

Submission to
Better Regulation Unit
re Consultation Document
“Towards Better Regulation”

1 July 2002

AerRianta

Introduction

1. This submission is being made by Aer Rianta in response to the request to interested parties to submit views on the contents of a Consultation Document “Towards Better Regulation”. The document posed a number of specific questions under three broad themes which interested parties were invited to address in the course of their responses.
2. The advent of economic regulation for companies in the energy, transport and communications sectors has brought significant change for those involved. Many regulatory decisions not only have a significant impact on the operators within the regulated market, but can also impinge on wider national economic, social and regional development issues.
3. In this context, Aer Rianta welcomes this study on the quality of Irish regulation and regulatory processes and looks forward to engaging fully with the High Level Group as it goes through the process of arriving at its recommendations.
4. Aer Rianta’s response is organized in 2 parts (1) high level issues, (2) regulatory issues in the aviation sector following the three themes raised in the consultation paper, namely Performance of the Economy and Consumer Welfare, Quality of Governance and Modernising the Regulatory Framework. At several points in this response we refer directly to Aer Rianta’s own experience of regulation with a view to illustrating points of wider relevance.
5. We agree with the overall aim that regulation should be justified, it should be fully transparent, it should not be overtly cumbersome, be properly enforced and have no unintended consequences.
6. Regulation is an intervention into the market and it is therefore critical it operates for its purpose of improving competitiveness (the effective and competitive operation of markets and improvement of infrastructure) and to foster sustainable growth.
7. The main objective of the High Level Group on Regulation as set out in the Terms of Reference, is to “provide a cross-agency mechanism to examine the findings of the OECD’s report on regulatory reform in Ireland...” However, the membership of the High Level Group does not appear to represent a true cross-agency mechanism. Aer Rianta is strongly of the view that the High Level Group would benefit from a broader range of perspectives being represented at the table when the future of the country’s regulatory governance is being discussed¹
8. Aer Rianta notes with particular dismay the exclusion of representation of regulated (and indeed unregulated) business from the High Level Group. This is a severe defect which goes back to the Government’s own consultation document. A theme which Aer Rianta wishes to stress in this submission is the vital importance of regulatory independence, or in other words the duty on a regulator to take into account, but not be captured by, the interests of any particular interest group. It is difficult to see how an independent regulatory body can arrive at a balanced view if it is encouraged simply to

¹ For instance, the members of the UK’s Better Regulation Task force come from a variety of backgrounds – large and small businesses, citizen and consumer groups, unions and those responsible for enforcing regulations.

ignore or exclude the views of regulated entities and of businesses which have substantial dealings with them.

High Level Issues

9. As stated in the Consultation Document a significant body of regulation already exists in Ireland affecting many aspects of business, consumer and social behaviour. There appears to be a tendency across Europe and in Ireland to increasing the level and extent of formal regulation of markets, and corporate, consumer and social behaviour. Introducing additional regulation is becoming an automatic response to perceived difficulties in markets and behaviours which are sometimes only short term in nature.
10. Markets are rapidly changing and are now global not local, corporate behaviour has become more aggressive, the drive for value is greater and the dominant players of yesterday may no longer operate in the market. Therefore any intervention into the operation of markets can have a serious impact far greater than just addressing the initial factor/entity which gave rise to it. It is therefore critical that any assessment with regard to the introduction of any new or additional regulation addresses the parameters around why regulation is justified and the factors giving rise to it. The nature of regulatory intervention should then be structured differently for short term and longer term factors and other means of dealing with market imperfections should be considered.
11. The issue of competition in Ireland is being reviewed with an overly strong focus on the local market only. The consumer market in Ireland is small and addressing competition to create several units to provide services to this market may make it uneconomic and ultimately the consumer will be worse off with higher prices, lack of investment in infrastructure and services. The drive in all industries now is for consolidation to achieve economies of scale which is what is achieving lower prices for consumers. This is happening in telecoms, pharmaceuticals, banking, media , airlines and airports. The ability of small single units to compete in today's marketplace is very difficult unless they have a niche product for a specific market. Companies are competing in the international marketplace. Regulation as an alternative to competition with a focus only on the domestic market is damaging.
12. The costs to industry and consumers of regulatory intervention is now a serious burden. It is difficult to see if the objectives of competitiveness and sustainable growth is being contributed to by regulation in Ireland. There appears to be a lesser incentive for companies to invest in key national infrastructure which is critical to our future growth and competitiveness. There is confusion between regulatory intervention to improve market behaviour in the interests of consumers and more regulation to remove the restrictive effects of existing regulation, ie.legal/licencing barriers to entry into the market. The role of the Commission for Aviation Regulation is very different as it provides price regulation for airports in a sector where there are no regulatory barriers to market entry. Currently anyone can set up an airport, in fact, there are greater regulatory barriers to entering the airline market than the airports market in Europe.
13. The role and operation of Regulation does not appear to transparently address this critical difference. Regulation to remove regulatory barriers to entry to a market is beneficial and as a result improves consumer welfare. However, it is difficult to see the

benefit to competitiveness and investment in infrastructure of further regulation once these barriers are removed.

