Airport Ownership, Management and Price Regulation

Report prepared for:

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1.0 Introduction

1.1 A Change in Policy

Governments around the world have been making profound changes in how their airport and port facilities are owned and managed. With the exception of the United States, most airports around the world historically were owned and managed by federal governments. However, this ownership and operations policy began to change in the mid 1980s. Air transport is a growth industry. Generally, the number of passengers carried by airlines grows at a rate double that of world economic growth. Cargo has grown at more than triple the rate. (See Figure.) This poses a challenge for the owners of an airport: as a pro-cyclical growth industry, there is a need for continual investment. If the airport is government owned, then there will be a never ending call for increasing amounts of investment.

In the 1980s, governments around the world faced enormous pressures from taxpayers, (or the International Monetary Fund in the case of developing countries) to control (i.e., reduce) government deficits. Priorities were established for government spending. Typically, airports fell to the bottom of the list. This sector was considered to be a mature industry and one which served a more affluent customer base.

The United Kingdom was the first country to adopt a new policy. In 1987, it sold its federal airport system. British Airports Authority plc. (now BAA plc) was formed from the three major London airports plus four others and was floated on the market. It is now a purely private sector enterprise. The newly privatised company immediately began to make major investments, it changed a number of operating policies to become more efficient and customer service focussed and it aggressively pursued development of non-aviation commercial revenues. Its common shares rose four fold in value in a short period. Its financial performance has been so strong that in the 1990s it was subjected to a special windfall profits tax. Yet, at the same time, it has led the world in reducing aeronautical charges. So strong has been its performance that there is now concern that landing fees will drop to zero – not a desirable policy for congested airports.

In the 1990s, governments across the world have been following suit and privatising their airports, either as systems or as individual airport companies. The trend has been so strong that paradoxically, the United States will soon become the only nation with a socialist airport ownership policy.
1.2 A Multiplicity of Privatization Models

Several different models have been used for transferring airports from government operation. They all achieve the primary objective of obtaining access to private sector financial markets for investing to meet the constant need for capital renewal and expansion. But they differ in several important respects including: ownership; for-profit versus not-for profit orientation; regulatory oversight; and subsidisation.

Some examples of airport ownership/operational models in use today include:

- United Kingdom: Pure private sector (for profit) ownership and operation.
- Canada: Private not-for-profit airport authorities leasing land on a long term basis from the federal government.
- Australia: Pure private sector (for profit) operation, but with a long term lease of land from the federal government.
- Chile: Pure private sector (for profit) operation of the international terminal via a medium term ground lease. Federal operation of the airfield and domestic terminal.
- Germany, New Zealand: private sector (for profit) operation and ownership of the airport but with local governments as minority investors. No federal investment.
- New Zealand has a unique situation in that its federal airport charters do not require continued operation as airports. Technically, an airport company could convert the land and buildings it owns to other uses.

1.3 Purpose of this Paper

This paper describes alternative institutional structures for the ownership and operation of airports. It covers how different nations have embraced the issues of ownership, operation, regulation, governance, transparency, economic guiding principles, alternative conceptual approaches to pricing structures and price regulation, and design of airport policies. The paper reviews the following elements:

- Alternative ownership and governance regimes for airports, including the various types of airport devolution in Canada (large NAS airports, small NAS, local/regional – NAS airports are leased whereas local/regional airports are fully transferred) as well as key exemplars elsewhere in the world.
- Alternative regulatory regimes for airports.
- How different countries chose their models for airport management/regulation/governance.
International exemplars of each of the key models.

The paper is organised as follows. Section 2 describes alternative airport governance models. Section 3 examines capital financing under the alternative models. This is followed in Section 4 by a discussion of price regulation of airports. Included is a discussion of emerging views which are now re-examining whether single till price cap regulation of airports in the UK achieves the economic efficiency objectives set for it, or whether it is achieving the opposite.

Section 5 then turns to the airport models chosen for Canada. It compare the ownership, governance, regulation, etc. policies of the various airport formats used in Canada. Comparisons are also made to models used for ports and air navigation. Section 6 supplements some of the discussion raised in the previous sections by looking at the issue of competition among airports. Chapter 7 provides some conclusions.
2.0 Airport Governance Models

There are several different governance models being used to operate airports. In many countries, airports are still the responsibility of some level of government either directly, by the Department of Transport, or indirectly, by an agency or corporation. Elsewhere, models embrace some degree of privatization such as the Airport Authority model or private corporation governance. The major models are summarised below.

