
Consultation Document: Quinquennium 2 (QQ2)

Norman Manley International Airport

23 October 2018



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Glossary

'AAJ': Airports Authority of Jamaica

'ACE': Additional Capital Expenditure

'AIF': airport improvement fee

'ATM': air traffic movement

'CAPEX': Capital expenditure

'CPI': Consumer price index. A measure of general price inflation

'IRR': internal rate of return

'JCAA': Jamaica Civil Aviation Authority

'NMIA': Norman Manley International Airport

'OPEX': Operating expenditure

'QQ2': Quinquennium 2, the next five-year review of airport charges at Norman Manley International Airport and Sangster International Airport

'RAB': Regulated asset base

'SIA': Sangster International Airport

'SMP': Significant market power

'VFR': Visiting friends and relatives. A customer segment within the air passenger market.

'WACC': Weighted average cost of capital

1 Introduction

1.1 Purpose of this consultation document

The current rates in place at Norman Manley International Airport (NMIA) are due to expire on 31 December 2019. As such, the JCAA has launched a review, as required by the Airports (Economic Regulation) Act, 2002, to determine the appropriate regulatory arrangements that should be put in place for the next rate review period (QQ2), which is due to commence on 1 January 2020.

This consultation document seeks views from all interested parties on the process, key themes and relevant issues that should affect our methodology for regulating NMIA for QQ2. The decisions ultimately made on the appropriate regulation of the airports will have significant implications for the airports, airlines, cargo shippers, passengers and other stakeholders in Jamaica.

1.2 Rate review timetable

This rate review process is a major programme of work and it is important that our decisions are well supported and subject to appropriate consultation.

In our general guidance on the economic regulation of airports from 2003, we set out a timetable for (interim, exceptional and periodic) rate reviews.¹ The programme of work and timings for this review are set out in Table 1.1 in below. This timetable is subject to discussion with stakeholders.

¹ JCAA (2003), 'Economic Regulation of Airports: General Guidance', 24 July, p. 9.

Table 1.1 Timetable for rate review

Requirement	Documents produced and input required	Date
The JCAA to publish a formal notice of the review, identifying the major issues and inviting formal responses (start date minus 15 months)	Consultation paper outlining the proposed timetable, consultation process, framework for the review and the JCAA's initial views on the key issues. Outline of the information that the JCAA will require from airports and users.	October 2018
	Airports and other stakeholders to respond to the consultation document by 12 November.	November 2018
	The JCAA to publish paper setting out initial positions by 30 November.	November 2018
The JCAA to begin detailed investigations, including meetings with the main interested parties (start date minus 12 months)	Airports are required to submit their business plans to the JCAA by 25 January 2019	January 2019
The JCAA to publish proposals, inviting comments and arranging meetings with the main parties (start date minus nine months)	The JCAA to publish an initial proposals document. Airports and other stakeholders to respond by May 2019	April 2019
The JCAA to issue its decisions, including the new charges conditions (start date minus six months)	JCAA to publish its final proposals document	July 2019
New regulatory period commences		1 January 2020

This timetable is driven by the need to reach a decision six months before airlines and passengers pay the new charges, as this is the minimum realistic period for airports to consult with airlines on the detailed structure of the new charges.

We note that we have already commenced this rate review process to some extent, with the publication of Oxera's key issues report in September 2017.² The issues raised in that report were determined based on extensive consultation and discussion with stakeholders. As such, the main themes in this consultation document largely pick up on topics raised in the key issues report.

We have prepared business planning guidance for the airports alongside this consultation document. The guidance is intended to help the airports (and other stakeholders) in putting together their forecasts, business plans and airport charges proposals for the QQ2 period.

However, we note that there is an interaction between the topics discussed in this consultation document and the business planning guidance. For instance, the decision on the appropriate till regime could affect the way in which

² Oxera (2017), 'Key issues for the 2020 rate review', prepared for the Jamaica Civil Aviation Authority, 11 September.

information about aeronautical and non-aeronautical assets should be provided by the airports. As such, and given the timings for the review, we have prepared the business planning guidance on the basis of the initial positions put forward in this document. However, to the extent that there are revisions to these positions, some elements of our guidance will need to change as well and we will make any updates as required.

1.3 Responding to this consultation

If you have any views on this consultation document, and in particular on the key questions set out throughout the document and in Appendix 1, please submit them as soon as possible to:

Mr Nari Williams-Singh JP
Director General
Jamaica Civil Aviation Authority
nari.williams-singh@jcaa.gov.jm

All submissions must be made by 12 November 2018. We cannot commit to taking into account representations made after this date.

We note that there are some topics that are not discussed in this consultation document. However, we welcome submissions on both the issues discussed in this document and any other issues that stakeholders consider that we should take into account.

2 Background

2.1 Context for the review

This section sets out the context within which the QQ2 rate review needs to be considered. This includes recent and future developments at NMIA and in Jamaica more generally. In addition, we consider how the legislative framework affects the context for the QQ2 rate review. These topics are briefly considered in turn below.

After the Airports (Economic Regulation) Act was passed in 2002, regulation was introduced for the first time and rates were set for NMIA for a 12-year period based on the rates proposed as part of the concession agreements. At the end of the first six years, we conducted an interim review, which determined whether the increase in airport charges should be permitted to continue for the remainder of the period. This was contingent on a number of factors, such as:

- no manifestly poor performance on service standards;
- the airports carrying out certain CAPEX programmes set out in the concession agreement;
- the IRR not exceeding 25%.³

We agreed to allow the rates to continue for another six years. We then undertook the full first rate review for the regulatory period that started in 2015.

In 2015, the outcome of the first rate review was that airport charges at NMIA were increased by 55%, split across the different charge components. Charges were then set to evolve at CPI - 0% for the next five-year period. We noted that NMIA had struggled to operate profitably.⁴

In setting the rate review, it is important that we have regard to the commercial characteristics of the airport. These include the nature of the passengers, airlines and cargo shippers that use each airport, the level of airport charges compared with benchmarks, other costs for passengers and airlines, and outcomes, such as the level of investment and service quality. Further detail on these factors for NMIA is included below.

2.2 Overview of Norman Manley International Airport

For the purpose of this overview, we have primarily relied on the data submitted and analysed as part of Oxera's analysis of outturns vs forecasts, which includes data until the end of the last review period, 2014/15. In some instances, we have updated these figures with more up-to-date information available.

In 2016/17, NMIA facilitated nearly 1.6m passenger journeys.⁵ While this was an increase on the previous year, it was still below the 1.75m passengers that passed through the airport in 2006/07. Overall, passenger numbers at NMIA declined steadily from 2007 to 2013 (at an average rate of 4% per annum). In 2014/15, traffic increased for the first time in six years (by 7%)⁶ and since then

³ JCAA (2009), 'Six Year "Interim Review": Norman Manley International Airport', 11 June. See Section 3 of the Airports (Economic Regulation) (Modification of Review Period) Notice 2003.

⁴ JCAA (2014), 'The Norman Manley Airport Economic Review Report', 18 November.

⁵ NMIA 2016–17 annual report. Note that while the figures we use from NMIA's annual report to provide context are reported in financial year, all figures submitted as part of QQ2 should be reported with respect to the calendar year. This is consistent with our separate business planning guidance.