14. There is an increasing tendency for regulators to extend their scope and power. Therefore, it is crucial that any monitoring/assessment of regulation address this issue of 'regulatory creep' beyond the objectives of regulation for market competitiveness and sustainable growth. This should be rigorously enforced.
15. It is crucial that the Government provides a review mechanism which in a timely basis addresses when regulation is no longer needed and removes regulatory interference in a market. The consequences for Ireland of not providing for this are great. We are a small local market and our strength and growth comes from operating in the international market place. Regulatory interference to deal with local market issues can have serious consequences for Irish companies' ability to operate in international markets. Irish companies are nearly all operating in the international arena, be it as suppliers, purchasers, investors, employers etc, and the forces of the market are making Irish companies competitive far more than regulatory intervention, as they will not survive if they do not meet market requirements.
16. Dominance of a business in the Irish market is not in itself a reason for regulatory intervention provided there are no regulatory barriers to entry into the market. The competitive pressures in business are forcing consolidation in all industries into a few big players and Ireland has to be able to deal with this market phenomenon. The markets, including the international capital markets which now generally provide the capital to Irish business, will force companies to behave properly or they will not be in a position to survive. Regulatory reform in Ireland should facilitate Irish companies becoming large international business players on the world stage and should not impede their progress.
17. Economic regulation can have a significant impact on a companies' ability to develop. Economic regulation which is not properly structured and not sufficiently informed of the international marketplace can severely impede a company's ability to grow and to attract capital. This may have greater consequences for the economy and consumer welfare than any short-term abuses by the industry. Poor structure or operation of economic regulation may impede investment in infrastructure, may make Irish companies less able to attract investment capital to fund growth, may reduce service/product quality, and may make enterprises less able to provide services to the market place.
18. It is crucial that regulators are properly informed about the wider market place in which their regulatees operate and the market dynamics and shifts at play in their industry. International and industry expertise is critical. Therefore, regulation in theory and practice needs to bring this international expertise to bear. This may prove more costly in the short term but it will have longer term benefits.
19. In Ireland the development and operation of regulation is sometimes overly influenced by local concerns and issues and in some cases short term issues. The media and lobbying have a strong influence on regulation in Ireland. It is critical that any form of regulation is non political and removed from undue influence.
20. A Code of Behaviour for good corporate governance should be developed for regulatory bodies as is currently applied to business and Government. This should be based on the principles of transparency, objectivity, non-discriminatory, proper

expertise, reporting and accountability, not just in relation to their own functions but also in relation to their regulatory decision making.

21. An expert panel including experts from international business and government should be considered for ongoing monitoring and assessment of Regulation in Ireland, in terms of continuing need for regulation, its operation, benefits and consequences.
22. In Ireland, the consumer market in some industries can be contain a few dominant players. These can overly influence the outcome of regulation and succeed in restricting proper market behaviour. There is also a tendency by regulators to deal with the issue of independence and regulatory capture by regulated entities by failing to engage properly with the entity being regulated and the industry. This is dangerous and will result in regulators being ill informed about the market dynamics and industry shifts taking place. These are serious issues which need to be addressed.
23. A set of standards/framework for implementing regulation should be developed in parallel with legislation. It is not appropriate that responsibility for this is left with the regulator as it is a policy matter which can effect regulatory outcomes. Standards and principles for engagement and operation are otherwise determined in response to behavioural issues and problems, rather than the proper functioning of the office.
24. Regulators should be prohibited from using the public relations and media other than to communicate information to do with its operation to users/public. Engaging in publicity/media debate puts regulators into the political fray and they are no longer seen as independent and objective and above influence/lobbying.
25. Regulation to ensure proper standards of safety, security service delivery, social standards is also of benefit to the economy and consumers. This is important for economic stability, confidence and sustainable growth. It is also necessary to attract capital investment into industry and the economy generally.
26. Formal regulation over and above these two forms is questionable. Economic regulation in the form of price setting/fixing/restrictions is a market intervention which may be more harmful than helpful. Markets are now global, so domestic regulatory interventions generally impede competitiveness rather than encourage it. This is why the trend in most industries is now for the removal of economic regulation and and the substitute of a monitoring/watchdog body to deal with any potential market abuses.
27. This should be seriously considered in the case of the Irish economy. The issue of lower costs and efficient services to business and consumers is best dealt with through market forces with regulation codifying standards of operation and removing existing barriers/restrictive practices to the marketplace Market forces will generally get prices to proper levels to manage supply and demand and to attract capital for investment in future capacity.
28. There is also confusion in relation to the issue of regulation and ownership. Regulation and the need for regulation should be independent of who the owners of the business are, be it the State or private enterprise. The issue of ownership of State companies should not impact the Regulatory area. There is also a preconception in Ireland that if it is private it is better. If this holds to be true, the issue for State company ownership needs to be dealt with by the existing owners, not by default forced by Regulation.