2.1 Operation by Federal Government Department

This was the model used in Canada and has been the traditional model in most other countries, with the Federal Government owning and operating airports. Typically, airports are the responsibility of a Department/Minister of Transport.\(^2\) The Department will generally oversee regulation, air traffic control, air navigation and in some case operation a national airline in addition to airport operations.

Many of the world’s airports started as government operations. Some current examples include Greece, Sweden and many of the centrally planned economies. Interestingly, many U.S. airports use the government department format, but with a municipal government rather than the national government.

Given the public ownership of the airports, theoretically there should be direct accountability of the airport to the public and to users. However, this has not always been the case. There can be significant inter-governmental jurisdictional issues, with federal operation being accused of being insensitive to local needs or concerns. Also there is not always transparency in decision making, as many federal cabinet and government decisions are made behind closed doors. Appeals are conducted through political intervention. A major criticism of this model is that policy driving the system is often poorly articulated or understood. As well, investment is dependent on the political process or other budget priorities, potentially resulting in serious under investment in airport infrastructure.

2.2 Operation by Municipal and Quasi-municipal Governments

This model has been unique to the U.S. Many airports, large and small are run directly by the city as an administrative department. Chicago, San Francisco and Los Angeles are examples. As well, there are cases of county operation of airports: Milwaukee and Miami (Dade County). Alaska and Hawaii have state run airport systems, a legacy of the era when they were territories rather than states. In some cases city run airports establish boards which provide an advisory role. San Francisco is a good example where a board has been established. However, the board has limited powers and is specifically excluded from day to day operations.

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\(^2\) Some governments assign responsibility for air transport to other portfolios. South Africa and Peru had operated their airports for a period as part of the Department of Defence. Other examples exist with airports being the responsibility of a Department of Communications or a Department of Investment or Public Works.
day operation decisions of the airport. City Council and the mayor are the ultimate decision makers.

Some U.S. airports are operated by authorities, some of which should be considered as an independent level of government or as quasi governmental. The Seattle-Tacoma airport is operated by an elected port/airport authority. This authority has taxation powers, which are enabled by its elected governance model. Orange County airport has zoning power, while Reno has veto power over local zoning decisions.

Some examples of alternative airport governance models in the U.S. are provided in Table 2-1.

**Table 2-1: Examples of U.S. Airport Governance Models**

<table>
<thead>
<tr>
<th>Direct Government</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>County:</strong></td>
<td></td>
</tr>
<tr>
<td>Milwaukee County</td>
<td>airport governed by County Board of Supervisors - publics works committee</td>
</tr>
<tr>
<td>Airport</td>
<td>consent (consolidated) motions</td>
</tr>
<tr>
<td><strong>City:</strong> SFO</td>
<td>airport board only sets policy</td>
</tr>
<tr>
<td></td>
<td>excluded from day to day operations</td>
</tr>
<tr>
<td><strong>State:</strong></td>
<td>State depart of transportation operates major airports in the state</td>
</tr>
<tr>
<td>Hawaii, Alaska</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Quasi-Government</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Seattle: Port of Seattle Commission</td>
<td>Elected, Taxation Powers</td>
</tr>
<tr>
<td>Reno</td>
<td>Airport has veto power over local zoning decisions</td>
</tr>
<tr>
<td>Orange County</td>
<td>airport has zoning powers into community</td>
</tr>
<tr>
<td>Path NY, NJ</td>
<td>governors can veto decisions of board</td>
</tr>
</tbody>
</table>

Some believe that the municipal model provides a high degree of accountability and transparency. However, within the U.S. model, airport governance varies significantly in terms of governance structures, the degree of transparency, powers and accountability. As an example, airport issues are dealt with in a consolidated consent motion at the monthly meetings of the County’s board of supervisors. A review of minutes reveals little discussion or debate of airport management policies or decisions. Few U.S. airports provide financial statements to the public.
Federal regulation of municipal airports is limited in the US. The Federal Aviation Administration was awarded powers by congress to regulate the prices of U.S. airports. By and large, they have not exercised these powers as there is not much to be gained by regulating a government operation as not-for-profit governance lacks the incentives for airports to attempt to set unfair prices. To date the few rulings that have been made were focussed on the transfer of airport revenues to cities.

Like other government operation of airports, financing needed airport infrastructure can be problematic as it depends on political decision making, and because local governments have limited funds and priorities which place airports low on the list. This has been dealt with in part by three major policies.

