

**German airport regulation:
framework agreements, civil law and the EU Directive**

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Abstract

Commentators have argued that German airport regulation lacks independence and an economic focus. They have recommended UK-style price control. However, framework agreements and civil law cases deserve more consideration than they have hitherto received. The problematic process of setting price caps has led to constructive engagement in the UK and light-handed regulation in Australia, which deserve consideration in Germany. The recent EU Directive emphasising the process of consultation and agreement between airports and airlines could be a step forward if it introduces properly independent dispute resolution.

Keywords: airport regulation, framework agreements, dispute resolution

1. Introduction

Airports and airport regulation in Germany present a mosaic of different kinds of ownership (national, state, municipality and private), regulatory frameworks (one in each federal state) and forms of regulatory constraint (rate of return, price cap, sliding-scale, etc). Annual cost-based regulation remains the norm. However, at Hamburg in 2000, and thereafter at three other major airports (Frankfurt, Hannover and Dusseldorf) there emerged multi-year „framework agreements“ between airports and airlines that embodied elements of price cap regulation.

Commentators have increasingly pressed for reform. Niemeier argues that the cost-based regulation leads to inefficient resource allocation. A price cap along the lines of „the Hamburg model“ would be a step towards more efficient incentive regulation, best introduced by an independent regulator following a UK style process. Mueller et al question the legitimacy, independence and cost efficiency of the present regulatory framework. They advocate the transfer of airport regulation to the Federal Network Agency.

The 2009 EU Directive is currently in course of consideration in Germany. Its obligation on member states to nominate a national independent supervisory authority has been seen as a vehicle for implementing the kinds of reform just mentioned. However, being a Directive rather than a Regulation, the precise implementation is a matter for each member state. Most airports and state regulatory authorities are reportedly not enthusiastic for reform. There is opposition to the potential size and role of a Federal regulatory body. It is possible – some would say plausible - that Germany will conclude that no further change in airport regulation is required.

The aim of this paper is fourfold:

- First, to provide some background on German airport regulation and experience, particularly with respect to airport-airline framework agreements, and on current policy debate. These issues are potentially of interest and relevance in other countries and other sectors.
- Second, drawing upon experience in other countries and sectors, to suggest some advantages of framework agreements that do not seem to have been fully appreciated in the discussions of policy. This section also explores the role that civil law cases have played in the development of German airport regulation. They have influenced both the existence and the content of the framework agreements.
- Third, to reappraise the implications for policy in the light of recent experience. UK-style price cap regulation is increasingly acknowledged to have limitations as well as advantages, and there are greater merits in alternative policy options, including constructive engagement, negotiated settlements and the Australian light-handed monitoring approach, than previously acknowledged.
- Fourth, to examine some pros and cons of the EU Directive. Where competition between airports is ineffective, a supervisory body that focused on dispute resolution rather than on implementing price cap regulation UK-style would be a step forward, provided that it was properly independent. This more

limited role for regulation would also address an objection to actively implementing the EU Directive in Germany.

PART ONE: BACKGROUND

2. The traditional regulatory approach

Section 43 of the Air Traffic Licensing Regulations¹ requires that airports must seek approval from the relevant regulatory authorities for their charges for take off, landing and parking of aircraft and for the use of passenger facilities. Section 39 of these Regulations designates as the relevant authorities the air transport authorities in each of the 16 federal states.² The Federal Department of Transport can intervene, but in practice has not done so in recent years. In consequence, Germany has no national regulatory authority for airports and their charging policies. Moreover, the states regulatory authorities are passive rather than active: they approve new proposed charges from the airport operator but cannot unilaterally increase, decrease or restructure airport charges.

In the absence of a statutory regulatory goal or any criteria for approval, the states in 1980 proposed a joint reference framework known as the Huenermann paper. The guiding principle in this paper was “the protection of the public interest” via “a secure and reliable aviation service, which fulfils all due public aspects”. From this, three criteria were developed: cost relatedness, transport policy and reasonableness.

- Cost relatedness in general implied charges related to next year’s forecast costs and revenues, generally done on an annual basis, with costs including depreciation related to future asset prices rather than book values, a normal return on capital, with no adjustment for any previous high profits, and using a single till principle applied to the airport as a whole.
- Transport policy could in principle be used to differentiate charges in order to further the public interest, but in practice has mostly been applied to noise issues and used to enforce a uniform level of charges.
- Reasonableness required that charges should balance the interests of the airports and airlines, but did not require fair or efficient charges, and in practice was interpreted to mean that increases in charges should not be rapid or unduly high for specific users.

A consultation process has evolved. Before proposing new charges, the airport will have informal talks with the relevant regulatory authority then formally advise the authority of its intent; explain its plans to the airlines and discuss them; then submit a formal request to the authority. The authority allows four weeks for comments from the airlines; discusses the comments with the airport, which has a chance to respond; then either accepts the proposals or remits them to the airport for possible modification. It allows a further four weeks for any comments from users; then reviews and finalises the approval.

¹ § 43 LuftVZO (Luftverkehrs-Zulassungs-Ordnung). As from 2007 the relevant obligation is in § 43a (in combination with § 6 LuftVG which defines the obligation for approval for the operation of an airfield).

² § 39 Abs. 1 LuftVZO. Berlin and Brandenburg recently merged their airport regulatory authorities.

In practice, airlines typically apply for fare changes on an annual basis. However, the implementation and outcome of the regulatory process has varied from state to state and over time. Airlines and commentators have been particularly critical of what they see as „cost plus regulation“, as noted below.

3. The ‘Hamburg model’

In 1982 the Federal Government announced a programme to privatise airports, though for more than a decade nothing happened. In 1995 the Federal Government indicated its wish to sell its minority shareholding in Hamburg Airport.³ The public shareholders were aware of the danger of the misuse of the airport’s monopoly position by a private owner. Together with the Ministry for Economic Affairs of Hamburg, they decided to establish a form of price cap regulation. They would have preferred a new regulatory regime. However,

“As the Department of Transport refused to change the legal structure, price cap regulation has to be implemented by a legal contract between the airport and the Regulator. Both parties agreed to sign a contract for the first 5 year price cap period from January 1 2000 until the end of 2004 and thereafter to be free to extend or end the contract.” (Niemeier 2002 p 13)

This contract was a condition for a future public-private partnership. In May 2000 price cap regulation under this contract replaced cost plus regulation. In October 2000 a private consortium Hamburg Airport Partners⁴ acquired a minority share of 36% with an option of a further 13%. The City of Hamburg (initially 64% stake) intended to remain a majority shareholder.⁵

The design and specification of this contract reflected a process of discussion and agreement between all the interested parties. The airlines were not actually party to the resulting contract, but they participated actively in the discussions. The main aspects were as follows:

- All parties (airlines, airport and Hamburg Ministry of Economic Affairs acting as regulator) agreed that price cap regulation was superior to the old cost-plus system.
- Economic principles suggested that the price cap should cover those services subject to monopoly provision and not those subject to competition. On that basis, the airlines argued for a cap on central infrastructure changes such as baggage handling. However, as the contract was linked to the statutory structure the scope of the cap was limited to the airport fees covered by Section 43 (i.e. including passenger charges for takeoff, landing, parking but not charges for ground-handling, baggage handling, non-aviation revenues, etc.).
- The airlines argued for a single till, but the Ministry considered that this would be inappropriate and less conducive to efficiency. The price cap effectively implied a dual till but it was left to the airport management to consider whether to apply a single till by setting lower charges in order to increase traffic and non-aviation revenues.
- The airport proposed a CPI-X price cap with an X value of 2% (i.e. a reduction of 2% per year in real terms, relative to the Consumer Price Index) on the assumption of a

³ The owners were the City of Hamburg 64%, the Federal State of Schleswig-Holstein 10% and the Federal Republic of Germany 26%.

⁴ This consortium comprised Hochtief Airport, an affiliate of the largest German construction company, and Aer Rianta, an affiliate of Dublin Airport Authority in Ireland. It had earlier acquired a 50% stake in Dusseldorf airport.