Regulatory Issues in the Aviation Sector

Performance of the Economy and Consumer Welfare

Consumer Welfare

29. The nature of the customer base is an important factor in determining the requirements for regulation in a certain sector. It is recognized that consumers are not a homogenous group; they range from individual persons to large enterprises. Regulation is generally applied in a concentrated market where a dominant firm provides essential services for consumption by the public. The demand side of the market contains a large number of individual customers consuming in relatively small quantities. There is a need to protect the interests of consumers dependent on a dominant provider².
30. For most regulated sectors, there is potential for conflict between the short term benefits to customers of low prices compared to the long term benefit of investment in infrastructure. If regulation focuses unduly on short term price movements and is inadequately concerned with the long term development of the sector, there is a danger that the regulated entity will be forced to adopt a short term business strategy, which will adversely affect the sector in the future. The balance to be struck between short term imperatives (or what are perceived to be imperatives) and long term requirements lies at the heart of regulatory independence. Although regulators almost invariably have a clear statutory duty to protect the interests of consumers where the structure of a market does not allow competition to do it for them, it does not follow that regulators should routinely overlook or subordinate the concerns of the regulated entity where these bear decisively and legitimately upon the longer term interests of the consumers themselves.
31. In the long term consumers' interests are best served by economically viable regulated entities where there is sufficient investment in infrastructure to enable the efficient maintenance and renewal of existing regulated assets, and the provision of additional infrastructure to meet future demand.
32. Economic regulation is applied in the airport sector where there is a belief that competition for aeronautical services is limited and airports have the ability to exert market power. In the case of the airport industry, the customer base is quite different from that of other regulated sectors. There are several groups which might be regarded legitimately as consumers of airport services: the airlines themselves, the customers of those airlines, other non airline customers such as groundhandling companies and other service providers. In arriving at its own operating and investment decisions, Aer Rianta has to take account of the interests of all these groups. Clearly, they do not all have equal bargaining power. By virtue of their size and the scale of their purchases of airport services, airlines have much more to bargain with than the individual consumers. But Aer Rianta has an obligation to consider the interests of the other consumer groups too: the airlines may well not adequately represent all the interests of passengers as they use airport services, and the airlines have no particular responsibility towards non-passengers. In the same way that Aer Rianta needs to take

² A Fair Deal for Consumers (1998) - Modernising the Framework for Utility Regulation, UK Department of Trade and Industry.

account of the requirements of all its consumers, the airports regulator needs to do likewise.

33. Under the Aviation Regulation Act, 2001, the Commission for Aviation Regulation has a statutory duty to aim to facilitate the development and operation of cost effective airports, which meet the requirements of users. The Commission must attempt to achieve the economic efficiency that would be delivered if effective competition were possible. This requires that the interests of current airline customers who tend to focus on short term cost implications must be weighed against the requirement for long-term development of the airport sector for the benefit of all airport users.
34. The role of the regulator should be to seek a balance between the objective of protecting the immediate interests of present airline users and ensuring the long term viability of the sector to meet the needs of future consumers. This is best achieved by applying a test of economic efficiency in order to maximise productive, allocative and dynamic efficiency.
35. However, economic efficiency in the strict sense is not the whole of the story. Economic efficiency can be achieved without regard to the distribution of benefits: a rise in (say) producer efficiency could be kept in its entirety by the producer without benefit to consumers, even though overall economic efficiency is higher. In the aviation context, all the benefits of economic efficiency could be channelled to airlines without regard to the legitimate interests of other groups. One theme of this current consultation is consumer welfare, and with that in mind Aer Rianta argues that economic efficiency has to go hand in hand with distributional fairness.

Operation of Markets and Competition

36. It is however acknowledged that in certain sectors competition may be inhibited by the structure of the market. These markets, commonly referred to as natural monopoly markets, have characteristics which might include any or all of: a high ratio of fixed and sunk costs to total costs, heavy capital investment requirements, and economies of scale, scope and density. The cost of production for the provision of aeronautical facilities is likely to be higher where a number of airports engage in supplying aeronautical services and it is more cost effective that a single producer supplies a large proportion of the market. Instead economic regulation is used to ensure an outcome which approximates to a competitive market outcome.
37. Market failure of itself is not always adequate justification for regulatory intervention. Regulation will only prove justifiable in the presence of market failure and the absence of regulatory failure. Regulatory failure is likely where Government intervention in the market is ill targeted and ineffective. Regulation is only justified where market failure is considerable so that blunt regulatory intervention can prove beneficial or in instances where regulatory intervention is extremely well targeted³. This is a view echoed by the economist David Starkie

It is only when a market does not work well, when there is a clear case of natural monopoly *and* when regulation can be reasonably expected to improve matters that the regulatory option is worthwhile. Market imperfections alone are not a sufficient justification for intervention. ⁴

³ Cubbin, D and Currie, C. 2002, Regulatory Creep and Regulatory Withdrawal: Why Regulatory Withdrawal is Feasible and Necessary

⁴ Starkie, D., 2001, Airport Regulation and Competition, Journal of Air Transport Management, Vol 7, no.5

38. Regulators need an appreciation that effective and robust competition although not perfect is superior to any regulatory intervention. Regulators need to comprehend that overlapping market interventions may stifle the performance of the market and generate unforeseen market inefficiencies. Regulatory interventions should be minimised and regulators should be encouraged to withdraw from market intervention in favour of competition⁵.
39. In keeping with the principles of good regulation, regulatory intervention should only be introduced in areas where a regulated entity possesses strong market power and it is clear that the regulatory system itself with all its distortions will improve the economic efficiency of the regulated market. The structure of the regulatory regime should be no more onerous than the requirement necessary to meet the statutory objectives laid down for it. The regulatory regime should allow the regulated entity to pursue, as far as possible, its chosen commercial strategy.
40. In the aviation sector, airports experience varying degrees of competition in the market for aeronautical services. Airports find themselves in competition with other airports in establishing themselves as the venue for the location of new airline services. Many airports have overlapping hinterlands and therefore compete with each other for airline services and passengers. Competition exists between airports as locations for the development of hub status. Competition also takes place within airports in relation to the provision of various non-aeronautical services at the airports.
41. However it should also be noted that there is no legislative barrier to entry to the airport business in Ireland. While some individual airports may have potential for market power, this arises largely as a result of the nature of the industry, airlines tend to have a strong preference for concentration of services on a limited number of airports to capture the benefits, including benefits to passengers, that can arise from network efficiencies, economies of scale and increased service frequencies. Opportunities for anti-competitive behaviour or abuses of dominant position in the airport sector are limited as all airports compete at one or more levels e.g. competition between hub airports, competition between airports for airline services etc.⁶
42. Given this context, it is appropriate that recent debate suggests that in regulating the airport sector, an *ex-post* method of regulation may be more appropriate than a stringent *ex-ante* approach. An *ex-post* approach would also enable the introduction of regulatory control, where there was evidence that a firm abused a position of market power.
43. It is interesting to note that following the publication of the Australian Productivity Commission Inquiry report on the regulation of airport services⁷, the Australian Government has taken the decision to abandon price cap regulation of the airport sector and to implement an alternative more light handed regulatory approach in the form of price monitoring of aeronautical charges. It believes that this approach will provide airports with greater scope to undertake effective investment and more flexibility to respond to a changing aviation environment. In the UK similar decisions to withdraw supply price caps have been taken by the gas and electricity regulators

