

IATA response to the financial/charges aspects on the *Draft Final Report of July 2003 of the RPI Study on the Implementation Rules of Economic Regulation within the Framework of the Single European Sky.*

SUMMARY

We agree the general conclusions of the Study that efficient development of European ATM is more likely to come from:

- Improvement in structure and performance of ANSPs.
- Combination of economic regulation and more involvement of users.

Determination of the precise charging structure is secondary to our main objective to lower the unit costs and charges of ANS provision.

We would like to see correct and harmonised cost allocation between en route and terminal navigation (TNC) with elimination of cross-subsidies and discriminatory charging, and site-specific charges for TNC.

In our view financial incentives are appropriate on monopoly ANSPs but not necessary on airlines that compete in an increasingly intense competitive business.

We have a strong requirement for independent economic regulation, but believe the full-cost-recovery system still has a role providing the necessary compliance and enforcement mechanism is established to ensure it is correctly interpreted and applied.

We do not support:

- Creation of "smoothing" or solidarity funds from user charges.
- Upper/lower airspace differentiation unless FABs are developed on a "top down" basis and accompanied by robust economic regulation.
- Introduction of weight "steps".
- Congestion-related charging mechanisms.
- Regional charging.
- Marginal pricing.

We feel there are difficulties, and not enough benefits from:

- Charging by ACC.
- Change to the weight exponent.

GENERAL

Single European Sky

IATA generally supports the EC Single European Sky (SES) initiative. We therefore welcome this Study as an important part of the preparatory work for implementation of SES.

As part of a "Five-Point Plan" for European ATC, IATA has previously proposed that politicians and decision makers should:

- Adopt the ATM 2000+ Strategy in full – including the financial objective to reduce the unit cost of ATM.
- Give EUROCONTROL (ECTL) and the EU the necessary regulatory powers and processes.
- Establish a permanent European-wide capacity planning process.
- Liberalise the provision of ATS.
- Develop incentives for ATS providers.

We are therefore pleased to see that this Study, within the SES initiative, provides an opportunity to address some of the barriers to more efficient structure and cost-effective performance of European ATM very much in line with the original IATA Five-Point Plan.

Airline crisis and need to restructure

The air transport industry is going through its worst crisis in its 100-year history, with USD 25 billion losses in 2001-2002. A loss of USD 10 billion is forecast for 2003.

Under tremendous pressure, our industry has shown the ability to change dramatically. Airlines have taken difficult and painful measures to restructure and contain costs for survival. Average yields per passenger, however, have decreased 3.4% annually on average over the past five years.

Over the last five years IATA Member airlines have reduced their unit costs by 2% per annum on average, despite their ever-increasing external costs. Eventual return of traffic to previously forecasted levels does not necessarily mean a return to profits. The increasingly intense competition in the airline business maintains a strong downward pressure on yields and therefore on costs.

The cost of ATC

No other airline cost has increased as much as ATS. Over the last ten years ATS charges have grown by 14% per annum worldwide, practically double the rate of the airlines' international capacity growth. The ECTL area cost base for 2003, paid through airline charges, is some USD 5 billion. The average weighted unit rate charges increased 13% for 2002 and 11% for 2003.

In previous years IATA asked for increases in capacity, new route structures, and access to more airspace. In general these problems were solved, but in a very expensive way. The airlines can no longer accept such increases. The current crisis should trigger immediate action that can be sustained and expanded.

For most ANSPs the answer to recent falling traffic has been to increase charges to make up the difference. We believe ATS providers should

instead consider cost reduction and increased efficiency, while maintaining safety, capacity and service quality at the required levels. This is no different than what the market demands from the airlines – better service at lower prices.

Against this background, we welcome the EC Study into the implementation rules for economic regulation and make the following comments.

SECTION 1 - INTRODUCTION

IATA is pleased to note that the intention of the Study is to comply with key general charges principles. We fully support the principles within Article 15 of the Chicago Convention and ICAO Document 9082/6 on charges policies. Charges should be cost-related, non-discriminatory, and equitably applied among all users. The EC objective to develop a more flexible charges system that encourages cost effectiveness, increases and makes better use of capacity, should be within these key principles.