⁶ Oxera: analysis of past performance.

has continued to rise (at an average rate of 4% per annum).⁷ Cargo activity at NMIA is limited compared with other airports.⁸

NMIA is the second largest airport in Jamaica and is located to the south of the island, serving Kingston. From 2003 to 2016, North America was consistently the largest origin and destination market in terms of passengers (with its share going up from 60% in 2004 to more than 70% in 2016).⁹ The Caribbean is the second largest origin and destination market, although this declined from 20% in 2004 to 15% in 2016.¹⁰

The profile of journeys at NMIA is mainly characterised by business and visiting friends and relatives (VFR) travel. However, it is considered that NMIA may attract more tourist traffic in the future with the increased use of the North–South Highway, which means that passengers may fly through NMIA to travel to Ocho Rios, for example.

High taxes on flights to/from Jamaica mean that NMIA is expensive for airlines and passengers, making it less attractive.¹¹ Air Jamaica’s financial difficulties and ultimate take-over also had a negative effect on traffic, although other airlines at the airport have grown significantly since then—such as Jet Blue and WestJet.

In the last review, we noted that traffic performance at NMIA had been poorer than expected.¹² While passenger numbers and freight volumes had underperformed relative to expectations, air traffic movements (ATMs) had remained above forecast, which implies that there were low load factors. To mitigate falling profitability, the airport increased non-aeronautical revenues. However, in our 2015 review, we identified room for improvement in non-aeronautical revenues in terms of improving the commercial offer and commercial facilities layout at the airport.¹³

As explained in Oxera’s outturns and forecasts report, both OPEX and CAPEX have been significantly above their forecast levels from the time NMIA became subject to regulation until the last rate review. Passenger satisfaction at the airport was high overall, but individual elements of service quality at the airport had been declining in recent years. At the time of the last price review, access, arrival services, baggage handling and airport facilities had been consistently below the minimum acceptable level.

NMIA is owned by the AAJ and is currently operated by NMIA Airports Limited, a wholly-owned subsidiary of the AAJ. In September 2018, Grupo Aeroportuario del Pacifico, S.A.B. de C.V. (‘GAP’), (whose subsidiary company Desarrollo de Concesiones Aeroportuarias already own 74.5% of MBJ Airports Limited), won a bid for the NMIA public–private partnership. The concession

⁷ NMIA 2016–17 annual report.

⁸ JCAA (2014), ‘The Norman Manley Airport Economic Review Report’, 18 November.

⁹ Oxera: analysis of past performance.

¹⁰ Ibid.

¹¹ JCAA (2014), ‘The Norman Manley Airport Economic Review Report’, 18 November.

¹² See Jamaica Civil Aviation Authority (2014), ‘The 2014 Norman Manley Airport Economic Review report’, 18 November, p. 17. ‘The national economy has experienced difficulties during the last four years but its performance cannot explain the decline in traffic at NMIA. It is a generally accepted principle that air traffic grows faster than GDP. In Jamaica, the numbers of air passengers are lagging behind the national GDP... This indicates that there must be a latent demand that is not being stimulated or which cannot find the right offer with respect to destinations, frequency or prices.’

¹³ See Jamaica Civil Aviation Authority (2014), ‘The 2014 Norman Manley International Economic Review Report’, 18 November, p. 18. ‘Non-aeronautical revenues represent a high percentage of total revenues at NMIA. Total revenue per passenger are also high... Despite this the commercial offer at the airport is very basic and the commercial facilities layout and location poor. There is significant room for improvement. Higher non-aeronautical revenues should alleviate the pressure on aeronautical revenues and airport charges.’

period will run for 25 years, with an option to extend the arrangements by an additional five years.¹⁴ During the concession period, GAP will be responsible for improving the efficiency of both landside and airside operations, financing and completing the planned modernisation and expansion, and maintaining and upgrading the facilities of the airport.¹⁵ The terms of the concession agreement are expected to be concluded by November 2018.¹⁶

2.3 Future developments

In deciding on the appropriate rates for NMIA at the next review, it is important to take into account future developments in Jamaica and wider market trends. We consider the relevant factors to take into account are as follows.

- Privatisation of NMIA. As noted above, following the privatisation of NMIA, there is currently an overlap in the majority owners of NMIA and SIA.
- Development of Jamaica as a logistics hub. There are plans for Jamaica to become a significant logistics hub, leveraging maritime and aviation activities (particularly air freight).
- Extending the runway at Ian Fleming Airport. The development of this airport could lead to growth in overall traffic to Jamaica, but it could also potentially abstract from traffic at NMIA and SIA. There is also discussion of a cargo development at Vernamfield (a former US military base).
- Economic trends in Jamaica and in key destination markets. For example, there has been a renewed emphasis on economic growth and job creation in Jamaica, and extensive growth (and future planned growth) in hotels and restaurants, some of which has been a result of foreign direct investment in the sector. Also trends in macroeconomic variables, such as the level of borrowing rates and restructuring of government debt.
- The potential development of Cuba as an origin and destinations market for Jamaican airports, depending on political developments.

2.4 The JCAA's duties

Our duties need to be central in deciding on the key issues and rates for the next review, particularly given that the framework being developed is likely to be in place for future reviews. In this respect, our duties according to the Airports (Economic Regulation) Act, 2002, are:

- further the reasonable interests of users of airports within Jamaica, and provide economical and reliable services to those users by establishing a system for regulation of the airports that takes account of those interests.
- promote the efficient, economic and profitable operation of airports;
- ensure compliance with Jamaica's international obligations, as notified by the Minister;
- create an enabling environment for potential investors in airports;

¹⁴ See Loop Jamaica News (2018), 'Mexican firm wins bid for for NMIA concession partnership', 11 September, <http://www.loopjamaica.com/content/mexican-firm-wins-bid-nmia-concession-partnership>.

¹⁵ The Jamaica Observer (2018), 'GAP is preferred bidder for NMIA', 12 September, <http://www.jamaicaobserver.com/business-observer/143949?profile=1606>.

¹⁶ The Jamaica Gleaner (2018), 'Provisional Preferred Bidder For Norman Manley Airport Selected', 12 September, <http://jamaica-gleaner.com/article/news/20180912/provisional-preferred-bidder-norman-manley-airport-selected>.

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- encourage investment in new facilities at airports in time to satisfy demands by users of the airports;
 - impose restrictions on the operator as consistent with the performance by the Authority of its functions;
 - further vital public interests as notified to the Authority by the Minister;
 - ensure the airport is operated in accordance with performance standards and service levels that are consistent with best industry practice.

Given that we have a number of duties that are given equal weight, in making decisions we may need to prioritise some duties over others. We will clearly set out the trade-offs that we are making in taking decisions on specific factors.

In addition, in making decisions in the exercise of our functions under this Act, we must observe reasonable standards of procedural fairness, act in a timely fashion, observe the rules of natural justice, and also:

- consult with persons who are likely to be affected by a decision;
- give to such persons an opportunity to make submissions and to be heard by the Authority;
- have regard to the evidence adduced at any such hearing and to the matters contained in any such submissions;
- give reasons in writing for each decision;
- give notice of each decision in the prescribed manner.

The Act also says that, in determining whether to approve airport charges, the Authority shall take account of:

- its objectives (listed above);
- the efficiency of the operations;
- compliance with quality and performance standards;
- performance by the operator in terms of commitments undertaken under the conditions by which they were approved as an airport operator;
- whether the proposed charges would be reasonable in light of the services provided;
- whether the proposed charges can be justified, taking into account revenue from the operations of the airport from all sources, including aeronautical and as much of the non-aeronautical revenues as the Authority deems appropriate.

