



An empirical evaluation of changes in Public Service Obligations in Spain[☆]



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ARTICLE INFO

Keywords:

Public Service Obligations

Air transport

Spain/JEL classification:

L93

H25

L13

ABSTRACT

Public Service Obligations are a key mechanism for countries to improve connections among islands and remote regions with the Continent. While Public Service Obligations are allowed by the European Commission, they represent an interference with free market competition, and impact on the entrance of competitors, prices and service frequency. This study employs Canarian air market data for 2002–2015 to econometrically evaluate the effects of two changes in European policy on the number of passengers transported. The results point to the need to make market access more flexible to benefit society by generating increases in the volume of passengers moved.

1. Introduction

Since the process of liberalization of the European air market initiated in 1987¹, a series of public interventions have aimed to enable mobility among diverse European regions. This interference in the free market has fundamentally occurred through two non-exclusive mechanisms: Public Service Obligations (hereafter PSO) and traveller discounts, predominantly to residents in these regions.²

Regarding the former, the imposition of a PSO on an air route involves the regulation of market access, service levels (frequencies, seats, time schedules, type of aircraft) and prices. The aim of PSO is to guarantee the connectivity of isolated regions where air transportation is the only viable mode of transportation. PSO may also be imposed in routes that are not able to generate enough traffic to be covered by airlines with adequate service levels and fares.

The PSO's basic legislation of 1992, modified by the current Regulation (EC) N° 1008/2008,³ has increased the number of protected routes over fourfold in the last 20 years.⁴

From a normative point of view, the main modification in 2008 was

to define with greater objectivity when PSO can be established on a route in part of a country (see articles 16 and 18, both inclusive). According to the article 16.1:

[A] Member State, following consultations with the other Member States concerned and after having informed the Commission, the airports concerned and air carriers operating on the route, may impose a public service obligation in respect of scheduled air services between an airport in the Community and an airport serving a peripheral or development region in its territory or on a thin route to any airport on its territory any such route being considered vital for the economic and social development of the region which the airport serves. That obligation shall be imposed only to the extent necessary to ensure on that route the minimum provision of scheduled air services satisfying fixed standards of continuity, regularity, pricing or minimum capacity, which air carriers would not assume if they were solely considering their commercial interest.

In addition, Member States shall assess the necessity and adequacy of the PSO taking into account the “*proportionality between the envisaged*

[☆] We thank comments and suggestions made by Joan-Ramon Borrell and an anonymous referee. José Abreu and Juan Luis Jiménez thank financial support by Programa Innova Canarias 2020, FULP (edición 2016). Nevertheless, all errors are ours.

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¹ The process of air transport liberalization began in the United States with the approval of the *Airline Deregulation Act* in 1978. This spread to countries such as Australia, Canada, Japan and New Zealand (Cáceres, 2010). In Europe the implementation of three 'packages' of measures was carried out in 1987, 1990 and 1992 with the same end. For more information, see Regulations (CEE) N° 3975/87 and 3976/87; Directive N° 87/601; Decision N° 87/602; Regulations (CEE) N° 2342/90, 2343/90 and 2344/90; and Regulations (CEE) N° 2407/92, 2408/92 and 2409/92.

² A line of empirical research exists about this measure, above all in Europe and Spain, in the works of Calzada and Fageda (2012, 2014), Fageda et al. (2012, forthcoming), among others.

³ <http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A32008R1008>.

⁴ See the post published by Fageda, Jiménez and Valido in this context: <http://nadaesgratis.es/admin/algunos-apuntes-acerca-de-la-eficiencia-de-las-ayudas-publicas-al-transporte-de-viajeros-en-avion>.

obligation and the economic development needs of the region concerned”, the existence and effectiveness of alternative modes of transport, the airfares and the “combined effect of all air carriers operating or intending to operate on the route” (art. 16.3).

Taking this into account, a typical case of a protected route by PSOs are domestic links between islands and the mainland (or between islands from a same country) where connectivity by surface or maritime transportation is difficult and/or expensive.

Any Community air carrier that meets all PSO requirements may provide scheduled air services (art. 16.8). However, if no Community air carrier provides such a PSO, the Member State may limit access to that route to a single company for up to 5 years by means of public tender (arts. 16.9 and 16.10). The winner will be entitled to compensation with an amount not to exceed “the net costs incurred in discharging each public service obligation, taking account of revenue relating thereto kept by the air carrier and a reasonable profit” (art 17.8). Thus, in some cases the imposition of PSOs is satisfied by airlines without the need of subsidies and no entry restrictions. In others, the government set an exclusivity contract with an airline that has to meet the PSO conditions regarding service levels and fares in exchange of a subsidy.

Note that PSO have to be developed within the legal framework of the European Union but, in practice, the specific implementation (selection of protected routes, the decision about the amount of subsidies, determination of fare and service levels, etc) is made by national governments.

This policy was established for the first time in Spain in 1998, when 13 PSO routes, all in the Canary Islands, were initiated. The reasons for its implementation were “the effective realization of the principle of solidarity, with particular attention to the circumstances derived from the insularity and “the need to articulate a public intervention, aimed at making possible the existence of a sufficient supply of services” (BOE, 1998). Since then there have been two reforms of the PSO system, in 2006 and 2011, which are the object of evaluation of this study.