We generally support the full cost recovery system providing it is properly used with the correct interpretation and application of the ECTL Principles and Guidance. Unfortunately, in our view, this is not the case in general. Full cost recovery could be effective providing robust and effective compliance and enforcement systems were established to ensure it is correctly interpreted and applied.

We recognize the major weakness of the current full cost recovery system is the lack of incentive for relatively low-risk monopolist ATC providers to reduce costs and increase efficiency. This is one of the main reasons we fully support the price-cap economic regulation style regime providing it has the necessary independent regulation as applied in the UK. While it may not necessarily be the perfect model, we believe this approach satisfactorily compensates for the incentives missing under full-cost recovery.

SECTION 2 – RESTRUCTURING ISSUES

2.3.1.a) **Commercialisation of service provision** – we fully support the separation of economic regulation from service provision. We also believe the trend towards increased autonomy for ANSPs results in more efficient business-like management of the facilities and delivery of the required infrastructure. Our experience is that this results in better value for money. Autonomous ANSPs generally provide better transparency and consultation.

2.3.1.b) **Unbundling of services** – we very much favour the unbundling of non-core services, particularly where this means services can be outsourced or open to competition to reduce costs. Our ECTL charges are currently based on a unit rate for each Member State and a single charge for each flight in the system. We would not want to see a

separation and proliferation of different charges. We expect States to be responsible for and control all costs within their individual cost bases.

2.3.2.a) The current airspace architecture charging model - we are not aware of airline user involvement in the CRCO simulations. We are therefore unable to share the conclusions drawn from these simulations. Further research on the effect of the proposals on airline finances and operations is required.

2.3.2.b) CRCO Task Force on charging – this was an enlarged Committee for Route Charges Possible Charging Mechanisms T/F. It had some 14 meetings over 18 months that only resulted in a status quo. The main disappointment from our view was that most of the significant proposals related to a redistribution of costs rather than actually addressing them.

2.4.1. Operational restructuring - We believe the current fragmentation and misplaced notion of sovereignty relating to the management of airspace are a major cause of the unnecessarily high costs and charges. The ECTL Performance Review Commission has identified that if all ECTL States and ANSPs were on the so-called “efficiency-frontier” this would save EUR 650-850 million per year. If these efficiencies were combined with the economies of scale from rationalization of European ATS provision significant potential efficiencies must be possible.

2.4.1.d) SES implications for operational restructuring – we support the RIK approach. We agree the requirement “to put in place regulatory arrangements and processes that will provide where necessary encouragement and pressures for restructuring and improved performance”. Limiting eventual restructuring to upper levels only would cause strong concerns on possible increasing costs due to duplication of overhead costs for ANSPs. We agree the RPI assessment and concern that the creation of new upper ACCs will simply give rise to extra assets and costs, without leading to offsetting reductions in assets in lower airspace provision (see concerns re CEATS below). In that case although en route unit costs and charges in upper airspace can be expected to fall, unit costs and charges for ATM in lower airspace will simply rise. On average users’ costs are likely to be worse off than before.

2.4.2.b) CEATS - we share RPI’s concerns that the current project will serve simply to increase overall costs for upper and lower airspace combined. We have not seen evidence of any positive cost-benefit. We are disappointed at what is a politically led expensive approach of a “distributed” solution. Our preference is to use this opportunity for a meaningful rationalization of ACCs and facilities.

2.4.2.c) NUAC – we naturally support the objective for this project to reduce from ten separate ACCs into one. While we appreciate the anticipated efficiency gains as a result of better direct routings and re-

sectorisation, we would be surprised and disappointed if efficiencies did not also result from scale economies and less costly coordination.

SECTION 3 – PRICE REGULATION

3.3. Price cap regulation – our support for price cap regulation, accompanied by the necessary independent economic regulation, was briefly outlined in Section 1. We believe any possible incentive to degrade the service quality can be effectively regulated. Our experience with UK NATS and their CAA regulator, for example, has clearly demonstrated this can be satisfactorily achieved. Safety and security are the main priority for ANSPs and airlines. We do not believe that any ANSPs or States would allow any degradation of this priority.