2.5 Regulatory best practice

We will ensure that we take account of relevant best practice and lessons from other regulatory regimes, including regulatory regimes at international airports and across other sectors both in and outside Jamaica. We would welcome views on particular examples that we should take into account, particularly where the relevance of these examples to the Jamaican context is demonstrated.

3 Stakeholder engagement

3.1 Objectives and key principles of stakeholder engagement

Stakeholder engagement is increasingly becoming a core feature of many regulatory regimes around the world. Through this process, a company proactively discusses, and engages with customers on, its plans for the period. It then uses this engagement to inform its business plan.

Stakeholder engagement was a feature of the last regulatory review at NMIA. Indeed, at the time of the 2015 review, we noted that:

Since the beginning of the airport charges review process special attention was paid to the stakeholders.¹⁷

While there was some stakeholder involvement over the course of the last regulatory review, stakeholders have noted that they expect to be more involved going forward.¹⁸

We expect the airports to seek input from stakeholders on the key outcomes that stakeholders want from the airports and the best ways in which these can be incentivised. We consider that the focus should be on outcomes—the higher-level objectives that customers want and value—rather than inputs (the resources a company needs) or outputs (actions a company needs to take). For instance, one issue that should be discussed is the investments required and the prioritisation of different investment options. Other issues that will need to be discussed in the context of deciding on the appropriate level of prices are the volume of passengers expected and the overall level of service that will be provided.

We consider that the engagement process may function more smoothly if there are some key principles set out to guide this process, as follows.¹⁹

- The discussions should be focused on **delivering outcomes that customers value**.
- All parties should provide **relevant information in a timely manner**, including responding to queries.
- All parties should **engage constructively and in good faith**.

Ideally, we would like to see (a number of) issues agreed between the airlines / other stakeholders and the airport during the development of the airports' business plans in a way that provides good outcomes to customers. Indeed, the process of engagement can be valuable in narrowing the differences and areas of disagreement between the parties. However, we appreciate that the interests of stakeholders are likely to diverge in some cases. In these cases, stakeholder engagement can still be valuable in ensuring that different parties are able to provide informed views to the rate review process.

We expect to see evidence of stakeholder engagement reflected in airports' business plans. Airports should highlight the areas of agreement with stakeholders, and in areas where agreement cannot be reached, they should set out the reasons for their differing views.

¹⁷ JCAA (2014), 'The 2014 Norman Manley International Airport Economic Review Report, 18 November, p. 35.

¹⁸ See Oxera (2017), 'Key issues for the 2020 rate review'.

¹⁹ Adapted from UK Civil Aviation Authority (2017), 'Strategic themes for the review of Heathrow Airport Limited's charges ("H7"): A discussion document', CAP 1383, p. 27.

Stakeholder engagement should be led by the airports rather than the regulator. Therefore, while we will generally not take part in discussions between stakeholders, there may be times when we take a more active or prominent role. For instance, there may be occasions when it would be appropriate for us to attend meetings and/or provide guidance to parties. Ultimately, we will also make the final decisions on most of the appropriate parameters for the rate review, and in doing so, we will need to ensure that the interests of both current and future customers (i.e. passengers) are taken into account.

3.2 The JCAA's initial position

Stakeholder engagement is an important feature of this regulatory review. As part of their business plans and airport charges proposals, the airports should highlight the points of consensus with airlines/other parties.

There are some areas where it may be more reasonable than others for the parties to engage and reach agreement. For instance, while we welcome stakeholder engagement on areas such as the appropriate WACC or RAB valuation, we will continue to have the ultimate role in determining the appropriate approach in these areas. However, it would be reasonable to expect engagement and agreement with stakeholders on, for example, the level of service quality desired, traffic forecasts and the capital investment programmes.

To the extent that there is evidence of good customer engagement, and in areas where there is broad agreement between the airport and stakeholders, we will apply less regulatory scrutiny (with the exception of highly technical areas, as outlined above). Therefore, the more effective the consultation, the more efficient the rate review will be since we will only have to undertake detailed analysis for areas of difference between the parties.

On issues where the parties are unable to agree, the airports should highlight how they have taken airlines' feedback into account and the reasons for the parties' different positions.

3.3 Questions for consultation

We welcome responses from stakeholders to the following questions.

1. Do you consider that the proposed process for stakeholder engagement is appropriate?
 2. Do you agree with the key principles set out to guide stakeholder engagement? Are there other principles that should be considered?
-

4 Form of regulation

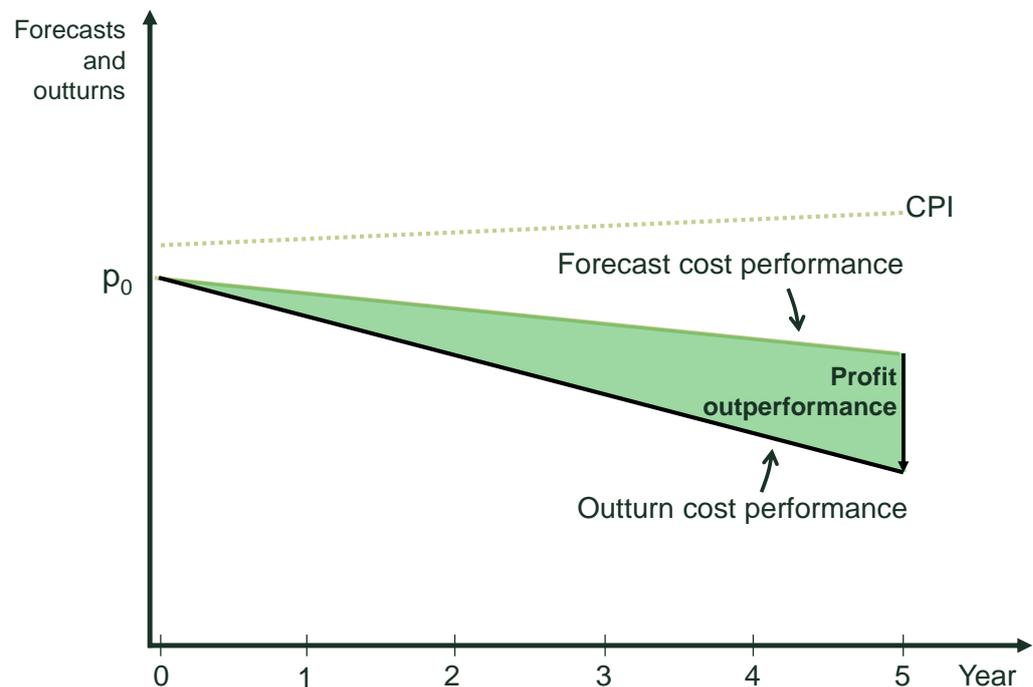
4.1 Options considered

There are four broad types of regulatory regimes frequently used at international airports and across other sectors, which are relevant to consider in determining the appropriate form of regulation for NMIA. These forms of regulation were set out in detail in Oxera's key issues report,²⁰ but we summarise them below.