⁵ Airport Partners increased its shareholding to 40% in January 2002 and to 49% in August 2002. Hochtief took over Aer Rianta’s share in January 2007. The City of Hamburg retains 51%.

passenger growth rate of 3.9% p.a. The airlines argued for an X value of 4%, on the grounds that the Airport would reap enormous profits if passenger demand grew faster than expected. The outcome was a sliding scale. "After intensive discussions and consultations an agreement between all parties was reached. If passenger growth exceeds 4 percent, then the X of 2 will be raised by 1/2 per cent for each 1 per cent of additional passenger growth." (Niemeier 2002 p. 16)

- The airport is obliged to implement a quality monitoring and consultation system which includes, among other things, regulator passenger surveys and service indicators, and regular meetings between airport and users to discuss problems of organization and service. (Similar monitoring systems had been established in the UK and Australia but were new to Germany.) If users remained unsatisfied, they could appeal to the City of Hamburg.
- The airlines wanted to be informed about expected passenger growth, major investments and in particular about changes in the structure of charges. They were concerned that the new arrangement would make such structural changes easier than under the old system. It was agreed to establish a Price Cap Review Board, including airlines and airline associations as well as the Airport, that would have significant responsibility. "This Board meets at least once annually and is in the position to change virtually any of the price cap regulation contract paragraphs." (Immelman 2004 p 161) The Ministry welcomed the increased transparency that the Review Board provided.

The flexibility provided by the Price Cap Review Board was soon called upon. After the 9/11 incident in 2001 traffic fell sharply. The contract made no provision for reductions in traffic. If the subsequent traffic recovery had been assessed as if it were normal growth, the sliding scale could have resulted in an unduly high value of X, thereby creating financial difficulties for the airport. In May 2002 the airlines agreed with the Airport to suspend the sliding scale for the remainder of the contract.⁶ The Board also incorporated some additional security fees and insurance costs.

4. Framework agreement at Frankfurt Airport

Privatisation was also envisaged at Frankfurt Airport (Fraport), then owned by the Federal Government, the state of Hesse and the City of Frankfurt. The airlines there (rather than the public shareholders) were again conscious of the need to avoid monopoly exploitation and to make privatisation acceptable. In April 2002 a so-called „framework agreement“ between the Airport and airlines was finally reached for the period to December 2006, which then had to be translated into a public law contract between the airport and the regulatory authority.⁷ The approach was influenced by regulation of Hamburg Airport, but took longer to negotiate. 9/11 destroyed the previous forecasts and the parties had different expectations. The regulatory authority did not initially take a supportive role, though it later changed its stance and began to act as a facilitator. (Klenk 2004 p. 137)

⁶ "The advantage for the airport is the chance to recover faster from the sudden decrease in passenger demand in all aviation-related business fields, the advantage for the airlines is the preservation of a long-term and safe scheme of airport fee decrease." (Immelman, 2004, p. 161)

⁷ "In April 2002, after one and a half years of complicated discussions, Frankfurt Airport (Fraport) and the Board of Airline Representatives in Germany (BARIG), the German Air Carrier Association (ADL) and Lufthansa agreed on a memorandum of understanding (MoU) on the future development of airport charges for the term between the year 2002 and 2006. Thereafter a public contract between Fraport and the regulator, Ministry of Economic Affairs and Transport of Hesse, was signed." (Niemeier 2003, p. 148)

The main elements of the Frankfurt agreement were as follows:

- As in Hamburg, the airlines wanted coverage of all the non-competitive areas but this was precluded by the statutory position, so coverage was limited to the scope of Section 43, albeit with some provision for further negotiation.⁸
- Unlike Hamburg, which chose a CPI-X formula, the negotiating parties chose a risk-sharing model that links the level of charges to the growth in passenger demand. With an assumed passenger growth rate of 4% it was agreed that average charges could be raised by 2%.⁹ In the case of higher passenger growth rate the airlines would have a 33% share of the resulting increase in revenue (compared to 50% at Hamburg). Learning from Hamburg and 9/11, the arrangement was symmetrical, so that in the case of lower passenger growth rate the airlines would take a 33% share of any reduction in revenues from lower than expected passenger growth rate.¹⁰
- A Review Board was established, with representatives of the negotiating airlines, the Airport and the local government.¹¹
- The framework contained provisions for a noise protection fund which the local government required Fraport to establish with effect from 2002.¹²
- Fraport commits to maintain and develop a competitive level of quality complying with international standards. The framework leaves the definition of detailed parameters to a working group.
- The framework contains a clause in which airlines waive any legal action against the level of charges.¹³

5. Subsequent framework agreements

Writing shortly after the signing of the Hamburg agreement, Niemeier (2002 p. 12) referred to it as “the emerging new system”. But the new system did not emerge easily or extensively.¹⁴ Even at Frankfurt, where privatisation was envisaged and the initial

⁸ The parties agreed to negotiate how to incorporate such other charges into the contract. Any potential additional costs of the airport’s extension programme for a fourth runway and new terminal in Frankfurt were explicitly excluded. However, the parties did agree arrangements for handling the preliminary planning costs, and agreed that future costs would be incorporated, the exact implementation being a matter for future negotiations.

⁹ This is in nominal terms – the agreement makes no adjustment for inflation, which at that time was relatively low, about 1.3%.

¹⁰ Thus, if passenger growth rate were 7% instead of 4%, the airlines would get revenue equivalent to 1 of the 3 percentage points, which would translate into an increase in charges of 1% rather than 2%. Conversely, if passenger growth rate were only 1% rather than 4% then charges would increase by 3% rather than 2%. The airport, for its part, would receive 67% of the revenue gain from a greater than expected increase in passenger demand, and would bear 67% of the revenue loss from lower demand.

¹¹ “The Review Board meets regularly and has the task of providing in-depth, efficient and transparent consultation on the contract. All matters concerning the implementation of the agreement shall be discussed here such as, for example, possible structural shifts of charges or the application of the formula, and brought to a settlement. Special provisions are laid down to ensure that comprehensive data are provided by the airport with regard to development of traffic, productivity and investments in order to accomplish a meaningful consultation process.” (Klenk 2004 p. 136)

¹² “Four months after 9/11 the airlines saw themselves economically incapable of bearing the full financial burden of the programme until certain conditions had been met. Among which, the conclusion of the MoU and the incorporation of the funding formula in the contract were the most important.” (Klenk 2004)

¹³ This seems to be comparable to a standard clause in negotiated settlements in the US, where both parties agree not to request the regulator to revise the negotiated charges during the period of the settlement.

¹⁴ “The adoption of a price cap regulation for Hamburg airport was followed by intensive discussions between airports and airlines and among the federal states and the federal Department of Transport.

public offering (IPO) took place in June 2001, negotiations were protracted, mainly as a result of the airport's reluctance to proceed. (Klenk 2004, p. 132)

Elsewhere, the take-up was limited. A framework agreement was reached at Hannover in 2003 and a four year agreement at Düsseldorf in December 2004 (retroactive to June 2004). The Berlin airports and also the airport of Nuremberg tried to obtain such a private framework agreement but did not reach agreement. (Mueller et al 2008 p. 15, ICAO 2008)

Common to all four agreements is the use of a sliding scale mechanism for determining charges.¹⁵ The level of the price cap is regarded as more demanding at Hamburg than at Frankfurt and Dusseldorf, which some would regard as more like cost-plus regulation. The agreements have service level provisions, which are more explicit at Hamburg than elsewhere. A user council involving airport and airlines is also standard.

At Hamburg, there was a major discussion at the end of the five year agreement. All parties agreed that it was advantageous to continue the agreement for another five years, from January 2005. It gave a known price and guaranteed quality of service. The second contract introduced a symmetric revenue-sharing arrangement, providing for 50% sharing of the change in revenue from passenger growth that is negative or above 4%. It also included some changes to reflect a European Court judgement to allow publicly owned airports to make a profit.¹⁶

Hamburg Airport is now engaged in a major expansion costing about 1 bn euros per year; it says this requires about 100 m euros additional revenue per year to cover interest and depreciation. A third agreement was reportedly signed in January 2010, similar in form to the previous ones, with some detailed modifications with respect to insurance fees.