3.4 Hybrid arrangements - We believe that one of the major benefits of regulation should be assurance of an efficient provision of service. To ensure this, the hybrid solution as proposed by RPI should strive for:

- Efficiency (cost-reduction)
- Quality of service
- Customer focus

3.6 Incentive regulation - we fully agree the RPI suggestion that “put simply, the provider becomes more customer focussed, and this alone can lead to major changes in business conduct.”

3.7. Investment issues – our major concern is identified by RPI –“Allowing providers to secure revenues on a cost-plus basis, including a reasonable return on capital will, if unsupported by other measures, tend to lead to gold-plating”.

3.9.a) Introduction of competition – this is already in place in limited form through the freedom of choice of routes. We recognise however, the choice is limited by factors including fuel and time, and can be considered artificial. We fully support the RPI suggestion that where competition through different suppliers is not feasible, there should be competitive tendering for franchising.

3.9.f) Incorporating customers into contract frameworks

We believe that collective multi-party agreement should be possible between providers and users. Such agreements can become more desirable and possible within economic regulation. Similarly, ANS provision has a significant impact in the home base of network carriers, and may encourage consideration of individual service agreements. Such multi-party or individual agreements must not be discriminatory or anti-competitive.

There is an understandable tendency for economic regulators to want to create a suitable framework and terms of reference within which the providers and users can “constructively engage”. This would avoid heavy-

handed or intrusive regulation as sometimes seen in other regulated sectors. In theory this approach may be correct, but implementation would not be easy due to reduced resources in the airlines and the need to avoid potential discriminatory or anti-competitive situations.

IATA and CANSO have agreed the need for a partnership approach between the airlines and the providers. We welcome this innovative business approach that has the potential to make the ANS industry more cost-effective and responsive to the needs of the customers.

SECTION 4 – CONTRACTUAL ARRANGEMENTS

4.2 Current institutional arrangements for charges setting.

4.2.1. Multilateral arrangements

We have lost confidence in the willingness or ability for the enlarged Committee for Route Charges meetings (enCom) to address our concerns. We agree with the main failings identified in the ECTL PRC PRR6 report:

- Club/cartel syndrome
- Conflict of interest between States/ANSPs
- Decision making weakened by consensus

In our view however, this criticism also reflects the weakness of the Provisional Council, to whom the enCom report, and the ECTL institutional organisation and process as a whole.

Clear breaches of the ECTL Principles have not resulted in any sanctions or redress. Central Route Charges Office supposedly assists enCom with the application and interpretation of the ECTL Principles. Supplementary advice on the definition and application of the Principles has been published in the “Guidance on the Rules & Procedures of the Route Charges System”. Experience has proven that CRCO cannot enforce compliance. The system relies almost entirely on the willingness and goodwill of individual States to redress any users’ concerns.

ECTL States have agreed to the enhanced information disclosure necessary for the PRC ATM Benchmarking, which uses historical actual results. By comparison, the information supplied by States to CRCO and the users for their preliminary and final proposals for their cost base and unit rates is far less detailed. While the historical costs are interesting, users are more interested in the costs for the charges they are paying in the current and future years. It should also be noted that it is virtually impossible to relate the ANSP costs provided to ECTL CRCO to the real costs published in reports and accounts.

4.2.2. Member State institutions and processes – the standard agenda, guidelines and structure for bilateral charges consultations were developed by the users and enCom. This was done through the Financial Information for the Users (“FIFU”) Task Force. As identified by RPI, the level of information disclosure and consultation does vary by ANSP/States,

but this is not the main problem. Timely receipt of the data and the degree to which the users' views are considered are more important.

4.5. Contractual arrangements - we believe the suggested steps in Table 4.1 provide a very useful proposal for the development of contractual arrangements. Establishment of the proposed Review Board would need careful consideration.

4.6.1.c) Disaggregation of cost data – we fully support the idea for separation of infrastructure costs and the costs for service provision. We would also emphasise the need for improved procurement processes by ANSPs, transparent though CNS costs disclosure.