Incentive regulation approaches typically take the form of ex ante charge controls that look to cap charges or revenues at a level that allows the company to recover the *efficient* level of costs incurred in providing the regulated service. At the same time, the company bears the risk of earning low profits or losses if it is unable to control its costs and meet the regulator's forecasts. This type of approach is in place at several airports worldwide, including at a number of Mexican airports.

Figure 4.1 illustrates the incentive regulation approach in more detail. If the company has costs equal to its forecast costs then it will meet the regulator's target level of profits. However, if it is able to deliver outturn costs that are below the regulator's forecast, as in the diagram, it is allowed to keep the outperformance in the form of higher profits.

Figure 4.1 How does incentive regulation work?



Source: Oxera.

This approach relies on forecast data and assumptions about how the market will evolve over the course of the rate review in order for the regulator to set the price or revenue cap in advance of the period.

Rate of return regulation is also known as 'cost-plus' regulation. The core principle underlying rate of return regulation is that prices should reflect the cost of service. Under this form of control, the regulated firm is allowed to

²⁰ Oxera (2017), 'Key issues for the 2020 rate review', 11 September, section 3.2.

charge prices that cover its actual operating costs and give it a 'fair return' on capital employed. This regulatory approach is used at a number of airports in the USA.

In a **contractual regulation** approach, the outcomes of the rate review are no longer determined by regulators; rather regulatory authorities establish, guide and approve the process by which the outcomes are determined. This occurs through negotiation and consultation between the regulated company and users, in order to form a consensus with respect to the outcomes desired, level of charges, quality of service and other important aspects of the rate review.

Regulators often continue to have an important role in providing information, as well as specifying and monitoring the review process and timetable. Therefore, contractual regulation does not remove the need for regulatory oversight altogether. However, the regulator should ensure a clear division of responsibilities between itself, the regulated firm and users to avoid a duplication of effort. Contractual regulatory approaches are applied at Gatwick and Copenhagen airports.

Under **light-touch** regulatory approaches, the regulator intentionally assumes a less intrusive role, leaving the regulated company to determine the means by which it arrives at the target outcome. It is not the case, however, that a light-touch regime is the same as full deregulation. Two examples of light-touch approaches are price monitoring and shadow regulation.

In a price monitoring regime, the regulator delegates responsibility for pricing arrangements to the regulated company, and prices are determined by commercial negotiations between the company and its customers. The regulator then monitors price and (usually) service quality outcomes on an ongoing basis, to ensure that the company is not abusing its market power, and only intervening if these outcomes are considered to be sub-optimal. A number of Australian airports²¹ are subject to a price monitoring regime.

Shadow regulation lies between price monitoring and full deregulation on the spectrum of regulation models. As with price monitoring, the regulated company is required to publish price information, and potentially service quality and financial information. However, shadow regulation differs from price monitoring in that it is 'reactive' rather than 'proactive'. That is, there is no requirement for the regulator to monitor prices formally, and there is no explicit sanction mechanism; rather, the regulator will typically intervene in the market only if it, or the government, receives a formal complaint from a market participant about the monopolist's behaviour.²²

4.2 The JCAA's initial position

As a general principle, where there is effective competition, we consider that this is likely to lead to better outcomes for users than regulation. While we have not conducted a formal market power assessment for NMIA, we consider that these airports compete with each other, and with airports in other jurisdictions, at least to some extent.

While the airlines at the airports are likely to have some degree of countervailing buyer power, the functioning of light-touch and contractual regulatory approaches relies on active engagement and challenge from stakeholders. When we have spoken to stakeholders in the past, they have

²¹ Sydney, Adelaide, Brisbane, Darwin, Melbourne and Perth.

²² In contrast, under price monitoring the regulator can choose to intervene from its own assessment of the company's performance.

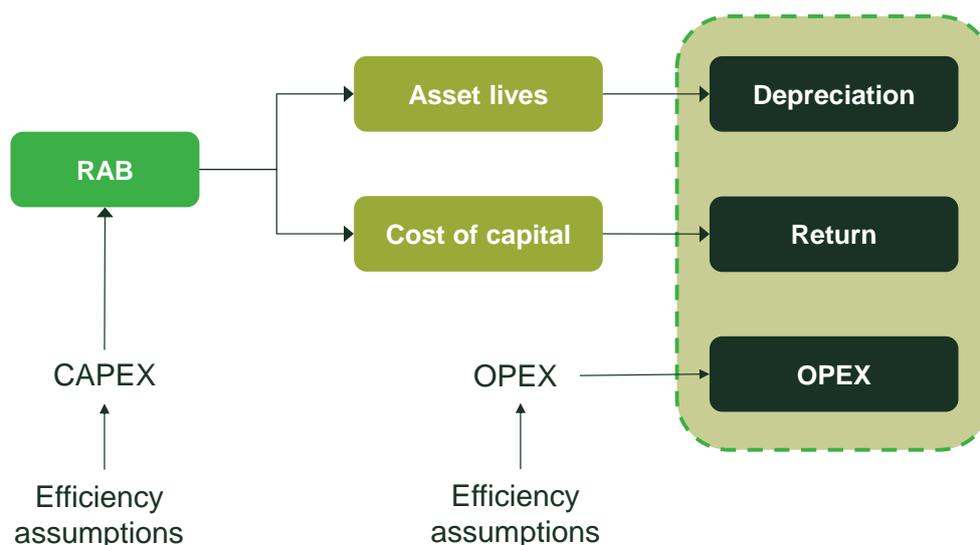
advised us that they consider that we are the best party ultimately to decide on the key factors for this rate review.

We believe that rate of return regulation is inappropriate based on the incentives that it provides, and its inconsistency with our duty to promote efficient airports. Rate of return regulation provides weak incentives for cost reduction, as any reduction in costs leads to a corresponding reduction in revenues.²³ Given this and other related drawbacks (incentives to increase costs to increase the absolute level of profits and reduced incentives to innovate), we would only consider introducing this form of regulation if our overriding concern was to ensure that a high level of service was provided by the airports, rather than focusing on the costs of securing that outcome.

Therefore, we consider that the most appropriate form of regulation to apply for the 2020 rate review for NMIA, in keeping with our duty to ‘promote the efficient, economic and profitable operation of airports’, is incentive regulation.

We consider that the determination of the required revenues, and hence charges, in this regime should be based on a RAB–WACC building blocks approach, which is outlined in Figure 4.2. The total revenue requirement is calculated as the sum of depreciation, the efficient level of OPEX and a target return on assets.

Figure 4.2 Building blocks approach to setting required revenues



Source: Oxera.

Within this process, we will estimate the target rate of return and forecast efficient cost levels, so that a reasonable cap can be set.

In determining a target rate of return, there are three parameters that need to be taken into account:

- the appropriate asset life (or lives) over which to depreciate the airports’ capital investments;
- the profile of depreciation (for example, whether it should be straight-line, front-loaded or back-loaded);

²³ Sappington, D. (2000), ‘Price Regulation and Incentives’, in M. Cave, S. Majumdar and I. Vogelsang (eds) (2002), *Handbook of Telecommunications Economics*.

- the rate of return that investors should earn on their investment.

The airports will already have established asset lives and depreciation profiles for the CAPEX invested at the airport. Our starting point for the next review would be to better understand the airports' choice of asset lives and depreciation profiles before proposing any changes.