At Frankfurt there were discussions about an extension but the parties' views and expectations differed on many issues, including the uncertain costs of the airport extension and cost allocation under the dual till system. (Mueller et al 2004 p. 18) The airlines claimed that traffic growth should allow a reduction in charges but the Airport filed for an increase.¹⁷ There was considerable argument and lobbying of the regulator

Politicians reacted mainly negatively, preferring to leave everything as it was. Only a few federal states were in favour of price cap regulation. The Department of Transport feared that a new regulatory agency would create a huge bureaucracy like the telecom regulatory authority and played a very passive role. While the airline organisations favoured price cap regulation the airports were against it. As the airlines could not achieve political reform at the federal level they adopted a piecemeal strategy by demanding price cap regulation in the consultation process at each airport." (Niemeier 2003, p. 148)

¹⁵ The parameters vary between airports: at Hannover and Frankfurt there is an annual increase in charges, but not at Hamburg; at Frankfurt the airline sharing parameter is less than at Hamburg and Hannover; at Dusseldorf the sharing kicks in only for extreme events (passenger decreases exceeding 7.5% or growth exceeding 10%). (Mueller et al 2008)

¹⁶ Judgement of the European Court (Sixth Chamber), 16 October 2003, in the case of Flughafen Hannover-Langenhagen GmbH v Deutsche Lufthansa AG.

¹⁷ I am told that Frankfurt airport envisaged spending some 7 billion euros on an expansion but airlines were concerned that there was no business plan that would cost out the relevant investments and allocate these costs, and that the cost of refinancing this would jeopardise the competitiveness of the airport. In addition, although the previous agreement had a headline increase in airport charges of 2%

and Ministers. The airlines declined to sign an extension of the agreement. “Frankfurt fell back into rate-of-return regulation in 2007” (Mueller et al 2008). However, the Airport adjusted its charging plans: in 2006 charges were slightly increased, in 2007 lowered, in 2008 frozen, and in 2009 increased by 2%.

By 2009 the new investment plan had largely been determined and construction was underway. Negotiations resumed. The Airport, conscious of long-term capital risks, would have been content with a short-term agreement until 2011, but the Hessen regulatory authority pressed for a long-term agreement given the likely conflicts over the allocation of the costs of the expansion. In December 2009, Frankfurt Airport and the airlines reached agreement for increases in charges totalling 12.5% phased over the next two years.¹⁸ This was contingent on agreement within the next two months on further increases in charges from 2012 to 2015. That agreement was in fact reached, with further increases of 2.9% annually scheduled for that period. There is provision for the airlines to share in a third of any extra revenue if demand grows faster than projected.¹⁹

At Dusseldorf, I understand that the initial agreement was renewed in 2008 “with a formula that is still working albeit more complex than at Hamburg. There has also been a new policy decision on expansion at Dusseldorf, which has led to changes in airport policy”.

At Hannover, there was provision for continuing the four year agreement for a further two years from 2007 but this was not taken up.²⁰

6. Evaluation and implications for policy: Niemeier

Niemeier (2002, 2003, 2004) identified numerous shortcomings in the traditional regulatory regime.²¹ The net effect was a low-powered system with incentives to build

per year, a combination of additional costs, additional activities and noise abatement regulations led to increases as high as 4% to 6%. The airlines found it difficult to accept this.

¹⁸ December 1 /PRNewswire, December 1, 2009, at airportcharges.com. “,In view of the enormous capital investments to be realized by Fraport in the coming years and the currently difficult economic situation faced particularly by the airlines, we have reached a result that provides the planning security we require,” explained Fraport executive board chairman Dr. Stefan Schulte. At the same time, it is the declared goal of the contract partners also to reach agreement quickly on the series of fee increases for the years up to and including 2015.” Charges will increase by 4 % on July 1, 2010, 3 % on October 1, 3 % on April 1, 2011, and 2.5% on October 1, 2011. The agreement itself is at http://docs.google.com/viewer?a=v&q=cache:p5SpIYsLxIIJ:www.presseportal.de/pdf.htm%3Fnr%3D1522495+airport+charges+agreement+hamburg&hl=en&gl=uk&pid=bl&srcid=ADGEESjwS4rv2IIQwxgsKBWVpXzKJR3O4ya7oZ0t7SqiwfbLX21NtU3jUOn8m3Sa1vIfXtQq7jhetCH7sHDgF-ijS2Xb2YzVA3KgK3U31lm5ingYdcLvGG95A6OUN_jh8nWZhUJBCah&sig=AHIEtbRinSIPGzvxbAs5VSy0q2NUmKiO9Q

¹⁹ Fraport press release 19 February 2010.

http://www.ots.at/presseaussendung/OTS_20091201_OTS0292 then <http://www.airtransportnews.aero/cgi-bin/article.pl?&id=21975>

²⁰ I am told that, whereas after 9/11 there was a common aim to limit airport fees and encourage passenger and airline growth, subsequently airlines differed as to whether a further agreement was necessary and what it should comprise. The airport, for its part, was content to revert to the traditional regulatory process, and the role of the federal state as both part-owner and regulator was conducive to the airport’s considerable planned expansion.

²¹ These included gold plating and lack of productive efficiency, the aggravating effect of a single till, a high level of charges consequent on these factors and the willingness to accept price rises related to

and operate airport structure inefficiently. He then examined three possible alternative regulatory policies.

The first policy was to give up ex ante regulation and rely on competition law, as advocated for some airports in the UK and Canada. (e.g. Starkie 2001, Gillen et al 2001, Gillen and Morrison 2004) He argued that, whatever the merits of this policy in other countries, it seemed unlikely that the extent of airport competition and elasticity of demand in Germany would be sufficient to change the situation significantly.

A second policy was to adopt the Australian approach of price monitoring with the threat of re-regulation, as suggested by the Productivity Commission (2002). He cited Forsyth (2004) on the risk that that policy would simply become a form of light-handed cost plus regulation. He also argued that Germany did not have the relevant independent institutions, and that the threat of re-regulation would not be effective.

Niemeier's third and preferred policy was price cap regulation with an independent regulator. He saw this as "following on from the Hamburg model", which "undoubtedly has its shortcomings, but it has the advantage that it has laid down the basis of effective regulation".²²

Niemeier argued that price cap regulation would provide incentives for productive efficiency and efficient pricing structures, would be accepted by airlines, would be a transparent and open process, and would have low transaction costs. In contrast to the Hamburg model, Niemeier proposed that the price caps be determined by a central airport regulatory body following a UK-style consultation process, rather than by negotiation between airports and airlines. In principle there was a danger of this process turning into cost based regulation, and of there being insufficient incentives for investment, but the empirical evidence did not suggest these were overwhelming problems in practice. It was therefore "worthwhile to risk price cap regulation in Germany".²³

7. Evaluation and implications for policy: Mueller et al

Mueller et al (2008) have recently surveyed regulatory arrangements for six major German airports. Their findings complement those of Niemeier.

inflation, an inefficient structure of charges that ignored congestion and any effect on passenger growth and led to misallocation of capacity, a lack of quality monitoring, and high costs of ineffective regulation including of small loss-making airports.

²² The advantages of the Hamburg model were that it embodied a price cap that was not set on the basis of rate of return regulation, it did not commit to the single till principle, it provided some incentives for cost reduction, it included a quality monitoring and consultation system, regulation was restricted to the monopoly bottleneck facilities, it gave more weight to price signals than the traditional cost-plus regulation, and it established a price cap review board which reduced the costs of effective regulation. The shortcomings of the Hamburg model were that it embodied no structural reform of airport charges, the incentives to cost efficiency were low because it was not informed by any knowledge of productivity growth, and there was no independent regulator. (Niemeier 2002 Table 3 pp. 17-18, also Niemeier 2009 p. 21)

²³ Niemeier had in mind price regulation on a dual till basis without a sliding scale. The X value would be determined by benchmarking, for the major airports such as Frankfurt, Berlin, Hamburg, Munich and Stuttgart. The others would be subject to the threat of regulation, with the need for regulation determined by an independent commission. His papers also advocate, in parallel, other measures to increase competition, such as slot auctioning, open skies, privatisation with controls on cross-airport ownership, etc.