⁵ Cubbin, D and Currie, C. 2002, Regulatory Creep and Regulatory Withdrawal: Why Regulatory Withdrawal is Feasible and Necessary

⁶ ACI Europe Policy Paper, October 1999, European Airports: A Competitive Industry

⁷ Productivity Commission, January 2002, Price regulation of Airport Services, Inquiry Report, Report No. 19.

44. In the Government's consultation document *Towards Better Regulation*, a number of alternatives to regulation are suggested. One of these options, co-regulation would involve a sharing of the regulatory role between the regulating authority and regulated parties where objectives are set by the regulator and implemented by the regulated entity. In the case of the Irish airport industry, this option could provide a better alternative to the current regulatory structure as it would provide greater investment incentives while minimising the risk of regulatory failure.
45. There is also a strong case to be made for the inclusion of a sunset clause in which it is agreed that at some date in the future, the justification for continued economic regulation of a particular sector will be reviewed. This will ensure that regulatory intervention is only maintained where economically justified and where it is no longer deemed necessary regulation of the sector will cease.
46. The theme of Markets and Competition leads Aer Rianta to comment on the very real danger of what has become known as "regulatory creep" – the tendency of regulators to find more and more activities to regulate rather than to give priority to withdrawal from regulation and the encouragement of competition. In this context, the approach that the Commission for Aviation Regulation has taken to the "single till" versus "dual till" form of airport regulation is a useful illustration.
47. In its Determination on the maximum permitted level of airport charges at the Aer Rianta airports, the Commission applied the single till principle to its derivation of the regulated asset base. This allows for revenue from selected non-aeronautical activities to be used to supplement the maximum allowable revenue from airport charges. Thus the Commission's price caps on the maximum permitted average revenue per passenger have been formulated by combining net revenue from the aeronautical activities and net revenue from selected non-aeronautical airport activities.
48. In practice the single-till mechanism extends the remit of economic regulation beyond the confines of aeronautical charges. It allows the Commission to introduce *ex-ante* regulation into commercial and retailing activities, which are fully open to competition, in a manner which is not only without legal precedent in Ireland but is also needless because Irish Competition Law allows (much more appropriately) for the application of *ex-post* regulation.
49. It is unacceptable to impose a form of regulation on an airport activity that is operating in a competitive market, because that merely exposes it to the rigours of both competition and regulation with no corresponding gain to consumers.
50. The dual till principle would separate aeronautical and non-aeronautical activities in the regulatory accounts, treating them as independent segments of the airport business. Airport charges would fully cover the costs directly attributable to aeronautical activities plus the aeronautical share of common costs incurred by the airport facility.
51. The arguments surrounding single-till versus dual till highlight an aspect of regulatory risk peculiar to Ireland. This is the risk that Irish regulators will adopt old regulatory techniques just as they are being discarded in jurisdictions where independent regulation has been longer established. The single till in airport regulation, adopted only last year in Ireland, is now being abandoned or reviewed in Australia (Sydney airport), the Netherlands (Schiphol), South Africa, Germany and the UK (Heathrow, Gatwick and Stansted – and Manchester)
52. Aer Rianta recommends the introduction of a dual till regulatory system in the regulation of the Irish airports to ensure that economic regulation is applied only to the

appropriate segments of the airport business. Such an approach would be wholly consistent with allowing the maximum scope for the operation of competition.

Quality of Governance

Independent Sectoral Regulators

53. In the Government's consultation paper *Towards Better Regulation*, it is acknowledged that regulation can be both enabling and constraining⁸. In order to establish an acceptable quality of regulation, there are a number of key principles of good regulation which must be both incorporated by the Government in the establishment of a statutory framework for independent regulatory bodies and followed by the regulatory authorities in carrying out their functions.
54. The overriding aim of regulation should be to command public confidence regulators have not been uniformly successful in this respect. Given that, the key principles of good regulation are
- Independence – regulatory authorities should operate independently of Government, regulated entities and other vested interest groups.
 - Transparency – it is critical that the regulatory process is transparent in order to ensure that regulatory decisions are made on an impartial basis and are based on factual and sound analysis and are open to scrutiny
 - Consistency – it is essential that regulatory authorities maintain a consistent approach to the regulatory process over time to ensure minimum regulatory risk and provide certainty for business.
 - Proportionality – regulatory authorities should aim to balance the impact associated with regulatory intervention against the likely benefits from the regulatory outcome
 - Accountability – the regulatory structure should ensure adequate reporting procedures, the openness of the regulatory decision making process and the ability to appeal and review regulatory decisions.