4.6.1.d) The quality of cost data – the "FIFU" Task Force is an ECTL enCom body. In our view it suffers exactly the same limitations and weaknesses outlined in 4.2.1 (above).

4.6.2. Forum for dialogue between ANSPs and users – as noted in the report, it is an unacceptable situation where the users paying 100% of the costs through their charges are only given observer status within ECTL on costs and charges dialogue. We believe a substantial change in this situation is justified.

4.6.3. Review advisory bodies

We believe the ECTL PRC produces excellent work and recommendations. This Study however, has identified the same weakness that we highlight in 4.2.1 (above). There is no necessity, nor compliance, for States to implement any recommendations even when agreed by the Provisional Council. It is an unsatisfactory situation when peer pressure or embarrassment can be considered two of the main motivators for States/ANSPs to apply PRC recommendations. Timetables should be established for agreed recommendations within meaningful compliance procedure. We would be concerned with the additional administration and costs if the intention is to create additional review or advisory bodies.

4.7.2. Processes for assessing ATM investment

4.7.2 b) ATM investment plans - In our view the UK NATS process of combining the business plan, Service & investment Plan, and charges consultation, all underpinned by regulatory requirements, is an excellent model. Users are given the opportunity for full consultation on the investments, with business cases and cost benefits where appropriate, together with capacity and service quality, against the impact of the costs and indicative charges.

4.7.2 c) Use of investment plans by ANSPs - we very much share the concern outlined by RPI regarding the lack of coordination of ANSP investment plans. This is reflected in our call for a harmonised and less fragmented European ATM system. Increased collaboration is necessary to provide the benefits of commonality and interoperability that can

produce economies of scale as well as reduced procurement and operating costs.

4.8.1 Incentives for cost-efficiency – we agree the need for greater focus by ANSPs on flexibility to respond to traffic levels variations. We would not agree the assumption that ANSPs have a high element of fixed costs that make flexibility difficult. In our view staff costs, averaging some 50% of total costs within the ECTL area, need not necessarily be regarded as fixed. We believe the protection and “comfort level” provided by guaranteed full cost recovery is the major reason for the general inertia on flexibility.

4.8.1.a) ECTL Costs - We agree it is entirely appropriate for the ECTL Agency to be subject to review within the PRC process. In our view the Agency is a very expensive organisation that needs to be more cost-effective. We note and support the good progress of the ECTL Advisory Financial Group (AFG) Budgetary Planning Task Force. This group is examining a new approach to the scrutiny of the Agency budget and Five-year plans. It has recommended a “top-down” strategic business approach with introduction of performance measurement and efficiency factors.

SECTION 5 – ATM COORDINATION & INFRASTRUCTURE MANAGEMENT

5.2.4 Infrastructure financing options

We fully support the SES aim to promote greater levels of harmonisation, integration and interoperability between European ATM infrastructure. We also agree the conclusion that creation of a European infrastructure fund is likely to be inefficient because it potentially detaches the funding of collective projects from the beneficiaries of these projects. We believe that ECTL should be considered as best placed to assume the role of European Infrastructure manager. This role would require the necessary appropriate enforcement and compliance powers.

The report correctly reflects that we are opposed to any form of fund created through additional user charges.

It should be noted in this regard that aviation is the only transport mode that fully funds its own infrastructure. A much wider community than just the users and ANSPs however, shares the benefits. Most States consider it is important to have a good ATM infrastructure but show a great reluctance to bear the costs. This is contrary and inconsistent with their provision of significant funds for roads and rail through public means. Civil aviation should be recognised as another mass transit system that provides vital economic benefits to travellers, industry and tourism.

SECTION 6 – RISK SHARING & BENEFIT SHARING IN ATM

6.1 Identifying the sources of traffic volatility – In the current situation ANSPs bear no risks for technical failures. All operational and financial costs, including cancellations and delays, are additional cost to the users. It should be investigated to what extent ANSPs could contract with their equipment suppliers for performance. Risk for non-performance should be considered within normal business means such as rebates, claims or insurance.

