



Light handed regulation—Can it play a role in the developing world?



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ABSTRACT

The private sector has become essential for the development of airport infrastructure worldwide, but ICAO maintains that all governments ultimately are responsible for protecting users from the abuse of market power and therefore they need to establish appropriate regulatory arrangements. Nevertheless, economic regulation is difficult, it involves risk of failure, it can be costly, and careful analysis might well suggest that presumptions of significant market power are not supported by the facts. Developing countries, in particular, face challenges in providing necessary financial and (qualified) human resources for their regulatory authorities, but such regulation also has to function in a sub-optimal framework.

We review less 'intrusive', less 'prescriptive', and potentially less costly models of regulation that have been applied in some developed countries. Such "light-handed regulation" does not involve direct ex-ante determination of airport prices or other terms and conditions by an external regulator. In particular we consider Australian and New Zealand experiences with light-handed approaches to regulating airports including price and quality of service monitoring, information disclosure, and negotiate-arbitrate-regulation. The various forms of light-handed regulation are examined in terms of their need for regulatory intervention and the extent to which they offer the prospect of a reduced need to maintain regulatory "infrastructure". The paper concludes that negotiate-arbitrate-regulation, or a variant of it, offers the potential of a light-handed form of economic regulation which could be applied to airports in developing countries taking account of the institutional setting in which such regulation has to function.

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1. Introduction

The European Union recently reflected positively on the remarkable transformation of its airports sector over the past few decades (European Commission, 2014), a transformation due in large part to the forces of corporatization and privatization. There is evidence that performance and managerial efficiency of airports improve significantly when they are given the freedom to operate on a commercial basis (Carney and Mew, 2003). Furthermore,

rapid growth in air travel has made it necessary to tap financial markets to support capital expenditure. These trends have not been confined to Europe or even to the most highly developed economies and, in the words of the International Civil Aviation Organization (ICAO), the private sector now has become "essential for the development of airport ... infrastructure worldwide" (ICAO, 2013a).

Corporatization and privatization of airports also gives rise to concerns about the potential for abuse of market power and raises questions about how governments can protect the public interest. Notably, ICAO's policy is that all states have an obligation to establish a system of "economic oversight" that supervises the commercial and operational practices of an airport (ICAO, 2012). However, there is a variety of models that can be applied, including competition law, price cap and rate of return regulation, institutional requirements involving 'checks' and 'balances' and light-handed forms of regulation, which may be used in combination. The appropriate model therefore will depend on the degree of competition that airports face and the prevailing institutional and legal framework.

ICAO's research reveals that governments granting the greatest degree of autonomy to airport management tend to use "price caps" to control any increases in charges (ICAO, 2013b). It has been

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argued that this approach to regulation can be problematic (Star-
kie, 2008; Gillen 2011), especially when there are developing
competitive forces (Sappington and Weisman, 2012). Price cap
regulation is a challenging task requiring strong institutions
staffed by specialists with requisite technical expertise and who
have access to a considerable amount of information about the
entities they supervise.³ Price cap regulation also involves sig-
nificant administrative costs. Not surprisingly, ICAO has found that
developing countries are not always able to endow their reg-
ulatory authorities with necessary resources (ICAO, 2013c).

In light of the costs and difficulties associated with direct ex-
ante regulation, such as price cap or rate of return regulation, it is
timely to consider whether there are less resource-intensive ways
to regulate airport services in circumstances where airports have
significant market power. One possibility is light-handed regula-
tion (LHR) wherein airports and airlines negotiate and agree on
contracts to govern their commercial relationships. Under the LHR
regimes that have applied in Australia and New Zealand the reg-
ulator does not determine airport prices up-front. Instead the
regulator is required to provide and comment on public informa-
tion related to airport prices or to arbitrate a dispute when ne-
gotiations fail. The regulatory tool that is expected to provide re-
straint on market power is a credible threat of instituting direct
regulation of airports against a background of general competition
law. Littlechild (2012), for example, has made a positive assess-
ment of the Australian experience.