2. U.S. airports have utilised bond guarantees from the airlines using their airports in order to obtain low interest rates and the ability to obtain higher debt : equity ratios than would otherwise be possible. This has been at a significant cost. Airlines insisted on veto power over airport capital programs, and at least in some cases, have used this to prevent developments which would have enhanced airline competition.

3. U.S. airports qualify for municipal status and can issue bonds which are free from income taxes. This is a form of subsidy, whereby the general U.S. taxpayer must face higher tax rates than would otherwise be the case so that airport users can enjoy lower taxes. While airport users are part of the taxpayer base, the result is a net transfer from non-airport user taxpayers to airport users.

4. The U.S. federal government has established a tax on airline tickets whose proceeds are used to provide capital grants to airports. The grants to airports are not in proportion to the tax revenue their ticket base provides. In general, the system is believed to result in a net subsidy from large to small aviation markets.

With regard to the first policy, it has been recognised by the U.S. congress that airport conditions have prevented rather than enhanced airline competition. In 2000, it passed a law requiring airports to have competition enhancing plans in place in order to qualify for grants. Further, it now allows grant applications for capital projects whose purpose is to provide facilities to accommodate competitor carriers. It should be noted that operation of airports in the U.S. airport has often given air carriers exclusive use of airport gates and ticketing facilities. In some cases this results in overbuilding of terminal capacity, as many exclusive use facilities have low utilisation rates.

2.3 Operation by Government Agency

This is a variation of the Government Department format. In this model all aviation matters are assigned to a semi-independent government agency, rather than being a direct responsibility of the Department/Minister of Transport. The department is responsible for the establishment of broad policy toward aviation, but the Agency is responsible for day to day establishment of regulations as well as operations.
Spain presents an example of airport operation via the Agency format. In this case, the agency is only responsible for airport/airway/air navigation operations, with the Department retaining regulatory powers.

2.4 Operation by a Government Corporation

This format vertically separates the airport system by disconnecting operations from regulatory functions. The Department of Transport retains direct responsibility for the establishment and enforcement of regulations for airports but operations are assigned to a government owned corporation, eliminating conflict of interest. Although the corporation will report to the Department of Transport, it has a degree of independence due to its corporate structure. While a departmental operation requires that all airport expenditures must go through the annual government budget review process, a government corporation has some independence in its financial planning. In some cases the government corporation has the ability to issue bonds to finance major projects, removing it somewhat from the vagaries of the federal budgeting and political process.

A number of examples of airport management by government corporation exist. One is the Aeroports de Paris (ADP). In this case, the French national government has determined that the two major airports in Paris are of national importance and operates them via ADP. (Other French airports are managed locally.) In Australia the Sydney airport is operated by a government corporation, although this is a temporary situation pending privatisation of the airport. Nevertheless, the Australian airports were operated for some years (prior to privatisation of all but Sydney) as the Federal Airports Corporation.

While some airport corporations are wholly owned by the national government, others are jointly owned by federal and local governments (e.g., Germany, the Netherlands).

2.5 Airport Authority

The Airport Authority terminology is one which has some ambiguity to it. It is used in Canada as a private sector corporate alternative to the government corporation. In the US, the term airport authority is used for a quasi governmental operation model.

In the US, there are airport authorities whose board members are elected and may have taxation, zoning and other powers. Others are appointed by local government (either an elected mayor or by an elected city council) and may have zoning or other powers. In both cases, airport financing can have guarantees, either based on the taxation powers of the authority, or a guarantee from the appointing municipal government. In this paper, these authorities are properly considered as variations of municipal government operation.

Here, the airport authority governance concept is that of a private sector corporation which operates an airport. To distinguish the airport authority concept from the private corporation concept discussed later, the term is applied to the governance model where the private sector corporation is not-for-profit, and thus has no shareholders (or shareholder paid in equity).
There are some significant differences between the government corporation format and that of the private not-for-profit airport authority model. First, the selection of members of the authority’s board of directors will vary from the government corporation format. Government corporations typically have boards which are appointed by the government and who serve at the pleasure of the current government. Authorities have an independent board selection process. For this reason, authority boards tend to remain in place when there is a change in government, providing an important element of stability to private corporate governance. Second, authorities have financing which is totally independent of government. Crown corporations almost always have either loan guarantees provided by government, or clauses which make the amount immediately due if the ownership status of the airport changes.