6.2. Impact of traffic volatility on ANSPs and users

Most ANSPs claim the current charges system is inflexible. In our view this inflexibility is also a symptom of the protection ANSPs enjoy from guaranteed full cost recovery. We recognise the system does not incentivise or encourage ANSP managements to take meaningful and robust action. The answer to traffic and revenues falling below forecast should not just be to increase charges to make up the difference. The reaction should be to reduce costs and improve efficiency on a sustainable basis.

The report considers profiling of cost recovery in periods when demand is less price-sensitive. This misses the point that the intense competition within the airline industry will continue the trend of reduced yields and margins. Under tremendous pressure the airlines focus is on dramatic cost reduction. Improving traffic no longer means profit.

6.3 Financing potential smoothing mechanisms

We do not support the establishment of any equalisation, stabilisation or reserve funds created through increased charges or retention of over-recoveries. As with the suggested “solidarity” fund, we strongly doubt the efficiency of such funds. We are not prepared to pay in advance without receiving any commitment in relation to the future benefits. Among the reasons we do not support such funds are:

- The ability to retain over-recoveries would tempt ANSPs to over-budget costs and/or under-estimate traffic forecasts.
- We do not support pre-financing – in our competitive market those paying into the fund may not be around to benefit in future.
- A ‘pot’ of idle money is unacceptable.
- Relatively easy access to a fund would diminish creative management.
- Funds can be open to political manipulation.

Within enCom there have been recent proposals for “smoothing” of charges through publication of unit rates, typically over a five-year period. We cannot support this proposal within the full cost recovery. This leads to an artificial smoothing of the rates. Without robust independent economic regulation the charges are open to manipulation and can result in a gradual loss of transparency and cost-relationship.

6.3.a) Rate stabilisation funds - many of the same weaknesses outlined above are applicable to "rate equalisation funds". We are aware of the argument that credit ratings, and therefore cost of capital, can be improved through the existence of an equalisation fund. There are however, few ANSPs subject to this financial structure, and the charges increases required to replace any draw down of the fund can be equally unacceptable to both the users and providers.

6.3. b) Establishment of pre-approved credit lines - we proposed this possible solution via the ECTL enCom Charges Study Group as a more preferable alternative to the unacceptable pre-financing of any fund. The potential problem would remain however, that vigorous and creative management approach to problems may not be considered necessary if there is relatively easy availability to credit-lines.

6.3.c) Allowing ANSPs to hold reserves from over-recoveries as mentioned in 6.3 (above), we do not support this approach as the ability to retain over-recoveries within the full cost recovery system may encourage either over-budgeting of costs or under forecasting of traffic. Such reserves could also be open to abuse. Allowing ANSPs over-recovery of costs and the build-up of reserves for monopolies is no more than the airline industry providing a cash advance from its own limited resources.

6.3.d) Re-negotiation of traffic forecasts and revenues - we could only envisage this approach under independent economic regulation. It is difficult to see how it could apply within full cost recovery. In the case of UK NATS, we supported the introduction of the traffic risk share term, in consultation with the regulator, in order to enable the necessary financial re-structuring. Under normal circumstances we would expect a privatised and economically regulated company to bear all the risks.

6.4. Revenue recovery imbalance account -in our view the main reason for financial deficits in difficult times is the lack of response in general by ANSPs to the market demand for lower costs. To simply add another level of costs for an imbalance account would neglect this airline concern.

SECTION 7 – STRUCTURE OF ROUTE CHARGES

7.2.1 a) Marginal cost pricing - we believe that marginal pricing is inappropriate for ANS. It is difficult to implement, ineffective in addressing capacity problems, and may result in discriminatory practices. It is noted that the PwC EC Study into TNC charges recognised these difficulties. In our view their recommendation was to leave consideration of a charging structure based on marginal costs on the "back-burner".

7.2.3 Charging principles - we fully support the three main principles of cost-reflectivity, non-discrimination, and transparency.

7.2.3 b) Non-discrimination - in addition to the "high-level" criteria, the Study should also consider the discriminatory impact of ANSPs

charging structure on individual airlines. This is particularly in the case of based carriers paying the largest or significant proportion of an ANSP's costs. Cost-allocation should be uniformly applied in a correct and harmonised manner to avoid discriminatory and anti-competitive charges. Accounting methods, pricing structures and cost-allocation should be transparent and harmonised throughout Europe, and should be under close independent review.