These reforms represented two different changes⁵. Since 1998, new infrastructures had been put into service and new fleets with larger fleets had been incorporated, events that invited the PSO system to be updated to meet the real needs of users. In 2006 greater flexibility over access to the market evolved due to an over 40% increase in demand for air transport compared to previous years. The reform also offered the firms greater freedom to adjust their offer, established a more flexible tariff system, and introduced new (generally upward) minimum requirements for frequencies and seats.

On the other hand, the 2011 modification,⁶ limited access to firms by offering a public tender contract for a two year period. Four of the weakest routes in the Canary Islands, deeply affected by the international crisis of 2008, had ceased to have economic interest for the only company that operated them. Such company had expressed its intention to abandon them. The contract compensated a company economically with a payment of almost five million euros, so that it would fulfill the PSO and provide a new minimum services on four routes.⁷

Therefore, as noted above, the aim of this study is to evaluate how Canarian air transport has been affected by these two opposing legislative changes; given that the 2006 reform was clearly pro-competition while the 2011 change was restrictive, in terms of demand. This analysis will allow us to clarify the benefits of these changes, which directly affect the General State budgets, and even form part of the parliamentary negotiation to support them.

Following this introduction, section 2 reviews the theoretical and

⁵ According to the Official State Bulletin, the justification in both cases is different. The 2006 reform was a response to economic changes: increases in demand, new infrastructures and companies, etc. In 2011 the system was modified due to the Binter air company abandoning four routes.

⁶ Resolution of the Council of Ministers, 7 October 2011.

⁷ For greater detail about the modifications established in the legislation on the minimum requirements of frequency and capacity, see Tables 1 and 2.

empirical literature on PSO at island, national and European level. A legislative survey of PSO in the Canaries is carried out in section 3, while section 4 presents data and the methodological strategy. Section 5 details the main results and discusses them, and the last section draws together the main conclusions of the study. This result confirms what was expected: only the procompetitive reform generated increases in demand.

2. Literature review

The academic literature on this topic has been predominantly empirical, with the exception, among others, of the work of Reynolds-Feighan (1995), who undertook a legislative comparison of PSO in Europe with the United States Essential Air Service (hereafter EAS)⁸ programme. This study argued that the administration and financing of PSO should decline in Europe in order to provide greater efficiency, transparency and regional development; and barriers to entry should similarly be identified, such as the possibility that an airline can operate a route for three years if no other company covers it (in the current legislation, 2008, the number has increased up to four/five years).

The first line of research has been descriptive, such as studies by Williams and Pagliari (2004) and Williams (2005). These works highlight the significant differences that exist regarding the use State members make of PSO, arguing that because the European Union manages them they should achieve a more efficient and equitable distribution of the subsidies (in line with Reynolds-Feighan, 1995). Merkert and O’Fee (2013) and Wittman et al. (2016) on the other hand emphasize the broad heterogeneity of the European PSO programmes, and note the different criteria employed to define a recipient route for aid, in the tariffs or in the subsidies.

In a separate piece of descriptive research, but with reference to Spain, Ramos (2015) analyzed the Canary market⁹. Considers that OSP minimize the potential impact of competition in the Canary Islands, and that the increase in demand observed during the period of competition between Binter and Islas Airways¹⁰ would be the result of the multiplication of trips by a small number of people rather than by the use of air transport.

One criticism of the system is that sometimes when companies are allowed to operate freely new routes are established, without the need for any aid. In this line, Betancor and Vicens (2012) find that PSO on high demand routes lack sense, given that the offer on those type of connections is guaranteed.

Regarding econometric studies, Santana (2009) compares the cost of European companies that use PSO with American airlines that operate through EAS, arguing that there are indicators that the latter are more efficient than the former. Along this same line, Merkert and Williams (2013) show that European operators obtain better results in the early months of PSO contracts than when they are near their end, suggesting that airlines have less incentives to improve efficiency as contracts draw to a close due to the absence of competition on the routes.

Bubalo (2012) on the other hand focuses on the Norwegian case and argues that bidding processes are inefficient due to scarcity of competition on PSO routes, a fact that frees the dominant operator to manipulate their costs and receive larger subsidies. Pita et al. (2013) applies a model for the Azores Islands with the aim of minimizing the social costs of a PSO route and therefore establishing a more efficient system of subsidies, a work that is in the same line as Pita et al. (2014); although this latter work was in relation to Norway.

Regarding the Spanish PSO case, a pioneering article by Calzada and Fageda (2012) provides evidence how, in the 2001–2009 period, the

⁸ This was a measure carried out in the United States to guarantee a basic air transport service for those small communities most affected by the deregulation of 1978.

⁹ Other works that analyze the PSOs in the Canary Islands are Hernández (2004, 2010).

¹⁰ However, Islas Airways left the market afterwards, again leaving Binter in a *de facto* monopoly situation. For an analysis of this exit, see Campos et al. (2015).

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