Section 43 regulation seems to be relatively undemanding.²⁴ Airports are generally content with this established procedure, which in their view does strongly involve users and has a stabilizing effect. Airlines are critical because it provides insufficient transparency, presents difficulties in allocating costs appropriately, is characterised by insufficient „know-how“ and insufficient possibility for comparisons across airports, and embodies a conflict of interest since the federal states are both airport owners and regulators. Regulators regard the procedure as often unnecessary since the airports do not have market power, but they find it complicated by the fact that some charges are regulated while others are not, and problematic insofar as the regulator does not possess the necessary means of sanctioning airports.

Airlines and airports both like the greater predictability of the charges resulting from framework agreements, which provide a better base for planning. Airlines also like the limits on the increases in charges. Airports that have entered such agreements like the greater transparency and better cooperation with airlines, and the reduced need for negotiations. Regulators find that the user council is simpler and has fewer parties than the consultation process. But airlines and regulators are conscious that unpredictable elements or other external factors have meant that in practice the desired increases in predictability and reductions in charges have not been achieved, nor has there been a reduction in complexity and working time. Airports that have not entered framework agreements feel that their flexibility is reduced, and argue that the concept is suitable only for large and stable airports, not for smaller ones.

Mueller et al find that the framework agreements concluded at the four airports are subject to limitations. They are not linked to actual or prospective costs, and the issue of cost allocation is not properly tackled. However, the agreements are “a first option” to replace the inefficient rate of return regulation based on Section 43 by a more incentive-based regulatory process.

Mueller et al conclude that the present regulatory framework is defective.

First, *legitimacy* is poor because the law does not state any requirements for the admissibility of charges. Second, *independence* of the state regulatory bodies is problematic since the federal states are not only in charge of running the airport authorities but also own at least a controlling stake in the airports on their territory. Finally, regulatory *cost efficiency* suffers under the fragmentation into fifteen separate authorities, each challenged with generating their own expert knowledge.

Accordingly, they propose that the Federal Network Agency (Bundesnetzagentur or BNetzA) should act as the national regulator for airport charges. This would remedy the three identified defects.²⁵ It would also be consistent with the (then proposed) EU

²⁴ Where the conventional rate of return approach is applied, regulators say they apply the principles of the Huenemann paper. In practice, however, they use a dual till rather than single till principle, on the ground that the law does not authorise them to verify non-aviation revenues. In order to control the allocation of costs between aviation and non-aviation activities, the regulators would need to inspect the accounts in detail, but in practice they rarely do so. The regulators are generally satisfied with the quantity and quality of information supplied by the airports, typically use no additional information, have limited ability to check costs and cost allocation, make no comparison of charges across airports, and do not explore efficiency issues.

²⁵ “Focusing the regulatory competence for airport charges at BNetzA does not only foster cost efficiency, as the numerous different administrations would no longer be needed. Additionally, this would also increase the independence of the regulator since the Federal Government has given up most

Directive. The law transferring regulatory authority should address several additional issues.²⁶ The authors also suggest for further research the first policy assessed by Niemeier, whether airport competition could be increased and ex ante regulation could be abolished, leaving any remaining airport market power to be dealt with by the antitrust authorities.

PART TWO: FRAMEWORK AGREEMENTS AND CIVIL LAW CASES

8. Some further attributes of framework agreements

The two sets of commentators thus share the view that the German regulatory framework is fundamentally flawed, primarily because of lack of regulatory independence and the consequent lack of focus on economically efficient regulations. The solution is an independent regulatory body to implement UK-style incentive regulation. Framework agreements may be a limited step in the right direction, but only insofar as they embody price caps for a period of time rather than allow annual cost-based price increases. Even here, however, the inability to set demanding targets and the use of sliding scale arrangements limit their efficiency.

From the perspective of UK-style regulation it is natural to focus on the level and nature of the price caps contained in the framework agreements, particularly in relation to the scope for productivity improvements. But the institutional framework is also important (Wolf 2004, Wolszczak 2009), and other aspects of the agreements merit consideration too.

The provisions of the agreements reflect the preferences of the parties rather than the regulator. Whereas an independent UK-style regulator might focus on productivity, the parties are concerned about sharing – of potential benefits and of costs of traffic reductions or environmental regulation. A regulator might be more concerned about the total revenue accruing to the airport at the time of application for approval, or over the total period of an agreement. The parties seem to be more concerned about the pattern of charges over time. Both parties are particularly concerned to secure predictability, which is lacking in a framework that allows annual applications for price changes.²⁷ The parties also emphasise the “marketing character” of the agreements (e.g. Immerman 2004 pp. 160, 162, Klenk 2004, pp. 132, 138), a concept not normally to be found in regulatory determinations. The agreements contain provisions for issues that are important to the parties but apparently not covered by previous Section 43 regulation – notably quality monitoring and consultation.

The agreements contain different provisions and parameters to reflect the particular conditions (no doubt including bargaining conditions) and different preferences of the parties at each airport. For example, there are differences in the sharing parameters in

of its equity holdings in German airports. The large regulator experience from the regulation of energy, post, telecom and rail would also help to set improved standards for energy regulation.” (p. 20, 21)

²⁶ Properly specified and documented cost allocation procedures to improve cost control; clarification of the valuation and depreciation of capital investment; and the use of cost models and benchmarking to calculate long run incremental costs, identify potential efficiency gains and incentivise efficient service provision.

²⁷ E.g. “The model delivers a more controlled and foreseeable development of charges for both sides. Planning security in terms of costs for airlines and revenues for airports is enhanced – a not to be underestimated factor in the given economic environment.” (Klenk 2004, p. 138)

the sliding scale (the slope) and the point at which the sharing kicks in, and in the linking or not to CPI. In contrast, a single regulator is in practice constrained to set substantially the same provisions for each company, as in the UK.

Successive agreements exhibit learning from the experience of other airports. For example, the Frankfurt agreement provides for sharing the effect of reductions in traffic, which had been overlooked at Hamburg. In the UK, such learning is constrained by the fact that the regulator sets the controls for all companies at the same point in time.

The agreements provide for flexibility of response within the terms of the agreement. This was most notable at Hamburg after 9/11, where the sliding scale was suspended for the rest of the agreement period, and new security charges introduced.²⁸ A regulated price cap would probably have involved a more bureaucratic and less flexible process.

The agreements provide for and indeed emphasise the parties working together, which is absent from the previous approach under Section 43 regulation.²⁹ This in turn has improved relationships and performance.³⁰ It has been suggested that the agreed suspension of the sliding scale at Hamburg “shows that in a relatively short time price cap regulation has built up trust and a sense of fairness. Both tend to lower transactions costs.” (Niemeier 2003 p. 147) But rather than price cap regulation (or the price cap itself) being critical, it was surely the process of negotiating and reaching agreement between airlines and airport, the provisions in the agreement for a Review Board with power to modify the price cap, and the subsequent implementation of those provisions, that built up this trust and sense of fairness.

Agreements could also avoid the need for changes in the structure of the industry to overcome the limitations of regulation.³¹ However, there is not space to explore this point here.

9. The scope and impact of civil law cases

²⁸ “In Hamburg, this communication structure gave airlines as well as airports the opportunity to react closely and jointly and – not least – very cost-effectively on the change of security paradigms after September 11.” (Immerman 2004, p. 161)

²⁹ E.g. “We have argued above that the incumbent systems fail in delivering balanced results for both system partners [airlines and airports] and they especially lack the necessary flexibility to adapt to the changing market requirements. ... A structural shift to more variable charges does not only lead to a greater participation in market risks by an airport but also provides a set of options that enables airports as well as airlines to reap beneficial effects they otherwise were not able to gather.” (Klenk 2004, pp. 128, 132)

³⁰ “From an internal perspective, the concept of the Review Board has to be emphasised. Already at this stage it can be said that the consultation process has improved in terms of transparency and efficiency. Better consultation of the users enhances trust and finally leads to higher customer satisfaction.” (Klenk 2004, p. 138) Immerman (2004) notes that at Hamburg, there has not yet been a need to appeal any disputes to the City of Hamburg.