One established methodology for determining the rate of return is an estimate of the company's weighted average cost of capital, or WACC. The WACC represents an average of the company's cost of equity and cost of debt, weighted by its level of gearing (i.e. the proportion of net debt to the value of the business):²⁴

$$WACC = (\text{cost of equity} \times \% \text{ of equity funding}) \\ + (\text{cost of debt} \times \% \text{ of debt funding})$$

We consider that the return on capital should be based on a forward-looking estimation of the WACC for NMIA. The regulatory WACC allowance may differ across the airports we regulate if they are found to face different levels of exposure to risk. More detail on our approach to the WACC is included in our business planning guidance.

While we will ultimately decide on most of the parameters noted above for this rate review, over time, as stakeholders build up experience of the regulatory regime and the cost bases of the airports are better understood, the onus of deciding the parameters could shift from the JCAA to stakeholders. This means that there would still need to be discussions about, for example, the appropriate level of costs, but this could be determined based on agreements between airports, airlines, passenger representatives and other stakeholders, more in line with a contractual regulatory approach.

4.3 Questions for consultation

We welcome responses from stakeholders to the following questions.

1. Do you consider that incentive regulation based on a RAB–WACC building blocks approach is the most appropriate regulatory approach for the 2020 rate review? If not, what form of regulation do you consider would be more appropriate given the JCAA's duties, and why?
2. What methodology do you think is most appropriate for setting asset lives and depreciation profiles?
3. Do you agree with the JCAA's proposed approach for determining the WACC?

²⁴ Tax can be dealt with in different ways depending on the approach taken to estimating the WACC. Vanilla WACC would capture tax separately, whereas in a pre-tax WACC the tax payments would be included in the WACC.

5 Till regime

5.1 Overview of till regimes

There are two main categories of activity from which airports derive revenue:

- **aeronautical activities:** activities that directly relate to providing services for aircraft and airline passengers, including runways, aircraft parking and terminals. Revenues for these activities are derived from the charges that the airport levies on airlines or passengers;
- **non-aeronautical (commercial) activities:** activities that are co-located with, but are not essential for, the production of aeronautical activities. Revenues from these activities are derived from concessions in the terminal (such as duty-free shops), car parking, car rental, or the provision of property-related services.

The distinction between till regimes relates to whether, and the extent to which, non-aeronautical activities are taken into account in determining the charges that the airport levies on airlines and passengers.

There are three possible till regimes we have considered (which are set out in detail in Oxera's key issues report).²⁵

1. **Single-till:** in a single-till regime, the costs and revenues of both the aeronautical and commercial activities of an airport are taken into account in determining the level of airport charges. The cost base includes the overall level of costs required to provide all services at the airport, not just those services for which charges are regulated. All commercial revenues are used to offset the cost base and therefore the charges to airlines. The RAB therefore comprises a combination of aeronautical and non-aeronautical assets.
2. **Dual-till:** in a dual-till regime, only the core aeronautical activities are taken into account in determining the level of airport charges, with the airport retaining all non-aeronautical revenue. Airport charges are derived on a stand-alone basis, so aeronautical revenues must cover only costs associated with aeronautical activities, including a reasonable return on those activities.
3. **Hybrid-till:** a hybrid till regime avoids the binary choice between a single and dual till, and instead considers which activities and/or revenues should be included in the till, and/or the extent to which commercial profits should be shared between the airport and users.

The Airports (Economic Regulation) Act allows for the adoption of any type of till regime.

NMIA has a single till. As part of the 2015 review, we proposed a single-till regime if traffic evolved in line with forecasts, although NMIA would be allowed to keep an increasing percentage of non-aeronautical revenue if traffic was above the forecast. For example, if traffic was 5% above the forecast, NMIA would be able to keep 5% of non-aeronautical revenue.²⁶ However, this has not been applied in practice and the airport is operating according to a single-till principle.

²⁵ Oxera (2017), 'Key issues for the 2020 rate review', 11 September, section 7.2.

²⁶ JCAA (2014), 'The 2014 Norman Manley Airport Economic Review Report', 18 November.

5.2 Analysis of till regimes

There is a considerable body of literature setting out the merits of different till regimes. Below, we highlight some of the key factors that are important to take into account when determining an appropriate regime. (Further detail can be found in Oxera's key issues report.)

- **Effect on charges.** One common justification for a single-till regime is that it leads to lower charges than a hybrid- or dual-till regime, as commercial revenues are used to reduce aeronautical charges. Proponents of a dual till often claim that the lower charges in a single till relative to a dual till do not necessarily lead to a benefit for passengers (the ultimate purchasers of the commercial goods) in terms of lower prices, particularly if the airport is capacity-constrained.
- **Economic efficiency.** It is often argued that there is a relationship between the prices of aeronautical and commercial services, such that a decline in the price of one leads to an increase in demand for the other. To the extent that this is the case, economic theory would suggest that the most efficient way for an airport to operate would be to set these prices together. This would imply a single till regime leads to the most efficient outcomes. However, in reality this relationship between aeronautical and commercial products is unlikely to be exact.
- **Ease of administration.** One of the commonly identified advantages of the single till is that it is relatively straightforward to administer, since it does not require cost allocation between aeronautical and commercial services. Under a dual or a hybrid till, it is necessary to define the activities that the regulated till would cover, in order to determine which costs and revenues should be taken into account when setting the price cap for airport charges.
- **Market power.** It is relevant to consider whether airports have significant market power (SMP) in relation to commercial activities in order to determine the appropriate till regime. But even if airports have SMP with respect to commercial activities, direct regulation of these activities or an overall commercial price cap could be more effective methods than a single-till regime.
- **Incentives for investment.** The choice of till regime may also have an effect on investment incentives in terms of both the level of overall investment and the type of investments undertaken.

5.3 The JCAA's initial position

While there are merits of both single- and dual-till regimes, we consider that a hybrid-till approach is the most appropriate regime for the next review. We consider this for a number of reasons. First, while aeronautical and non-aeronautical services are not perfectly complementary, there are likely to be some demand dependencies between the two. A hybrid-till regime may therefore be optimal in terms of economic efficiency, as it allows an airport to use some of its profits from non-aeronautical activities—those for which there is a clear direction of causation from aeronautical activity to non-aeronautical income—to contribute to the costs of aeronautical services without the complete cross-subsidy required under a single-till regime, or no cross-subsidy in a dual-till regime.

In addition, in determining the appropriate till regime it is important to take account of the commercial characteristics of the airports. There is scope for an

increase in non-aeronautical activity and revenue at NMIA. We consider that a single till would not necessarily provide the appropriate incentives for the airports to focus on this aspect of their businesses. At the same time, at the last review it was determined that NMIA is an expensive destination when considering taxes and charges. While this is mainly due to the taxes applied rather than the airport charges themselves, using a proportion of non-aeronautical revenue to reduce charges may be helpful in driving traffic growth at the airports.

We consider that there are three main options within a hybrid-till approach, as follows.

1. **Activity-based hybrid till.** Under this approach, some non-aeronautical activities would be included in the regulated till, while some activities would be excluded. The split could be based on activities that are perceived to be more related to aeronautical activities. For example, car parking might be included in the hybrid till, while retail revenue could be excluded. In this type of hybrid till, assets would need to be allocated to the regulated or the non-regulated till.
2. **Fixed revenue-sharing.** Instead of designating specific activities as within or outside the till, a fixed proportion of non-aeronautical revenue would be used to reduce the charges (i.e. included within the till).
3. **Dynamic revenue-sharing.** Rather than deducting a fixed proportion of non-aeronautical revenue, a certain amount could be deducted depending on the performance of other aspects of the regime. For example, as we set out at the time of the last review, the proportion deducted could vary depending on the airport's performance on traffic as compared with forecasts.

