with the unique opportunity of testing new regulatory frameworks in order to seek for the one that provides the best outcomes for consumers. For example, for the block of Vitoria (VIX) and Macae (MAE) ANAC could consider testing a framework that is a true cost-based and single-till model. Our proposition is based on the fact that:



- VIX has just inaugurated (or is about to) its new terminal and second runway. We understand that the current terminal will be decommissioned and the original runway requires intensive reconditioning. Under this scenario, at the limit, none of the assets in VIX carry “historical costs”, i.e., all assets are new and their costs are known, thus allowing for a true cost-based model.
- The same rationale applies to MAE, where – as per our understanding - a new terminal will be built and the runway equally needs to be completely revamped.
- Based on the above, this block could become a case study for ANAC to “experiment/learn” from and eventually adopt learning in upcoming concessions.

8) Conclusions

IATA once again welcomes ANAC’s decision to consult on the way for improving the Economic regulation of Brazilian airports under concession. In this submission, IATA has focused on a number of key factors such as:

- The need to re-think the main objectives for concession agreements and focus on furthering the best interest of consumers by promoting cost efficient airport services for consumers.
- Information asymmetry actually calls for more robust forms of regulation (rather than less).
- A cost-based approach, based on a single till and combined with incentive regulation, is more effective in fostering efficiencies at airports and ensuring these are passed on to consumers
- Extreme care is necessary in the setting of the structure of charges in order to avoid discriminatory practices.
- While consultation with users is one of the cornerstones for setting charges, this doesn’t eliminate the need for regulatory intervention.
- CAPEX should not be pre-determined as a contractual obligation, but rather derived from a well-structured masterplan built in close collaboration with the airport users.
- Proposal of a number of principles (as described in section 6) to be followed in order to implement successful economic regulation of airports under concession.
- Proposal of additional principles provided in Section 7 in order to deal with airport networks.
- While acknowledging that the principles described above may take some time to implement, IATA proposes a way forward to test their validity and viability and then to a more widespread roll out.

In closing, IATA would appreciate the opportunity to discuss the above proposals and views in more detail during a meeting at your offices in Brasilia, and remain available to meet at your best convenience.

Sincerely,

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