³¹ It has been suggested that Lufthansa purchased a stake in Frankfurt airport partly in order to obtain more information about the costs and implications of operating an airport than regulation under Section 43 would provide. Agreements that provided for adequate information sharing might therefore avoid the necessity for vertical integration that might not otherwise be necessary or desirable. It has also been argued (Fuhr and Beckers, 2006) that regulation provides insufficient protection for parties making large investments. Contractual agreements, on the other hand, can provide the necessary complementary incentives and safeguards for major investment to take place.

Framework agreements to replace regulation under Section 43 are evidently associated with privatisation. Five of the 18 international airports in Germany now have a minority private shareholding, and agreements were signed at four of them. The first agreement preceded privatisation, the next three followed it.³² This suggests that privatised airports are more amenable to such agreements, or perhaps more concerned by the previous regulatory approach and its potential for conflict.

A critical role was played by legal disputes between airlines and airports at Dusseldorf and Frankfurt, which went to court in 2000. The desire to avoid such litigation was an added incentive on Hamburg airport to reach agreement before privatisation, and was later important at Frankfurt too. (Klenk 2004, p. 137)

Airlines were concerned that regulation under Section 43 tended to favour airports, not least because the state was both part-owner and regulatory authority. Airlines were particularly concerned following increases in airport charges, including after privatisation at Dusseldorf in 1997 and Hannover in 1998, and with the prospect of privatisation at other airports too. But their bargaining power was weak.

In addition to the regulatory process under Section 43, airport operators are also subject to Section 315 (paragraph 1) of the German Civil Code. This provides that if a party fixes prices unilaterally, with no bargaining or any entitlement to bargain, that party must set prices according to the principles of equity (literally, „on a bona fide basis“). The interpretation of the principles of equity is not spelled out in the Civil Code, but reflects case law precedents. It remained to be determined what it would mean in the context of airport charges.

Developments in the EU regulatory framework offered some encouragement to the airlines vis a vis the airports. In October 1996 EU Directive 96/67 opened up the groundhandling market to competition. It provided that an airport could charge a fee for groundhandling services, and that such a fee “may in particular contribute to the self-financing of the airport in so far as it is determined on the basis of relevant, objective, transparent and non-discriminatory criteria”. This raised the question whether the charges proposed by airports under Section 43 were in practice determined and approved on the basis of appropriate criteria. Cases at Dusseldorf, Frankfurt and Berlin put this question to the test.

10. Dusseldorf Airport case

In December 1997 Dusseldorf Airport acquired a new part-owner (the Airport Partners consortium of Hochtief and Aer Rianta). There was no scope to increase traffic at the airport, and limited slots were available. The Airport proposed to increase its fees significantly as from 1 April 2000. It also proposed to change the structure of its fees, recovering a larger part of the revenues from variable fees (per passenger) as opposed to fixed fees (per aircraft). This would have a differential impact on different types of airlines, increasing the charges for smaller fuller planes

³² Hamburg reached an agreement in January 2000 and was privatised in October 2000. Dusseldorf was privatised in December 1997 and reached an agreement in December 2004. Hannover was privatised in 1998 and reached an agreement in 2003. Frankfurt was privatised in June 2001 and reached an agreement in April 2002.

(e.g. from low cost carriers) and reducing the charges for larger less full planes (e.g. from full-service incumbents).

Initially the Airport proposed a 15% increase in fees plus charges for noise abatement. After airline opposition it modified its proposed increase to 12%. The state regulatory authority (North Rhine - Westphalia) approved a 7.1% increase.

Lufthansa City Line and a group of about 20 smaller airlines including Hapag-Lloyd decided to challenge the Airport on the basis of Civil Law rather than Public Law - that is, on the basis of Section 315. The airlines had to consider carefully how to take forward their case. If they refused to pay the proposed charges, could the airport refuse permission to land, or insist on payment in cash? But if the airlines paid the charges before suing, this would imply acceptance of the proposed terms and charges, and the airlines would bear the burden of proving that the charges were *not* set on a bona fide basis. The solution adopted was to pay 50% of the increased fee plus part of the noise abatement charges. Civil Law provides that if a complainant pays a reduced fee, the party setting the fee has to sue the complainant for the remainder and thereby bears the burden of proving that the fee *is* set according to the principles of equity.

The case began in December 2000. The Court decision in the first instance, given relatively quickly in June 2001, went against the airlines.³³ In January 2003, the Court of Appeal (with the same panel that judged appeals against Cartel Law) held that the Airport had not discharged the burden of proof. Airport charges had to be based on direct costing and contribution margin accounting. The charges for each part of the airport business had to reflect only the revenues and costs of that part. The Airport had not demonstrated that the proposed fee was equitable in that respect.

In the light of the new judgement, Dusseldorf Airport and the airlines negotiated their four year agreement in December 2004. This included a 3.5% increase in charges (less than the previously approved 7.1%) and part of the cost of noise abatement.

11. Frankfurt Airport case

Frankfurt Airport proposed a fee increase averaging 12% (for the airline client [?]) as of 1 January 2000. (The fee structure was complex, with different increases for different elements.) The airline objected and deducted 10% of the fee increase.

The Airport was privatised in June 2001. On 1 October 2001 the Airport sued the airline for fees due in the years 2000 and 2001. The Airport was not prepared to show how its fee was cost-related, and argued that it did not have cost data. The Court held that cost allocation was important, and appointed Ernst & Young to advise it. The Airport then argued that only the Court expert should be allowed to look at its costs.

The Court's decision, not given until April 2008, again held that the Airport had not met the burden of proof. In the light of the Ernst & Young report the Court concluded

³³ "The Court compared the charges of Dusseldorf with other German airports. As the charges were about the same level the court ruled that Dusseldorf was not abusing its monopoly power. The lower charges of price-capped Hamburg airport were explicitly treated as an exception." (Niemeier 2004 p. 177)

that the Airport had not demonstrated that its proposal was equitable: it was not transparent and there were doubts whether it was properly cost-related.

While the case had been progressing, Frankfurt Airport and the airlines agreed the Memorandum of Understanding (see above) covering fees for the years 2002-2006. The Airport appealed the Court's April decision on the fees for 2000-2001. Later in 2008, before the appeal was heard, the parties reached a compromise to cover the fees for 2000 and 2001.

12. Cologne/Bonn and Berlin Airports cases

In a case involving a small charter airline, the Court held in 2006 that the attribution of costs had to be reasonably related to the actual consumption of the infrastructure facilities by the airline. The Court asked for an asset-specific attribution. It found that Cologne/Bonn Airport had not appropriately disclosed how airport parking costs were attributed and how the total amount of the airline parking charges was calculated.

There have been several cases with respect to airports in Berlin, and some are still pending. The three Berlin airports are now part of a single holding company.³⁴ In 2002 the airline Germania argued that increased airport charges at Berlin-Tegel Airport amounted to a cross-subsidy of the operation of Berlin-Schönefeld Airport, which concentrates mainly on low cost carriers. (Mueller et al 2008 pp. 9-10)

In November 2008 the Court held in favour of the Airport.³⁵ The calculation of costs underlying the charges had to be transparent. However, the Berlin Airports holding company could operate their three separate airports as a single commercial system, and cross-subsidy of Schönefeld was permitted because it was an „infrastructure in the public interest“ whose closure due to rising deficits was not legitimate.