Accountability and Transparency

55. The main issue for the Government in establishing an independent regulatory agency is to establish transparent and accountable procedures that ensure confidence in the regulatory process. This was acknowledged in the Government's recent policy document, *Governance and Accountability in the Regulatory Process*⁹, which notes that:

“the interests of democracy demand that such delegation of authority (from Minister to regulator) be accompanied by clear and defined accountability mechanisms. Accountability...concerns the obligation to explain, answer for and bear the consequences of the manner in which one has discharged duties, fulfilled functions and utilized resources”

⁸ Department of the Taoiseach: *Towards Better Regulation*, Section 1.5, p.16

⁹ Department of Public Enterprise, *Governance and Accountability in the Regulatory Process: Policy Proposals*, March 2000, p.8

56. Under the legislation establishing the regulatory bodies, it should be ensured that regulatory authorities are statutorily obliged, when required, to account to a joint Committee of the Oireachtas for the performance of their functions. This is a minimum necessary requirement in view of the perceived democratic deficit arising from the Government's delegation of responsibility to independent regulatory bodies. Current legislation should be amended to compel all sectoral regulatory authorities to report to the Oireachtas regarding their functions on an annual basis.
57. Since the regulatory decision making process has a significant impact not only on regulated entities but also on the wider economy, it is essential that the decision making process of a regulatory body be transparent, published and clearly defined to provide an objective basis for a regulatory determination.
58. From the perspective of the regulated entity, it is the manner in which a regulatory authority carries out its functions which gives legitimacy. Thus:
- Regulators should establish efficient processes and procedures,
 - They should engage in industry consultation
 - They should be flexible and objective with a willingness to update their regulatory approach.
 - Above all, they should think and act independently of the interests which they have to take into account when reaching their decisions.
 - The process should be objective and transparent.
59. A lack of predictability, an inconsistent treatment of market participants, prejudgment of issues and lack of objectivity all reduce confidence in a regulatory regime. Aer Rianta's experience has been that in Aviation Regulation the lack of transparency in the Commission's Determination has left the company in a position where it is unable to understand the basis for the Commission's decision or to comprehend the rationale underlying its Determination. This has restricted the ability of the company to undertake financial planning, to develop the airports and to manage its business efficiently.
60. Concern has been expressed that the independent sectoral regulators need additional powers to avoid the prospect of industry capture. However, under current legislation the sectoral regulators have extensive powers which allow them to obtain information from regulated entities. This provision may be used to safeguard against any form of regulatory capture by the regulated entity. The issue to be considered, at least in Aer Rianta's experience so far, is (a) whether regulators go far enough to inform themselves by acquiring and using information available to them and (b) making clear in their conclusions how they have used that information.
61. To date much of the focus regarding regulatory capture has centred on the relationship between the regulatory and the regulated entity, insufficient attention has been given to the incidence of regulatory capture by industry third parties, in other words the tendency of regulators to give more than due weight to groups who do not have a direct stake in the regulatory outcome. This has serious implications for the independence and integrity of the regulatory process.

Interpretation of Government Policy Objectives

62. Aer Rianta firmly believes that the formation of policy objectives is a responsibility and function of Government which by its very nature should not be delegated or surrendered to sectoral regulators.
63. In carrying out their functions, independent sectoral regulators should in turn adhere to the broader policy objectives laid down by Government. In order to ensure that this is achieved, the principle of separation of powers demands that provisions for Government policy objectives be clearly articulated in the legislation underlying sectoral regulation. The regulatory structures put in place should simply not allow regulators discretion to interpret or tinker with Government policy.
64. The consultation document *Towards Better Regulation* acknowledges that regulations or regulatory reforms intended to achieve one particular economic or social purpose may involve consequences that inhibit the achievement of another¹⁰. In airport regulation we have a clear example of the kind of conflict.
65. In the regulation of airport charges at the Aer Rianta airports, the Commission for Aviation Regulation was directed by the Minister for Public Enterprise to have regard to the role of Irish airports in achieving the Government's policy of balanced regional development. This seems to Aer Rianta precisely the kind of overall policy guidance which Ministers are entitled to give to sectoral regulators.
66. The question then arises: how does the Commission for Aviation Regulation give effect to the Minister's policy? Under the provisions of the Aviation Regulation Act, 2001, the Commission has the discretion to regulate a group of airports individually or as a unit. In reaching its Determination on the maximum permitted levels of airport charges at the three Aer Rianta airports, the Commission specified an overall price cap on airport charges at the Aer Rianta airports accompanied by a sub-cap on airport charges at Dublin Airport.
67. Since the subcap on airport charges at Dublin Airport was set at a lower level than the overall price cap, this means that the resulting cap on charges for Cork and Shannon is effectively much higher than that at Dublin. If this maximum were to be implemented at Cork and Shannon, then these airports would be placed in a much less competitive position relative to Dublin. This would have a material effect on traffic growth and development at Cork and Shannon airports and it would also have wider implications for the local economies given the acknowledged importance of regional airports in achieving balanced regional development.
68. At a detail level Aer Rianta is strongly of the opinion that regulation of the three airports as a single unit is the most certain way to enable long term competitiveness for Cork and Shannon and it would ensure full compliance with the Government's policy on regional development. This would be in keeping with the policy provisions of both the National Development Plan and the National Spatial Strategy which recognizes the important role of airports in achieving balanced regional development. In the context of a consultation on Better Regulation, Aer Rianta observes that more needs to be done to ensure that regulators abide by Government policy, and that there are workable processes in place for the resolution of policy conflicts.