This paper focuses on those least developed economies at-
tempting to implement a system of economic oversight for their
corporatized and/or privatized airports. Examples of unfortunate
failures are not difficult to find, but there has been little attempt
in the literature to search for more effective solutions. Indeed, almost
all of the published work on airport regulation is devoted to ap-
plications in advanced economies. This paper therefore aims to fill
a gap in the literature by examining the regulatory challenges in
reforming governance of airports in the developing world. We
present an overview of the global situation to paint a picture about
the environment in which regulation must function and this is
further illustrated with some cases from selected countries. We
draw upon the literature on economic regulation as well as con-
tributions on the general nature of regulation in developing
countries to explain that, to be successful, regulations need to be
designed to fit with the legal, cultural and policy environment in
which they will be applied. In the spirit of searching for a less
costly form of regulation that seeks to enhance the effectiveness of
long-term contracts, we focus on two broad forms of LHR that
have been applied to airport charges – the price monitoring/in-
formation disclosure approach and the application of negotiate-
arbitrate regulation (NAR) – to assess their suitability for airports
in developing countries. In our analysis we pay particular attention
to the conditions that are necessary for successful implementation.
We then assess the likelihood of success of LHR in developing
country contexts.

2. The environment for financing and regulating infra- structure in developing aviation markets

Two approaches are taken to understanding issues involved in

³ We are indebted to an anonymous referee for pointing out that the number of
skilled people required to perform the regulatory function is not necessarily large.
Of course much depends on the model of regulation and of the strength of existing
institutions, but the effectiveness of any regulator would depend on the capabilities
of other entities, particularly those in the regulated sector. What is more, there is
strong competition for the available talent. It cannot be taken for granted that the
requisite skills to manage and to comply are available.

the development of airport infrastructure and the choice of ap-
proach to economic oversight in developing countries. We first
examine general information about the environment in low in-
come countries relevant to attracting investment in airport infra-
structure and the establishing governance arrangements. Further
insights are then provided by examining the specific experiences
of airports in four case studies from developing countries: India,
Bolivia, Cameroon, and Cambodia.

2.1. The circumstances of developing countries relevant to economic oversight of airports

2.1.1. The general environment

ICAO (2012) described the situation in developing countries,
which comprise approximately half of its 191 Contracting States⁴
as follows:

- There are limited financial resources available for economic
development;
- Higher priority is assigned to non-aviation sectors of the
economy considered to have more urgent needs;
- Airports are under-utilised;
- Equipment is costly to acquire;
- There are difficulties in recruiting and retaining sufficient
numbers of qualified human resources; and
- Infrastructure is often poor, safety standards often below those
of developed countries, sources of capital are required for new
infrastructure.

Table 1 presents a set of indicators on conditions likely to fa-
cilitate government actions to commercialize airports, to attract
private financing, and to regulate effectively in developing coun-
tries. Each row in Table 1 presents the average result for the
countries by income group; for example, the average seat capacity
departing each country per week, measured in available seat
kilometres (ASKs) on international, scheduled flights, ranges from
1957 million per week for high income countries to only 56 million
per week for low income countries.

An additional factor to consider is government policy towards
liberalizing the airline industry. When there is greater scope for
competition in air services in a liberalized environment there are
incentives for airports to undertake marketing activities to retain
and attract airlines. To consider this factor, we make use of the
World Trade Organization's "Air Transport Liberalization Index"
(ALI) which is based on the provisions contained in air services
agreements (Piermartini and Rousová, 2008). It is worth noting
that only 15% of all countries had what would be considered to be
a high degree of liberalization ($40 \leq ALI \leq 45$), and 70% of coun-
tries continued to apply "traditional" provisions in their air ser-
vices agreements ($0 \leq ALI < 15$). The average ALI scores for each
group are presented in Row 2 of Table 1, and it is clear that a high
income country is more likely to be liberal in its approach to
regulation of international air transport than counterparts even in
upper middle income countries, let alone in the low income
countries.

Summaries of results obtained from the World Economic For-
um's annual surveys of executives in each country are also re-
ported in Table 1, including responses to a question on the quality
of air transport infrastructure. A 7-point rating scale was employed
and the average result for the high income countries was 5.43, and
progressively lower ratings were reported in the other income

⁴ This statement is based on the assessment by the World Bank about those
countries that can be classified as having either low income or lower middle
income.

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