In a later case, the Berlin Airports holding company proposed an increased fee for central infrastructure. In the light of previous cases it took the view that there was no point in hiding information, and flooded the complainant with information. The Court held that the burden of proof lay on the airline since the Airport had obviously provided sufficient information. The airline has appealed. [need to clarify this]

PART THREE: REAPPRAISING POLICY

13. Reappraising price cap regulation

Niemeier reviewed three options for policy. On balance he advocated price cap regulation with an independent regulator, as in the UK. Nonetheless, he noted some reservations about it. Increasingly, others in the UK are sharing these reservations. Several of the utility regulators are reappraising their traditional price control approaches. Ofgem's RPI-X@20 review has concluded that this approach, whilst very

³⁴ Following German reunification in 1990, in spring 1991 West Berlin's Tegel and Tempelhof airports and East Berlin's Schönefeld airport were pooled within a single holding company, the Berlin Brandenburg Flughafen Holding Company (BBF). This was owned by the Federal Government (26%) and the states of Berlin and Brandenburg (37 % each).

³⁵ Berlin Airports press release, 1 December 2008.

http://www.berlin-airport.de/EN/Presse/Pressemitteilungen/2008/2008_11_28_Rechtsstreit.html

effective in the past, is no longer fit for purpose in future and needs to change. (Ofgem 2010a,b) I have elsewhere argued (e.g. Littlechild 2008) that, despite the achievements in the past, and the advantages of a price cap in terms of incentives, the present process of setting the price cap has become unduly costly and time-consuming, does not reflect the views of customers and companies and local circumstances as well as it might, and is not conducive to innovation.

The CAA has had serious reservations about form and process. In fact, it has come to the view that the limitations of its previous approach exceed the benefits.

At Stansted, the CAA recommended de-designation, hence no price control. Since the Government did not accept this recommendation, the CAA was nevertheless obliged to continue to set a price control there. However, the CAA (2009a) said explicitly that “there should be no presumption that a RAB-based approach would be used in any future modification of price controls at Stansted airport”. (p. 10)³⁶

For airports that remained designated, the CAA proposed and implemented the concept of „constructive engagement“; precisely because of its dissatisfaction with the process of the conventional price control review.³⁷ It invited each designated airport and its airlines to discuss and agree a number of the price control inputs (notably traffic forecasts, capital expenditure plans and quality of service parameters). It undertook to embody those agreed inputs in setting the price control. To the extent that the parties were unable to agree, the decision would revert to the CAA.

Initially expectations were not high. Nonetheless at Heathrow and Gatwick the process worked relatively well (with some qualifications). The Competition Commission (CC) was initially sceptical, and critical of BAA’s and CAA’s processes for conducting constructive engagement, but made numerous recommendations to improve the process. These have since been adopted. At Stansted, the process was delayed by the possibility of de-designation. Agreement was not reached initially, but the CC itself later used the constructive engagement process there. With the controversial second runway by now off the table, the parties did manage to agree.

The CAA has since used a version of the constructive engagement process (referred to as customer consultation) in setting charges for air traffic control services. Reflecting

³⁶ In earlier papers, “The CAA’s own technical analysis of the standard building block (or RAB-based) approach to setting price controls supports to the possibility that it is regulation itself which distorts dialogues and conduct of Stansted airport and its users.” “... there appears to be a clear risk that RAB-based regulation could – in the circumstances that apply at Stansted – artificially distort the incentives on the airport operator. The corollary is that RAB-based regulation could also distort the incentives of the airport users.” (CAA 2006 paras 23.11, 23.16) The CAA noted that an airport like Stansted could be led to invest more or earlier than a competitive market would require, and airlines could be led to delay or oppose investments that would otherwise be in the interests of themselves and their customers. (CAA 2006 paras 23.15, 23.16)

³⁷ “The conduct of the price review left many stakeholders, notably the airlines, concerned that the regulatory process had moved too far towards somewhat abstract economic constructs, discussed in inaccessible technical language, and too far away from the more pressing requirements of delivering substantially better physical infrastructure, service quality and cost efficiency. Airlines also expressed frustration at their inability to influence the strategic direction of the price review.” (CAA 2009b para 10) “The process encouraged influencing the regulator rather than customers, airlines did not buy into it, it was adversarial and at odds with underlying business relationships.” (Bush 2007 slide 17)

the lessons of experience, this has a more structured process agreed in advance. It has worked very well.

Regulators of other services in some other jurisdictions have gone further. Over a long period, the US Federal Energy Regulatory Commission (FERC) has actively and successfully facilitated negotiated settlements between gas pipelines and electricity transmission systems and their customers: this happens in about 95 % of cases. (Wang 2004) Similarly, the National Energy Board in Canada has encouraged negotiated settlements between regulated oil and gas pipelines and their users. Over the last fifteen years or so, almost all transmission toll cases have been the subject of agreements rather than a regulated (litigated) outcome. (Doucet and Littlechild 2009)

Negotiated settlements preserve the incentive to more efficient operating expenditures and (in US terminology) accept only „used and useful“ capital expenditure. Constructive engagement is efficient insofar as it incorporates future capital expenditure plans that are agreed with users.

The initial failure of airlines to reach agreement with Stansted Airport about a second runway is not a failure of the process: rather, it indicates the ability of the process to identify and isolate investment projects of dubious economic viability.³⁸ If the possibility of the new runway had remained on the table a conventional price control process would have faced a difficult choice between accepting it against customers“ wishes and rejecting it against the company“s wishes and possibly against Government policy. As noted, the CAA took the view that the normal price control process would have distorted the outcome rather than secured efficient investment.

14. Reappraising the effectiveness of competition and competition law

If price cap regulation is less attractive than previously thought, what of Niemeier“s other options? He evaluated and dismissed the option of giving up ex ante regulation and relying on competition and competition law. He argued that competitive pressures between German airports would be rather low.

In contrast, in the UK, the CAA concluded that, where there is sufficient competition or prospect of it, the best approach is indeed to give up ex ante regulation and rely on competition and competition law. On this basis the CAA recommended de-designation (deregulation) of two of the four then-designated airports, namely Manchester and London Stansted. The Government accepted this recommendation with respect to the first airport but not the second.

³⁸ “The ostensible reasons for the failure of CE to start were disagreements about the scope of the information set to be provided by BAA to the airlines as a precursor to discussions and about the terms of engagement for CE. In the CAA“s view, though, there was an underlying distortion to the incentives of airport and airlines at Stansted respectively, which arose from the operation of the standard approach to setting prices based on historic and projected capital expenditure: BAA“s interests lay in early expansion funded in advance by current users, while airlines“ interests lay in benefiting from their incumbency at the airport and not funding capacity for new entrants. The prospects for CE were likely to have been further diminished by the perceived stance of BAA in promoting development of a second runway at Stansted primarily on the grounds that this was Government policy, without building a solid base of user support and demonstrating commercial viability.” (CAA 2009b para 79)

The extent of competition is not independent of industry structure and ownership. (Starkie 2008) The break-up of the BAA monopoly in London (via the sale of Gatwick, as recommended by the Competition Commission) will improve competition between London airports. The prospective divestment of Stansted too will further improve the prospect of competition, and the consequent de-designation of Stansted. It might be argued that there is presently little competition between airports in Germany. However, this is not to say that there is no scope for enhancing this competition, for example by the extension of private ownership and/or by restructuring where nearby airports are in the same ownership.

Niemeier (2003) commented that “The German competition law, at least as practised by the courts, is quite ineffective in setting incentives for efficiency or even preventing the abuse of monopoly power as the court case between Düsseldorf Airport and the airline Hapag-Lloyd shows.” (fn 38 p. 154). Strictly speaking this case is an example of civil law (invoked by airlines as airport customers) rather than of competition law (invoked by a competition authority). Nonetheless, it is worth examining. It may have been a fair comment on the initial judgement of the Court as of the time of writing, but it is no longer a valid assessment of the whole experience to date. As noted above, the Court of Appeal subsequently found that Düsseldorf Airport had not demonstrated that its proposed charges were equitable. The Court also found that Frankfurt Airport had not demonstrated that its proposed charges were transparent and cost-reflective. In both cases the airlines and airport subsequently negotiated agreed fees that were substantially lower than those initially proposed by the airports.