¹⁰ Department of the Taoiseach, *Towards Better Regulation*, section 4.26 p.32

69. In order to avoid similar future occurrences in regulated sectors, it is proposed that a regulatory oversight body should be established to oversee

- the implementation of government policy by sectoral regulators
- regulatory transparency in the sectoral regulatory bodies
- reviewing the efficacy of regulatory impact analysis undertaken by regulators (see below)
- Reporting back to Government on legislative changes that may be required to ensure policy objectives are appropriately adhered to and implemented in regulatory decisions

Clearly, there is a need for further discussion as to the appropriate staffing, budgeting etc for such a proposed body.

Regulatory Impact Assessment

70. The use of regulatory impact analysis is one of the key recommendations made by OECD in its report on Regulatory Reform in Ireland and the Government in April 2001 adopted it. Regulatory impact analysis (RIA) is a structured methodology for carrying out objective assessments of proposed legislation/regulations.

71. Regulatory impact analysis assesses the potential cost, benefits and risks associated with a regulatory proposal. It examines the various means of achieving a potential outcome and the associated costs incurred in administering and implementing a proposal.

72. In view of the independent nature of regulatory authorities and the way in which regulatory decision making can have a significant effect on the regulated markets, it is recommended that a number of the principles incorporated in regulatory impact analysis should be applied in regulatory decision making. The proposed regulatory oversight body could oversee the application of regulatory impact assessments for the sectoral regulatory bodies.

73. The following principles used in regulatory impact analysis should be applied in sectoral regulation

- Identification of the potential impacts of a regulatory proposal on the regulated industry
- Identification of the various options for achieving a proposed outcome
- An assessment of the likely impact
- Consultation with interested parties
- A weighting of the potential costs and benefits of a regulatory proposal

74. While it is recognised that it is often difficult to fully assess the costs and benefits associated with a particular regulatory policy, the sectoral regulators, to ensure greater accountability and transparency in independent regulation, should apply the broad principle of regulatory impact assessment.

75. It would be hard to exaggerate the benefits of applying rigorous RIA. Had such an exercise been executed before the Commission's Determination of airport charges, the outcome could have been more appropriate to the interests of all airport users, to Aer Rianta as the regulated entity and to the then Minister in her capacity as policy-maker. What is needed as a result of this consultation is a process which would embed RIA in the work of regulatory bodies before they take decisions.

The Costs of Regulation

76. While it is recognised that considerable costs are incurred by regulatory bodies in fulfilling their regulatory functions, a key principle for the effective and efficient operation of regulatory systems is that the costs associated with regulation should not outweigh the benefits to overall economic welfare. It is therefore desirable that proper, objective and transparent provisions are put in place for the recovery of a regulator's costs.

77. A regulatory body should only be permitted to recoup its costs from the regulated industry in the following circumstances

- where it has provided full transparency regarding the components of its cost base
- where it has provided supporting evidence to demonstrate that its cost base is efficient
- where it has consulted with the regulated industry on a work programme for the forthcoming regulatory period
- where it has indicated or quantified the outputs that it seeks to achieve in return for the cost burden associated with its office

78. The costs associated with the economic regulation of a regulated entity are a legitimate externally imposed expense over which a regulated company has no discretion. It is therefore appropriate that these regulatory costs should constitute part of the overall cost base, which the regulated company is allowed to pass through to users.

79. As a measure to contain the costs associated with independent sectoral regulation, it is suggested that consideration be given to the potential advantages of combining the single-sector regulatory units into a combined cross-sectoral regulatory body.

- Ireland is a very small country. It is difficult to replicate the high level of expertise required across a number of sectoral regulatory offices. The adoption of a cross sectoral approach would mean that regulatory staff with expertise in one sector would be able to use that expertise in another.
- It would ensure a common and consistent approach to the organisation of regulatory processes e.g. individual sectoral regulators could adopt common procedures regarding consultation and the regulatory review process.

- Scale economies could be achieved by combining certain functions of sectoral regulators into one office e.g. reductions in administrative costs such as personnel, finance, general consultancy advice etc.

Interaction with the legal and judicial process

80. The Government has appointed regulatory bodies to act independently in carrying out economic regulation of various markets. However, since regulatory decisions have a significant impact not only on the regulated entity but also on the wider economic and social environment, it is essential that legislative provisions ensure an adequate process, common to all sectoral regulators, for appeal of regulatory decisions. Consistency of the appeals mechanism across regulated sectors will enable Ireland to develop more quickly a corpus of relevant expertise in the appeal bodies, up to and including the courts.
81. Under the legislation governing the regulation of airport charges at Irish airports, an appeal of a Determination by the Commission for Aviation Regulation on airport charges is made by way of appeal to an appeal panel established by the Minister for Public Enterprise. Where the validity of the determination is being challenged, this is made by way of application to the High Court for judicial review.
82. Under the provisions of the Aviation Regulation Act, 2001, the process of appeal by way of appeal panel is quite restricted and falls short of an appeal on merit. Aer Rianta found that the current appeal panel process was insufficient for the following reasons
- Under Section 40 of the Act, the appeal panel considers a Determination made by the Commission for Aviation Regulation and either confirms a Determination or where it considers there are sufficient grounds for doing so refers a Determination back to the Commission. The legislation does not define what would constitute sufficient grounds for referring a Determination back to the Commission.
 - The appeal panel is given a very short time limit of two months within which to make its decision and there is no provision for an extension of this limit.
 - The appeal panel does not have the procedural powers of the court system with regard to discovery, taking evidence and calling witnesses.
 - This process is limited as the appeal panel is not permitted to substitute its judgement for that of the Commission.
83. Aer Rianta is of the view that the provision of an adequate appeals procedure needs to be addressed. Consideration should be given to a number of options including the adoption of the UK structure with the possibility of an appeal of a regulator's decision to the Irish Competition Authority or alternatively the establishment of a specialist regulatory appeals panel.
84. In a recent interview, the chairman of the first Aviation Appeal Panel Rory Brady SC spoke of its review of the Commission for Aviation Regulation's Determination on the maximum permitted level of airport charges. Mr Brady suggested that consideration should be given to the establishment of an appeals tribunal to hear appeals on merit of decisions from the various regulatory bodies with a right of appeal from this tribunal to the High Court on points of law. It is envisaged that the structure of this body would

