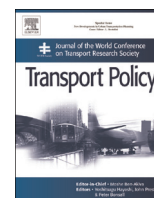




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# Transport Policy

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## 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,

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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

argued that this approach to regulation can be problematic (Starikie, 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.<sup>3</sup> Price cap regulation also involves significant administrative costs. Not surprisingly, ICAO has found that developing countries are not always able to endow their regulatory 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 regulation (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 regulator does not determine airport prices up-front. Instead the regulator is required to provide and comment on public information related to airport prices or to arbitrate a dispute when negotiations fail. The regulatory tool that is expected to provide restraint 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 assessment of the Australian experience.

This paper focuses on those least developed economies attempting 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 applications 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 contributions 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/information 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 infrastructure in developing aviation markets

Two approaches are taken to understanding issues involved in

<sup>3</sup> 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 approach to economic oversight in developing countries. We first examine general information about the environment in low income countries relevant to attracting investment in airport infrastructure 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 States<sup>4</sup> 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 facilitate government actions to commercialize airports, to attract private financing, and to regulate effectively in developing countries. 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 countries continued to apply "traditional" provisions in their air services 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 Forum's annual surveys of executives in each country are also reported 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

<sup>4</sup> 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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