The Cologne/Bonn, Berlin and other cases have further clarified the rights and obligations of airports and airlines.³⁹ Appeals are still in process so the eventual outcome is not yet known. Nonetheless, German civil law has already proved to be more effective in protecting against monopoly power than earlier assumed. How far the decisions have produced a clear and settled set of principles consistent with economic efficiency may be subject to debate. Nonetheless, they have demonstrated that airlines have rights and airports have obligations that go beyond satisfying the state regulators under Section 43. Furthermore, airlines have been able to use these rights, or the threat of seeking to exercise them, as a means of negotiating more acceptable airport charges than they would otherwise have received.

How far such legal processes will be able to challenge airport inefficiency given the present extent of state ownership remains to be seen. The civil law requirements for greater transparency and cost-reflectiveness may be a move in this direction. Recent experience suggests that the option of removing ex ante regulation and relying on competition and competition law (and civil law) should still remain on the table. Mueller et al rightly suggest that this - and the exploration of methods to increase competition - should be a topic for further research.

Having said this, it is costly and time-consuming for airlines to challenge airports in the courts, and the outcome is uncertain. Undue legal involvement is inconsistent with the parties effectively running their commercial businesses. And airports still have the

³⁹ See the unpublished note by Maik Wolf, Barriers from civil law to setting airport charges, Working Paper, June 2010.

upper hand in any negotiation, not least because Section 43 is in practice more supportive of them. Given the transactions costs to airlines of legal challenge and the relatively comfortable alternative available to airports, there is less incentive to negotiate agreements than would otherwise be the case. This suggests that, where competition is less effective, it would be helpful to provide some way of resolving disputes with lower transactions costs than the courts. The concept of independent dispute resolution has been proposed and discussed in Australia, and the EU Directive in fact provides for it, as we shall see below.

15. Reappraising the Australian airport regulation model

Niemeier's other option was the Australian airport regulation model, variously called price monitoring or light-handed regulation. Under this approach, there is no formal constraint on airport charges. However, the Government has enunciated a set of Aeronautical Pricing Principles; the ACCC monitors and reports annually on prices, costs, financial returns and quality of service; there is a possibility of invoking an access regime with ACCC arbitration; and there is a threat of re-regulation in the event of unacceptable behaviour by airports. Niemeier noted that this approach could encourage an efficient price structure (via the Pricing Principles) and lower costs, and its flexibility could take account of unexpected crises in aviation. He rejected it because of three main objections. We may evaluate these against subsequent experience.

First, he noted the concern of Forsyth (2004) that, given the ACCC's history as a price monitor, there was a real chance that high profits, per se, will be taken as the criterion of poor performance, hence "there is a distinct risk that monitoring may become a form of light-handed cost-plus regulation".

In its review of experience, the Productivity Commission (2006) was complimentary about investment, productivity and service quality.⁴⁰ In 2007 the Australian Government concluded that a continuation of price monitoring was preferable to a return to price control, and extended the policy for a further six years. I have not seen or heard any argument against a further extension. The once-expressed view that it is unlikely that monitoring will be successfully conducted in Australia seems no longer tenable.

In a later paper, Forsyth (2008) concludes that "the system is consistent with good incentives for productive efficiency and most airports perform well in terms of productivity". (p. 67). He is still concerned about investment incentives. "Many airports are under pressure from regional interests to make excessive investments, and the airports can recover the costs of these investments by passing them on to users." (p. 67) His solution to this is better-defined guidelines for pricing and for re-regulation, making reference to "benchmarking, detailed analysis of costs or cost-benefit analysis of investments".

Against this, the ACCC (2010) has recently suggested that Sydney airport has underinvested, so it is not clear how extensive is any overinvestment. It has been

⁴⁰ "It has been easier to undertake the investment necessary to sustain and enhance airport services in the face of growing demand for air travel. Airports' productivity performance has been high by international standards, and service quality has been satisfactory to good." (Overview p. XII)

argued that the Pricing Principles are already too prescriptive and cost-based. The ACCC (2006) argued against expanded monitoring.⁴¹ Rather than make cost benefit analysis a required element of regulatory appraisal at this stage, further research might usefully try to assess the extent of any problem.

Second, Niemeier (2003) says that “A precondition of effective monitoring is that the institutions are independent and the threat to re-regulate is real otherwise the airports have no incentive to behave efficiently. Germany does not meet these criteria, as it has no independent regulator with enough expertise.” (p.155)

There are actually two points here. Monitoring in Australia does not seem to require very deep expertise. The ACCC’s useful annual reports are based on information provided by the airports. It does not regard the reports as providing sufficiently detailed and robust information on which to make a proper assessment of whether the airports are acting consistently with the Pricing Principles, or operating and investing efficiently. And it may be doubted whether monitoring is in fact a critical element of the Australian light-handed regulatory regime. (Littlechild 2010)

The need to clarify the threat of re-regulation can also be overstated. The Australian Government has recently decided not to pursue the Productivity Commission’s recommended „show cause“ procedure.⁴² Moreover, the „cure“ of regulation is widely regarded as worse than any present disease, so a threat of re-regulation may be a rather empty one in Australia. Nonetheless, re-regulation would be worse for airports than the present approach, so they do need to have some regard to this threat.

This does not seem to be the case in Germany. The regulatory institutions there are not independent, and are generally sympathetic to the airports. For a different reason, the threat of re-regulation is a rather hollow one. The airports might find that re-regulation with present institutional arrangements would be nearly as agreeable as monitoring without a price control.

What *is* really needed in both cases is an effective method of dispute resolution, which is independent of airports and airlines. In Australia this is presently provided by the Part IIIA access regime, which in the event of dispute provides for binding arbitration by the ACCC. In Germany, there is the possibility of recourse to the civil law courts. In both cases, however, legal processes are time consuming and costly, and arrangements could usefully be improved. As argued shortly, this could be achieved in Germany via the EU Directive, but only if the appeal body is independent of the airport. That is not the case with present regulatory bodies, but in principle the Federal Network Agency or independent dispute resolution organisations could be used instead.

⁴¹ “Both examples [of expanded monitoring] in effect represent „shadow“ forms of heavier regulation, potentially involving a retrospective rate of return approach. They are likely to impose greater compliance costs and regulatory uncertainty and therefore are likely to be less effective in preventing abuses of monopoly power than some direct forms of regulation.” (pp. ix,x)

⁴² Airports were concerned that the resulting uncertainty might impede their capacity to raise finance, airlines said that it would not necessarily help resolve negotiation disputes with the airports, and both sets of parties expressed concerns that the procedure would be resource and time intensive. (Australian Government 2009 p. 180)

Third and finally, Niemeier expresses concern that monitoring might be tantamount to deregulation, and that this could lead to excessive litigation (as in the Düsseldorf Airport case) and high transactions costs as a result of a poor relationship between airports and airlines. In contrast, “ex ante regulation by price cap has the advantage of reducing transactions costs as it brings all parties involved together in an orderly involved discourse.” (p. 156)

In fact, however, the Düsseldorf Airport case was followed by a four year agreement between airlines and the airport beginning in 2004, which was subsequently renewed in 2008. The same was true at Frankfurt Airport, where the agreement was also renewed albeit after a four year gap. This is not to say that all parties are completely satisfied with the general situation in Germany. Airlines in particular feel that they have little bargaining power, and to some extent have to „take it or leave it“. But they prefer to negotiate and reach agreement where possible than to continue litigation. Moreover, as noted earlier, both parties report that information flows and commercial relationships are better with negotiated agreements than with regulation under Section 43

This is consistent with experience in Australia. The Australian Government and the Productivity Commission have put great emphasis on commercial negotiations and agreements between airports and airlines. For the most part these have been achieved. There was a long-running legal case between Sydney Airport and the airlines, as to whether the airlines had a right to independent dispute resolution (binding arbitration) to establish acceptable terms of access. Once it was established that they did, the parties agreed a mutually acceptable outcome and it was not necessary actually to go to arbitration. This is consistent with evidence elsewhere suggesting that access to independent dispute resolution is generally conducive to agreement rather than undermining of it.