resemble that of An Bord Pleanála¹¹. Mr Brady suggested that an appeal board would offer a better solution for dealing with the regulatory appeal process than the court system

I think that a system like that, which would benefit from experience and regular use, is more likely to facilitate a speedy resolution of appeals. The court system operates on an adversarial basis. I would not think of this body being of an adversarial nature¹².

85. In view of the current limitations on the appeal panel process under Section 40 of the Aviation Regulation Act, 2001 and the restricted nature of the judicial review process, Aer Rianta would welcome the establishment of an appropriate procedure to hear appeals on merit of regulatory decisions taken by sectoral regulators.

Modernising the Regulatory Framework

The Regulatory Model

86. In the US, the traditional form of regulation is the rate of return model. The aim of this form of regulation is to regulate a company's level of profit and to keep price/cost margins in line with competitive rates. The regulator allows a regulated company to make profits equal to the return on capital employed based on a firm's Regulated Asset Base (RAB), so that all costs are recovered. The regulator then approves the tariff levels that the company requires to generate the revenue requirement, as derived from an accounting cost perspective.
87. However, a number of notable disadvantages are attributed to the operation of this model.
- There is little incentive for the regulated activity to pursue operational efficiency or cost reduction as all profit benefits are captured.
 - It can give rise to overcapitalization and overcapacity, by using capital-intensive technologies or advancing investment in advance of need - the Averch Johnson effect. Indeed, there have been allegations of 'gold-plating' of assets by companies, which are subject to this form of regulation, to increase their asset base and improve their absolute return.
 - For businesses which are a mix of regulated and unregulated activities, there are considerable problems of allocation of costs and assets in order to determine an appropriate return on the regulated activity.
 - Rate of return regulation proves costly, as it requires a very detailed and accurate cost analysis of the company, thereby imposing a high administrative and negotiating burden on the regulated entity and the regulator.
88. In response to the criticisms of the rate of the return model, an alternative RPI -X price cap model was developed in 1983 by the UK economist Stephen Littlechild¹³. This model has been applied consistently in sectoral regulation both in the UK and Ireland.

¹¹ Competition Vol 11 Edition 1 Section A.1 Irish Competition

¹² op cit p.14

¹³ Littlechild, S, (1983), Regulation of British Telecommunications' Profitability, HMSO, London

89. In general, price cap regulation has proved superior to rate of return regulation as it provides for a more forward-looking method of regulation, with an emphasis on raising efficiency. Under an RPI –X model, the initial level of prices are set for a base year, and the regulator forecasts what a reasonably efficient company would require over the regulatory period in terms of operating expenditure and capital expenditure. The regulator then sets an annual real price reduction factor X. Since the regulated company is entitled to keep any benefits it secures in excess of the X factor, this approach gives an incentive to the company to improve efficiency and reduce unit costs.
90. Over the past 15 years RPI-X regulation has proved its worth in the UK - operating costs have fallen and customers have benefitted from reduced prices¹⁴. It is recognised that the RPI-X model is particularly beneficial in encouraging efficiency improvements in the initial phase of regulation. However over the longer term, a number of difficulties arise in this model.
91. The principal problems are:
- It becomes increasingly difficult for the company to continue to make significant efficiency or productivity savings from one period to the next, as the regulator re-sets X at each review to incorporate efficiencies made in the previous period. Therefore, it becomes harder for the company to 'beat X' and its incentive to continue searching for efficiency savings is eroded.
 - At the start of each new regulatory period the operating cost base is redefined to incorporate any efficiencies made in the intervening period. The regulated entity is thus encouraged to introduce changes that have a positive effect on the operating cost base at the start of the regulatory period where it could extract benefit for the longest period of time before savings are subsumed into the base for the subsequent period.
 - This type of regulation encourages regulated firms to delay capital expenditure until the end of a review period, so that the new assets enter the regulated asset base (RAB) as soon as possible and the company can start to earn a return on them.
 - There may be an incentive to over-estimate expenditure depending on the specific claw-back provisions of the regulatory regime.
92. A particular difficulty of the price cap regulatory model is how to estimate potential efficiency gains for the regulated company over the review period (which is characteristically five years, but need not always be so). In the case of the Aer Rianta airports, the Commission for Aviation Regulation based its efficiency targets on the findings of a benchmarking exercise undertaken on behalf of the Commission by its consultants IMG. This benchmarking analysis was based on simple "partial" productivity comparisons, using the ratio between single measures of inputs and outputs. There are acknowledged difficulties associated with the use of partial productivity comparisons though the Commission's consultants IMG gave no indication that it was aware of or understood these limitations.

¹⁴ The McKinsey Quarterly, (1999) Current Research Regulating Utilities: Have we got the formula right?