While there are no right answers to the proportion of profit-sharing that is appropriate under a hybrid till, it should strike a balance between leading to airport charges that are in line with those that would arise in a competitive environment, and retaining some of the positive incentive properties to invest.

5.4 Questions for consultation

We welcome responses from stakeholders to the following questions:

1. Do you agree that a hybrid-till regime is most appropriate for NMIA?
2. Which type of hybrid-till regime do you think is most appropriate for NMIA?

6 Setting the rates

6.1 Type of charge cap

As outlined in section 4.1, incentive regulation requires the regulator to set an ex ante charge or revenue cap, which companies are then incentivised to outperform.

Typically, regulated charges are expressed on a forward-looking basis in real terms—that is, they are adjusted for changes in price levels through a formula based on the principle of $CPI - X$, where CPI is the rise in consumer prices and X is an efficiency factor.²⁷

One important regulatory decision is whether the cap is set on revenue or prices. A price cap places the risk of actual passenger volumes deviating from forecasts on the airport. In a price cap, the airport stands to gain if passenger numbers are greater than those forecast, but it might not be able to earn its target rate of return if passenger numbers are lower than forecast. This is a commonly used approach at international airports, and is often referred to as a revenue yield cap.

An alternative approach would be to cap total revenues and allow prices to fluctuate in response to changing levels of demand. In this case, if demand is lower than expected then the price per passenger would need to rise in order to ensure that the airport earns the same level of allowed revenue. On the other hand, if passenger numbers are greater than expected then the price per passenger would fall. In all scenarios, the airport earns the same amount of overall revenue. This effectively transfers volume risk from the airport to the airlines and passengers. While this approach eliminates the potential for regulatory error or exogenous shocks to have an impact on the financeability of the airport, it also reduces the airport's incentives to grow traffic.

Given the difference in risk placed on the airport in a price cap vs a revenue cap, the choice between the two may also affect other parameters of the regulatory regime, such as the appropriate WACC.

6.2 Structure of charges

Once the allowed revenues and the price/revenue cap are determined, the way in which those revenues are allocated among users can be considered.

In the last rate review, we set the maximum price cap as well as the structure of charges. The increase in charges at NMIA was balanced across different elements within the structure of charges. Airports were then not permitted to change the structure of the charges for the duration of the rate review.

In a number of other regulatory regimes, airports are provided with the flexibility to determine, and change, the structure of charges within the overall charge cap set by the regulator. The changes are often limited to once or twice a year, and users need to be consulted in advance of any change.

The way in which charges are structured can have important implications for the type of traffic that is incentivised to use the airport. For example, higher charges at peak times than at off-peak times may incentivise airlines to shift to off-peak times. Similarly, charges could be set lower for the lower-demand

²⁷ It is also possible to have charges expressed in nominal terms, which means that the company bears all the risk of cost inflation in the economy varying from the levels used in the regulator's forecasts.

season than the higher-demand season in an attempt to encourage traffic throughout the year.

6.3 The JCAA's initial position

We consider that an approach that incentivises airports to achieve passenger growth is important. At NMIA, passenger numbers have not returned to the levels achieved in 2006/07. As such, and consistent with our current approach, we consider that a revenue yield cap should be put in place for the next review.

Traffic forecasts will therefore be an important part of the engagement between airlines and the airport, and in setting the charge control. We discuss the methods for forecasting passengers in our business plan guidance.

Within the overall cap, we consider that airports should be provided with flexibility to set the structure of charges and undertake periodic or annual rebalancing of airport charges within overall guidance from the JCAA. However, it will be important to ensure that the airports consult with users on any changes in the structure of charges.

Airports should also be permitted to offer airlines discounts below the maximum price cap. NMIA often works with other stakeholders, such as the Jamaica Tourist Board or the Ministry of Finance, on incentive schemes to encourage airlines to enter the Jamaican market. This should be permitted to continue. However, any charges and discounts must be set in accordance with ICAO's Doc 9082, which promotes four charging principles—consultation, non-discrimination, cost-relatedness and transparency.

6.4 Questions for consultation

We welcome responses from stakeholders to the following questions.

1. Do you agree that a revenue yield cap is most appropriate for the 2020 rate review? If not, please explain why.
 2. Do you agree that airports should be provided with the flexibility to set the appropriate structure of charges, subject to consultation with airlines and overall guidance from the JCAA?
-

7 Capital expenditure

7.1 Setting the RAB

It is important that the opening RAB for 2020 is clearly defined and valued as this will form the basis of the charges set for the next period. Regulators typically set the initial RAB value using one of the following approaches.

- **A market value approach.** This approach, which has been used to set the initial RAB in many regulated sectors, involves setting the value of the assets on the basis of the market value of the company at, or around, the time of privatisation, plus the book value of debt.²⁸
- **A depreciated replacement cost approach.** An alternative approach is to set the initial RAB equal to the cost that would be incurred if the existing assets were to be replaced with modern assets capable of providing an equivalent level of service, taking into account depreciation of the assets.
- **Derived RAB.** Determining the value of the RAB based on tariffs and other parameters (cost of capital, OPEX, CAPEX and asset lives) set at the time of the concession agreement in 2003, or based on the 2015 charge control, is another possible option for NMIA.
- **Indexed historical cost.** This approach takes historical costs from the airports' accounts, and applies inflation estimates to the assets in those accounts to revalue them in today's terms.

The initial value of the RAB will also be affected by the decision as to whether to include commercial activities in the regulatory till (discussed in section 5).

Our first reference for setting the RAB will be the RAB values available in the airport's regulatory accounts. These will be retained to the extent to which the principles and approaches used to set the value are consistent with regulatory best practice. Further guidance on this will be set out in Oxera's report on RAB valuation, to be published in the coming months.

7.2 Setting CAPEX forecasts

A core feature of the RAB–WACC model is its separate treatment of expenditure on infrastructure (CAPEX), such as a new terminal or pier, and expenditure on day-to-day running costs (OPEX), such as employee pay and maintenance costs.

CAPEX is added to the RAB and recovered over the assumed life of the asset. This has the effect of smoothing out the recovery of CAPEX over time and across users, and ensures that future generations bear a fair proportion of the costs associated with the construction of assets today that will benefit them in the future. Since the recovery of costs is spread out over the life of the asset, investors are allowed to earn a return on their CAPEX.

In determining the allowed revenue, the efficient level of CAPEX will need to be determined based on engagement with users or by us monitoring the processes the airports have put in place when procuring the work required to fulfil user requirements. This is consistent with our duty under the Airports

²⁸ Grout, P., Jenkins, A. and Zalewska, A. (2004), 'Privatisation of Utilities and the Asset Value Problem', *European Economic Review*, 48:4, pp. 927–41.

(Economic Regulation) Act to 'encourage investment in new facilities in time to satisfy demands by users of the airports'.

We note that we would expect the airports to engage with users on the schemes required and desired. Further detail about our approach to setting CAPEX forecasts for the next regulatory period, and monitoring delivery against these forecasts, is included in the business planning guidance.