Regulatory discourse in the UK is systematic, but whether it is „orderly“ is debateable: the CAA was led to propose constructive engagement precisely because the previous price control review process was so unsatisfactory and antagonistic. It would be difficult to persuade UK utilities that ex ante regulation by price cap reduces transactions costs. Over time, the regulatory process has become steadily more complicated and more costly.⁴³ It has typically involved much more complex calculations and incentive mechanisms than the parties would embody in a negotiated settlement. In contrast, negotiations and agreements have led to better understanding, information flows and commercial relationships, not only in Germany but also in Australia (Schuster 2009, Littlechild 2010), the UK (Bush 2007) and Canada (Doucet and Littlechild 2009).

16. The EU Directive on airport charges

The 2009 EU Directive says that “It is necessary to establish a common framework regulating the essential features of airport charges and the way they are set”.⁴⁴

⁴³ I have elsewhere calculated that the number of documents issued in the electricity distribution network price control reviews increased eightfold over the first three reviews. A colleague involved in the fourth review suggests that it may have doubled again.

⁴⁴ Directive 2009/12/EC of the European Parliament and of the Council of 11 March 2009 on airport charges, *Official Journal of the European Union*, 14.3.2009, page L 70/11 – 70/16.

However, the Directive is not prescriptive about airport charges themselves, other than requiring that they do not discriminate among airport users (i.e. airlines). It does not preclude Member states from applying “additional economic oversight measures, such as the approval of charging systems and/or the level of charges, including incentive-based charging methods or price caps”. But it does not require or even encourage such additional measures.

The stated aim is related to process rather than to a particular outcome: “in the absence of such a framework, basic requirements in the relationship between airport managing bodies and airport users may not be met”. The main thrust of the Directive is to establish a compulsory procedure for regular consultation between the airport and its users, with respect to the system (i.e. structure) and level of airport charges, and the quality of service provided. Wherever possible, changes to the structure or level of charges should be by agreement between the airport and its users. There are detailed provisions on the process of consultation, and an obligation on the airport to justify its decision if agreement is not reached.

In the event of disagreement, either party may seek the intervention of an independent supervisory authority that must be established. This authority must make an interim determination within four weeks and a final determination normally within four months (or exceptionally within six months). The authority’s independence is guaranteed “by ensuring that it is legally distinct from and functionally independent of any airport managing body and air carrier”.

The charges must also be transparent. This means that the airport and airlines must provide each other with information relevant to the aforementioned consultations. Thus, airports must provide “information on the components serving as a basis for determining the system or the level of all charges levied at each airport”. This is to include the methodology for setting charges, the overall cost structure, the revenue of the different charges, any public authority financing, forecasts of traffic, costs and proposed investments, actual historical usage of airport facilities, and the predicted impact of any major proposed investment on airport capacity. Airport users for their part must provide the airport with their forecasts of traffic, the composition and use of their fleet, their development projects and their requirements at the airport.

There is an additional obligation to consult on plans for new infrastructure. Airports should provide information so as to make monitoring of infrastructure costs possible, and with a view to providing suitable and cost-effective facilities. There is also provision for negotiations with a view to concluding a service level agreement on quality of service, which takes into account the structure and level of charges as well as the quality of service provided. These services and charges may differentiate amongst users.

17. The EU Directive in Germany

The major thrust of the Directive is not to dictate to the airports what they should charge, but to enable and encourage negotiations between airports and airlines. Where there is not effective competition between airports, it would redress the imbalance resulting from airport market power, a significant improvement on present practice under Section 43. It would also facilitate the development of framework agreements.

If properly implemented the Directive should have a positive effect. But in practice, will the Directive be implemented in Germany so as to have this desired effect?

Member states that retain ownership or control of airports or airlines “shall ensure that the functions relating to such ownership or control are not vested in the independent supervisory authority”. However, the authority may delegate the implementation of its duties to other independent supervisory authorities. A real concern in Germany is that the Federal Government might delegate implementation of the duties to the same federal state authorities that are presently responsible for airport regulation under Section 43, even though these federal states have ownership stakes in their airports. In this case nothing might change from today. This would seem to thwart the purpose of the Directive, and would frustrate the development of responsive airports, better relationships and effective framework agreements. Provision for delegating disputes to the Federal Network Agency or to an independent dispute resolution entity would address this deficiency.

Some might be concerned at the increased risk of disputes arising as a result of the new possibility of appeal to a fully independent authority. (NERA 2009) However, experience in Germany and elsewhere suggests that this is likely to be a relatively temporary problem, and could be a necessary and desirable stage in the evolution of satisfactory attitudes and relationships. It would tend to occur at airports that are slow or reluctant to provide the prescribed information, or that fail to negotiate fairly with the airlines. In general, in Germany and Australia, establishing the right to independent dispute resolution has tended to facilitate realistic commercial bargaining and agreement, rather than discourage it.

Given the concern about inefficiency in airport operations and investment in Germany, some might take the view that the Directive does not go far enough. For example, it does not require cost-benefit analysis of major investments. However, the preamble does specifically refer to the aim of providing cost-effective facilities, and requires the airport to provide information about costs. If airlines were concerned at having to pay for what they regarded as unnecessary investment, an appeal invoking also the Section 315 principles of equity should provide a means of addressing this. As to efficiency generally, economic analysis and experience elsewhere suggest that the major driver for greater airport efficiency in Germany lies in the nature of ownership rather than a further refinement of regulation.

Others might be concerned at the opposite possibility of a large national regulatory bureaucracy dictating airport charges to the airports and airlines. Niemeier () has suggested that the bureaucracy need not be large. However, in the UK, the CAA has a larger staff than proposed for Germany, even though the CAA has taken a relatively hands-off approach to regulation, and now sets a price control at only three designated airports. Rather than claiming that price cap regulation need not require a large bureaucracy, it would seem more assuring not to aim at price regulation in the first place, and to limit the role of the independent supervisory authority simply to discharging the appeal functions set out in the Directive.

One significant reservation is in order. The Directive applies to airports handling over 5 million passengers per year, and to the largest airport in each country. This would catch many airports (about a dozen in the UK) that are already subject to competition

and where relationships between airports and airlines have not been an issue. In such cases the obligations of the Directive would be unduly intrusive and burdensome, and the requirements for methodology and transparency could prejudice the development of individual contracts between airport and airlines.

18. Conclusions

Niemeier's lucid analysis of German airport regulation argues that the present regulatory framework under Section 43 is conducive to inefficient investment and operation of airports, that the framework agreements between airports and airlines at four airports are a step in the right direction, but that the best solution is price cap regulation with an independent regulatory body using a UK style consultation process. This is preferable to deregulation plus relying on competition law, or to airport monitoring (light-handed regulation) as in Australia.

Mueller et al draw attention to the lack of legitimacy and independence of present federal state regulatory bodies. They share Niemeier's view on policy, and propose that the new EU Directive be used to establish the Federal Network Agency as an independent regulator, so as to implement better price cap regulation.

This paper argues that the framework agreements are indeed superior to Section 43 regulation, but not simply because of the form of regulation (price cap rather than cost-based). The negotiation process by which the agreements are derived is also important, because it better reflects the interests of both sets of parties. It is also more conducive to the exchange of information and to better commercial relationships in the sector. In addition, legal cases at Dusseldorf, Frankfurt, Cologne/Bonn and Berlin Airports, brought under the Civil Law Section 315, have curbed the market power of airports and encouraged the signing of framework agreements.

Recent experience suggests that the UK process of price cap regulation is more problematic than previously realised. At the same time, reliance on competition and competition law (where competition is relatively effective) and Australian-style light-handed regulation or monitoring (where competition is less effective) are more effective policies and more applicable in Germany than previously realised.

For both these latter policies, the main „missing link“ is a means of resolving disputes between airlines and airports that is less costly and time-consuming than civil law legal processes. The new EU Directive provides that missing link – but only if the independent supervisory authority is truly independent of the present state regulatory bodies. If the role of the proposed independent supervisory body were to focus on dispute resolution, rather than on implementing price cap regulation UK style, this would address the objection that actively implementing the EU Directive would require a large bureaucracy. To avoid undue burden, the applicability of the Directive should be restricted to those airports not subject to effective competition.

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