7.3.a) Weight and "willingness to pay" – we agree the Study assessment there is not a strong case for changing the exponent used in the current charging formula.

7.3.b) Using specified intervals for weight – proposals to introduce a "stepped" weight system could be considered a step backward. As with any slab or step system, it can penalise or discriminate against those falling just outside any particular interval, and favours those just below it.

7.3.b) Charging by passengers

Placing en route and TNC charges directly into the ticket tax box does result in a dampening of incentives on airlines to put pressure on ANSP costs. It could also be said that European charges unit rates (+13% 2002 and +11% 2003) and ANSP real unit cost increases (+9% 2000-03) prove that airlines have negligible influence over charges anyway. This situation is unlikely to change until airlines are considered more than just observers at charges consultations. Indeed, the level of frustration at the seemingly uncontrollable ANSP costs has already raised the possibility of putting charges directly onto the tickets payable by the passengers.

We therefore believe there are grounds to continue this discussion. Treatment of charges as a tax would increase media, consumer group and political attention on the need to control costs and improve the efficiency of ATC provision.

The question of how to deal with cargo has been addressed for airport charges. 100kgs of cargo for example, can be the equivalent of one passenger.

7.4 Two-part tariffs – we see too many difficulties and not enough advantages for consideration of two-part tariffs.

7.4.1 The distance factor – The motivation to change from the old "most frequently used routing" to "route per State overflown" (RSO) came equally from the users. RSO eliminated the undesirable possibility for "double-charging", and ensured that States/ANSPs are paid for the service they actually provide. It also introduced an element of competition in that ANSPs were encouraged to compete for traffic that might otherwise seek to avoid their airspace due to their higher costs. Competition is clearly severely limited in a scenario of monopoly ATC provision with guaranteed full cost recovery. We therefore support continued use of RSO.

7.4.2 Congestion-related charging mechanisms – we cannot support any system of congestion or peak/off-peak charging that only arbitrarily redistributes costs between different users. Airlines have no opportunity to adjust to such a system in an efficient way due to the complex task of scheduling its operations. ATC capacity is considered as a joint costs for all users – it is difficult to allocate capacity fairly without influencing all users. Users benefit jointly from availability of ATC systems that have not been developed for any single users. All users should contribute their fair share to the joint costs. An average cost pricing regime, as used in general practice, is considered the most transparent, fair and equitable regime.

SECTION 8 – ALTERNATIVE OPTIONS FOR ATM CHARGING STRUCTURES

Functional Airspace Blocks (FABs) and Airspace Charging Blocks (ACBs) – our understanding was that the original FAB concept allowed for a “top-down” approach. We support this approach that would enable competitive tendering of blocks of airspace. The competitive element could be expected to drive cost-effectiveness and efficiencies. The ANSP preference for a “bottom-up” approach must therefore be accompanied by strong independent economic regulation to ensure the expected scale economies and prevent costs and charges from the tendency to rise to the highest common denominator.

Differentiation between upper and lower airspace – we agree with the Study assessment that different charges for upper and lower airspace does not have any benefit regarding the efficient use of the system and are not easily justifiable from a cost-relationship viewpoint.

Differentiation of charges by ACC – as with possible differential between upper and lower airspace, we believe this type of proposal is secondary to our main requirement for a reduction in the overall level of en route and TNC costs. We agree the Study assessment that larger ANSPs with multiple ACCs will be tempted to manipulate the costs to achieve a similar unit rate to cover their areas. As mentioned in 7.4.1 (above), we value retention of what little competitive element does exist within monopolistic and guaranteed full cost recovery ANS provision.

CONCLUSION

We agree with the Study conclusion it is unlikely that charging structures will have substantial effects on overall ANS performance. The main effect will come from more effective regulation of charges levels. Our major objective is for a reduction to the average level of en route and TNC costs. Relative to this the determination of the precise charging structure is of secondary importance. We expect that EC membership of ECTL and SES developments will result in an improved economic framework and cost-efficiency, with the creation of a robust independent European economic Regulator.