7.3 Airport improvement fee

An important consideration in setting the baseline CAPEX is the AIF. The AIF is levied by the Jamaican government on international departing passengers and is to be used to pay for assets approved by the Minister of Transport and Mining. The fee will remain in place at NMIA until 2030. The AIF is not currently included in the RAB, and therefore the airports do not earn a return on this expenditure.

We consider that there are two main options for treatment of the AIF going forward, as follows.

- A division of the AIF between expenditure on which the airport is taking a financial risk and expenditure for which there is no financial risk. The AIF derived expenditure for which an airport is taking a financial risk should be added to the RAB and it may be reasonable to include a return on capital component in the charges. Other AIF expenditure might be included in the RAB, but would not earn a WACC. The mechanism for determining the quantity of AIF expenditure that contains financial risk and the quantity that does not would require further development. This designation would need to be subject to clear criteria.
- None of the AIF is included in the RAB.

Whichever approach is adopted, it will be important that contributions from the AIF to CAPEX projects are recorded, to avoid double counting in the CAPEX forecasts.

7.4 Dealing with deviations from CAPEX forecasts

While it is important to set robust CAPEX forecasts at the outset of the rate review, actual CAPEX may deviate from forecasts for a number of reasons.

- Changing circumstances/user preferences have rendered a previously agreed capital project uneconomic, or indicate that additional investment is required.
- The airport has underspent due to deferring/cancelling agreed capital projects, or overspent due to bringing forward projects/undertaking additional investment that was not agreed in advance.
- The airport has underspent or overspent while delivering the agreed programme as a result of external factors.

In these scenarios, there are mechanisms that could deal with the differences between forecast and actual CAPEX within the period or at the end of the period. In terms of the potential regulatory mechanisms that can be used to deal with deviations from plan within period, these are as follows.

- The potential for the airport/airlines to request, or for the regulator to trigger, a reopening of the price control. This might be linked to a threshold being

met (for example, traffic or costs deviating by more than x% from forecast). This is already a feature of the regulatory regime for NMIA.

- An agreed change control process for dealing with proposed changes to the capital programme within period. This might include obtaining agreement from a certain proportion of airlines (by passenger numbers), or a requirement to consult users.
- An adjustment mechanism that is agreed in advance. In the last rate review, we proposed an additional CAPEX mechanism, the Additional Capital Expenditure (ACE), although this has not yet been implemented in practice. Under this approach, we would be able to approve CAPEX during the rate review subject to following a pre-specified and published methodology. Any additional CAPEX approved by us would lead to an adjustment of the charges cap within period.
- Agreed triggers that link the point in time at which CAPEX is added to the RAB to project milestones being met (i.e. milestone-based remuneration). This can help to prevent airports from benefiting by deferring projects. This is similar to the interim review requirement set in 2009, whereby the airports had to demonstrate that there had been 'material construction commencement' in order for prices to be allowed to continue to rise for the remainder of the period.
- Agreed triggers that tie decisions (such as commencing design of a new project) to an agreed event (such as volumes reaching an agreed threshold).²⁹

There could also be a separate 'logging-up' or 'logging-down' procedure at the end of the review in advance of establishing the rates for the next period. For example, if an airport needs to spend more on a particular capital investment than initially allowed for by the regulator, and this additional expenditure is efficient, the regulator may allow (a portion of) this CAPEX in the RAB at the next rate review, by increasing the opening RAB for the following period.

It could also be the case that the airport has underspent or overspent while delivering the agreed programme as a result of efficiencies or inefficiencies. However, in this case we consider that the company would typically be required to bear the pain of any inefficiencies and retain the additional profits from outperforming on efficiencies. As such, no adjustments would be made.

7.5 The JCAA's initial position

Our first reference for setting the RAB will be the RAB values available in the airport's regulatory accounts. These will be retained insofar as the principles and approaches used to set the value correspond to regulatory best practice. Further guidance on this will be set out in Oxera's report on RAB valuation, to be published in the coming months.

We consider that it is important for the airports to establish robust CAPEX forecasts in line with the methodologies set out in our business planning guidance. However, we appreciate that CAPEX plans may change over the course of the period, for example to reflect a change in customer requirements. Therefore, we consider that it would be appropriate to include a mechanism for

²⁹ For example, a trigger was proposed for Dublin Airport Authority (daa) to automatically increase its price cap to allow for additional CAPEX once it reached 25mppa in any 12-month period, in order to allow it to incur planning costs for a second runway. The Irish Commission for Aviation Regulation (CAR) has since changed its regulatory approach to remuneration of the runway.

making adjustments within the period as well as at the end of the period (in advance of the next rate review) to take account of differences between actual and forecast CAPEX.

We welcome consultation responses on the appropriate approach to the treatment of the AIF in the context of the RAB.

7.6 Questions for consultation

We welcome responses from stakeholders to the following questions.

1. Do you agree with the JCAA's proposed approach for setting the RAB?
 2. Do you consider that there should be a mechanism for adjusting CAPEX within period? If so, which mechanism do you consider is most appropriate?
 3. How do you consider the AIF should be treated as part of the review?
-

8 Operating expenditure

8.1 Establishing baseline OPEX

A key input into setting the rates for the next period is a determination of the level of efficient OPEX that can be recovered. Our approach to setting appropriate OPEX forecasts is described in more detail in our business planning guidance. However, there are some aspects of our approach that would be useful to consult on at this stage and these are included below.

A company incurs OPEX costs in the day-to-day running of its business—e.g. rent, salaries, utility costs. OPEX is recovered in the year in which it is incurred, since this expenditure directly relates to providing a service to users today.

In order to set a target for efficient OPEX, it is important to consider which costs are within a company's control and which are predominantly driven by other factors. Controllable costs are OPEX items over which the airport operators have influence or a considerable degree of control. Uncontrollable costs are OPEX items where, while the airport operators may still have some degree of influence, public policy or market factors determine the level of costs that the operators have to bear to a considerable extent.

In general, most costs will be somewhat controllable, particularly in the long run, and we would therefore expect the majority of costs to be included in controllable OPEX. However, there are some costs that are likely to be uncontrollable, and for these costs partial or full pass-through may be warranted such that the airport does not bear the risk of actual costs deviating from forecasts.

One of these cost items is security costs. Security procedures are fixed by the Jamaican government and international requirements and security staff are provided by a government body (Port Security Corps). The airports have limited ability to determine the contractual terms. For this reason, we included a pass-through for any additional security costs relative to the forecast level as part of the last review. This pass-through reflects the nature of security expenditure, which is often outside the control of airport management.

We understand that NMIA collects operating expenses under the following categories set out in Table 8.1 below.³⁰ For each category we have identified the expense item as controllable or uncontrollable. We would expect to set efficiency targets only on the controllable expenses.

³⁰ Based on the financial model submitted by NMIA to the JCAA in May 2017.

Table 8.1 NMIA expenses

Expense line	Controllable or uncontrollable?
Staff costs	Controllable
Utilities	Controllable
Security	Uncontrollable
Repairs and maintenance	Controllable
Professional fees	Controllable
Concession fees	Uncontrollable
Other expenses	Controllable
Bad debt expenses	Uncontrollable
Irrecoverable GCT	Uncontrollable

Source: NMIA financial model.

8.2 Input price pressure

As at the last price review, the US market remains the most important market for NMIA.³¹ It seems appropriate, therefore, to continue to use US CPI as a measure for overall inflation at the 2020 rate review.