93. There is widespread agreement that there is value for both the regulator and the regulated entity in comparing its performance against appropriate comparators in terms of the efficiency of specific, identifiable airport services, processes and in terms of cost effectiveness (including the costs of major investment projects). Benchmarking can also be a useful tool to counter information asymmetries that exist in all regulated environments. Aer Rianta fully supports the concept of benchmarking. However, since there are many difficulties associated with carrying out partial productivity analysis, both at a national and international level, benchmarking should not be relied upon as the sole means of identifying the comparative efficiency of regulated firms.
94. Since Ireland is a late entrant in the establishment of independent regulation, it should avail itself of the opportunity to avoid the difficulties identified in the application of regulatory models in other jurisdictions and in particular the UK.
95. A means of addressing the deficiencies of the RPI –X model would be the adoption of a form of incentive regulation. In the medium and long term, the interests of the consumer and the regulated company are best served by a charging regime which allows for the sharing of both operating efficiencies and capital efficiencies on an ongoing basis between both the regulated entity and consumers. This requires that a proportion of operating expenditure and capital expenditure efficiency gains achieved in excess of the regulatory target be retained by the regulated company at the end of the review period. This approach is the one best geared to drive continuous innovation, efficiency and service improvements to the benefit of both the consumer and regulated company. Furthermore,
- a sharing element in the formula will reduce the incentives for, and suspicion of, gaming between the regulator and the regulatee.¹⁵
96. A variant approach worthy of consideration is the Glide Path model. This would facilitate the progressive phasing of operating and capital efficiencies and productivity gains in excess of the target into the cost base of the regulated entity over an extended period. Such a process would allow the retention by the regulated entity of some of the differential between projected and achieved efficiencies as a reward/incentive rather than having the benefit immediately subsumed into the baseline at the start of the next review period (as happens in traditional formulations of the RPI-X model).
97. The tendency to skew the timing of investment within a review period, which is implicit in the traditional price cap regulation model, would also be reduced, as savings would be rewarded appropriately regardless of timing. This could ultimately facilitate more efficient capital expenditure by regulated companies.
98. The ‘glide path’ approach to the sharing of benefits was implemented in the 1999 review of UK electricity and water companies and is also the basis for consultation in preparation for the next determination of UK airport charges. It is proposed in the case of the Australian electricity industry.
99. While it is recognised that the estimation of an ‘unanticipated efficiency’ for the purposes of such a mechanism is potentially a difficult issue, some regulatory advisors have suggested that the approach adopted should be quite a simple one where there are no distinctions made between capital expenditure efficiencies and operating

¹⁵ Harry Moulson, (1995) Transco-Ofgas Consultation: the British Gas Response, CRI Seminar Paper.

efficiencies, and the difference between expected and actual spend is defined as the measure of efficiency, subject to confirmation that program outcomes have been achieved as planned. This amount is then deemed to be the 'benefit' to be shared between consumers and the regulated entity.

Incentivising Investment in Infrastructure

100. It is acknowledged in the Government's consultation document *Towards Better Regulation* that a key aspect to improving economic competitiveness and ultimately achieving sustainable growth is the development of infrastructure¹⁶. It is therefore essential that the regulatory regime ensures incentivisation of investment to secure adequate long-term provision of infrastructural capacity.

101. It has also been acknowledged that the price cap model of economic regulation, which has been adopted by the Irish regulators, offers little by way of incentive for investment. This price cap regulatory model encourages firms to improve their operational efficiency rather than the efficiency of their capital spend (although one has to acknowledge that, over time, the two are connected). Experience has shown that this has caused particular problems in capital intensive industries with long asset lives where it is possible to raise spending on maintenance to delay the need for renewal. In the airport sector incentives for investment are further weakened by the use of the single till principle where commercial revenues are used to complement aeronautical revenue.

102. Investment plans are critical to decisions taken by the regulator on price regulation. The magnitude of capital spend has profound effects on the cashflow and capital structure position, its timing affects the operational throughput of the regulated company and the cost effectiveness of the capital programme will affect the regulated company's self-financing capability and the level of consumer charges.

103. In the case of utilities with a major building or construction component the treatment of capital investment is a difficult and potentially contentious area for regulation since

- capital expenditure tends to be so lumpy that history provides a poor guide to future needs. Major investment tends not to be linear but 'chunked' into target threshold conditions i.e. 2 million additional passengers, 10 megawatts of additional electrical supply, a railway or light-rail interchange etc.
- commitments of significant capital are required before actual growth justifies the projects. Project lead times can extend to between 3 and 5 years.
- it is difficult to define an efficient investment programme, whether in terms of the value of outputs delivered or the efficiency of capital inputs
- it is difficult to judge *ex post* whether variations between planned and actual capital expenditure are due to changing circumstances, efficiency gains in delivering agreed outputs, or failure to deliver outputs (perhaps over the longer term)

104. In the case of airports, lack of appropriate infrastructure would constrain growth in economic development far more than any short term increases in consumer charges. Actions that inhibit investment in new capacity and improved service levels at airports

¹⁶ Department of the Taoiseach, *Towards Better Regulation*, p.35

create significant disincentive to new entrants to the local economic area and inhibit competitiveness in the economy.

105. Since the price cap regulation model offers insufficient incentives for long term investment and there are a number of issues concerning the application of the model that warrant debate, Aer Rianta recommends the establishment of a regulatory forum drawn from the various regulatory sectors. This would allow representatives of the regulators and the regulated entities to meet with the objective of carrying out a detailed examination of the use of the price cap model in the Irish regulatory context. This would help to identify a means of addressing the shortcomings in this model, particularly in relation to incentives to investment in infrastructure.