In addition to controlling for economy-wide measures of inflation it is also important to control for how the prices of specific inputs may differ. For example, wage costs might be expected to grow by 3% relative to inflation of 2%. If staff costs make up 20% of OPEX, then the net amount of inflation allowed would be 2.2%.³²

We consider that airports should submit evidence for areas of OPEX in which they consider that input price growth is likely to differ from US CPI. We would expect evidence submitted in support of an input price pressure claim to:

- clearly link expected price growth to credible economic indicators;
- explicitly link these prices to input factors;
- demonstrate that all possible steps to mitigate the impact of the price pressure available to management have been taken.

This is set out in more detail in our business plan guidance.

8.3 The JCAA's initial position

NMIA should provide submissions about the cost items that it considers to be controllable and those that it considers to be uncontrollable. To the extent that this differs from our classification, it would be helpful if NMIA could provide justification for its position.

We propose to continue to apply a pass-through mechanism for additional security costs above the forecast amount. For other uncontrollable cost items, we will not allow for a pass-through if forecasts differ from actual costs; however, there will be no efficiency target applied to these costs.

³¹ JCAA (2014), 'The 2014 Norman Manley Airport Economic Review Report', 18 November, p. 38.

³² 80% x 2% + 20% x 3%.

We propose using US CPI as a measure of general inflation. Evidence of input price pressure incremental to this should be submitted to us for consideration as part of the rate review process.

8.4 Questions for consultation

We welcome responses from stakeholders to the following questions.

1. Do you agree with our proposed classification of controllable and uncontrollable costs?
 2. Do you consider that the pass-through arrangement should continue for additional security costs above the forecast level? Are there any other costs that you consider should be subject to a pass-through mechanism?
 3. Do you agree with our approach to input price pressure?
-

9 Service quality regulation

9.1 Service quality performance

NMIA collects a significant amount of information about performance, which it submits to the AAJ and the JCAA. This includes comment cards—passenger satisfaction questionnaires administered and analysed by the airports on a periodic basis—and passenger satisfaction surveys undertaken by an external party (as required under the concession agreement). These look at:

- passenger satisfaction (for example, with respect to access, quality of airport facilities, flight information, and courtesy of staff);
- baggage-handling indicators (such as delivery and waiting times for luggage);
- availability and repair times for airport facilities (such as elevators and conveyors).

There are minimum and target mean scores set for each area.

In 2017, Oxera analysed NMIA's performance on service quality since the last time this was reviewed by the JCAA in 2009.³³ Overall, Oxera found that passenger satisfaction at NMIA was high, but its performance on key indicators was not always at or above targeted levels. Across all main areas (passenger satisfaction surveys, baggage-handling indicators, availability and repair times), a non-negligible proportion of indicators did not meet the minimum requirements.

9.2 Incentivising service quality improvement

The Airports (Economic Regulation) Act specifies that we should carry out our functions in a manner that will 'ensure that the airport is operated in accordance with performance standards and service levels consistent with best industry practice.'

While we do not currently undertake formal service quality regulation of NMIA, there are a number of safeguards/monitoring processes in place:

- NMIA and the AAJ have noted that they review the data collected on service quality performance and take corrective action if they are performing poorly;
- the JCAA collects the service quality data from NMIA;
- if NMIA's performance falls below levels established in the concession agreement, this would be considered a breach of the agreement.

Several regulators, in the aviation sector and across sectors, have looked to implement service quality incentives in addition to, or as part of, price controls. Such incentives have been introduced for different objectives: shielding customers from unexpected failures in service; safeguarding current service levels; raising current service levels to, or above, those of competitors; or differentiating the service package provided by the airport from its competitors in terms of its scope or style.

³³ Oxera: analysis of past performance.

9.3 The JCAA's initial position

Given the number of issues that need to be considered as part of this rate review, the generally satisfactory level of service quality performance at NMIA, and the fact that there is already some degree of monitoring (for example, reporting to AAJ and minimum standards in the concession agreements), we do not consider that introducing formal service quality regulation (i.e. financial incentives to meet or beat service quality targets) is a priority for the 2020 rate review.

However, we note that at the time of the last review, there were a number of areas where NMIA's performance was below the minimum acceptable levels and therefore there was room for improvement.

As a result, we consider that it may be appropriate to introduce a reputational incentive, whereby, for example, the airports would be required to publish their service quality performance each month in the airports and on their websites. This would lead to some level of monitoring and oversight, but without a high degree of intervention. However, we note there may be some indicators, for example with respect to asset availability, where it would be appropriate for us to take more of an enforcement role if they fall below minimum standards.

We note that our recommendations in this area may have implications for other aspects of the price control—for example, targeting higher levels of service quality may require new capital investments and higher OPEX.

9.4 Questions for consultation

We welcome responses from stakeholders to the following questions.

1. Do you consider that the use of a reputational incentive approach to regulating service quality is appropriate? Please explain why or why not.
 2. If you do not consider that a reputational incentive is appropriate, what would you propose as an alternative?
 3. Which service quality measures do you think should be reported under the reputational incentive proposed?
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10 Conclusion

This consultation document has set out the process, key themes and relevant issues for the next rate review of NMIA. We are seeking views from interested parties on all of the issues discussed in this consultation document in advance of finalising our proposals for the regulation of NMIA for QQ2. We also welcome input on issues that have not been addressed in this consultation document, but which stakeholders consider to be important to take into account.

A1 Questions for consultation

We have set out the questions on which we are seeking stakeholder engagement throughout this document. These questions are summarised, by topic, below.

Stakeholder engagement

1. Do you consider that the proposed process for stakeholder engagement is appropriate?
2. Do you agree with the key principles set out to guide stakeholder engagement? Are there other principles that should be considered?

Form of regulation

1. Do you consider that incentive regulation based on a RAB–WACC building blocks approach is the most appropriate regulatory approach for the 2020 rate review? If not, what form of regulation do you consider would be more appropriate given the JCAA's duties, and why?
2. What methodology do you think is most appropriate for setting asset lives and depreciation profiles?
3. Do you agree with the JCAA's proposed approach for determining the WACC?

Till regime

1. Do you agree that a hybrid till regime is most appropriate at NMIA?
2. Which type of hybrid till regime do you think is most appropriate for NMIA?

Setting the rates

1. Do you agree that a revenue yield cap is most appropriate for the 2020 rate review? If not, please explain why.
2. Do you agree that airports should be provided with the flexibility to set the appropriate structure of charges, subject to consultation with airlines and overall guidance from the JCAA?

Capital expenditure

1. Do you agree with the JCAA's proposed approach for setting the RAB?
2. Do you consider that there should be a mechanism for adjusting CAPEX within period? If so, which mechanism do you consider is most appropriate?
3. How do you consider the AIF should be treated as part of the review?

Operating expenditure

1. Do you agree with our proposed classification of controllable and uncontrollable costs?
 2. Do you consider that the pass-through arrangement should continue for additional security costs above the forecast level? Are there any other costs that you consider should be subject to a pass-through mechanism?
 3. Do you agree with our approach to input price pressure?
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Service quality regulation

1. Do you consider that the use of a reputational incentive approach to regulating service quality is appropriate? Please explain why or why not.
 2. If you do not consider that a reputational incentive is appropriate, what would you propose as an alternative?
 3. Which service quality measures do you think should be reported under the reputational incentive proposed?
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