This not-for-profit airport authority model is unique to Canada. Canadian airport authorities operate with virtually no federal assistance or subsidy. To the contrary, with required ground lease payments (as the federal government retained ownership of the land), the private not-for-profit authorities have become a source of significant general treasury revenues for the federal government. No regulatory oversight is currently in place in Canada. (E.g., there is no formal appeals mechanism to deal with disputes arising between authorities and their tenants).

2.6 Joint Government/Private Corporations

Here, the airport is governed via the corporate format, but there is some private participation in the ownership of the airport. Partial private ownership introduces a number of changes to corporate governance. First, the private shareholders vote for a number of members of the corporation’s Board of Directors, giving the Board some stability when governments change. Second, with private ownership (possibly publicly traded), the airport corporation’s reporting and disclosure requirements become more strict. Third, the private sector ownership, even if only partial ownership, gives the airport a much more commercial orientation. The private sector investors will be looking to earn a rate of return on their investment. This often manifests itself in greater incentives for cost control and efficiency, as well as in the pursuit of new revenue opportunities.

Copenhagen and Vienna have recently floated equity to private sector investors, with the governments retaining a slight majority interest. Rome’s airport corporation was an interesting variant, as for a time the major private sector owner was the national airline, Alitalia, although this could also be viewed as a variant of pure government ownership.

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3 The Board members of the airport authorities in Canada are generally appointed by local community organisations. The Vancouver International Airport Authority is a good example, with Board members appointed by groups such as Chambers of Commerce, Professional Engineers Society, etc., as well (non-elected official) appointments by three local governments. Various levels of government may have the opportunity to appoint authority board members, but the board members, once appointed, have a fiduciary responsibility to the airport authority corporation. As well, authority boards are constructed so that changes in a government will not result in a change in the majority composition of an airport authority board.

4 Some of Canada’s airport authorities were provided with either a capital grant or financing through postponement of ground rent payments, as a transitional matter to accommodate capital investment while the authority established its own operation and financing status.
2.7 Private Corporation

When the airport corporation is wholly owned by a private for-profit corporation, the airport may be publicly traded with ownership dispersed among a number of shareholders (e.g., BAA plc which operates the London UK airports, among others), or closely held (e.g., TradePort Corporation which leases and operates the Hamilton Ontario airport). Variations exist regarding ownership versus lease. In some cases, the private corporation may own the airport lands and facilities outright (BAA plc), or may simply lease the land on a long term basis (Hamilton Ontario). Leases may be pay-as-you-go (Hamilton Ontario) or prepaid (Melbourne, Brisbane and Perth in Australia). The issue of lease versus ownership is important in determining whether the government has any residual liabilities, or whether it can step in and immediately operate should an airport file for or be brought into bankruptcy. As well, lease versus ownership has implications for land development, as tenants of the airport corporation will require assurances from the government landlord that leases will be honoured should the government landlord re-assume control of the property.

A number of examples of private operation of airports have been given (BAA plc, Hamilton’s TradePort International, and the private sector operators in Australia). Tokyo’s domestic airport (Haneda), the busiest airport in Asia, is another example.

There are a number of variations of private sector airport operation. Table 2-2 provides some examples. Two variants are worth noting.

Private Sector: Build-Operate-Transfer (BOT). This format uses the private sector for short to medium term development of needed airport infrastructure. The private sector finances and builds either all airport infrastructure or a single needed project (such as a terminal). In exchange it is given the right to operate the airport (or terminal) for a period of time sufficient to allow it to earn revenues to cover the costs of the project and to earn a return on their investment. The government will retain regulatory powers, and might also regulate the airport’s rates and charges.

While BOT has been widely used in other infrastructure industries, it is a new development in airport financing and management. Nevertheless it promises to become a format of increasing popularity. This structure solves the immediate problem of financing needed airport infrastructure, while retaining government ownership of the infrastructure in the long term.

Private Sector: Separate Operation of Terminals. At some airports, individual terminals may be operated by private sector investors. A common format is for airlines to develop their own terminals. Many U.S. airports use this format, especially for domestic terminals. Examples include United Airline’s terminal at Chicago, and the various airlines’ terminals at New York’s JFK. In Australia the two major carriers (Ansett and Qantas) own and operate their own domestic terminals at all major airports, but share common use facilities for international flights. There are also examples of non-airline private sector operation of

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5 This issue of the bankruptcy of an airport corporation is a hypothetical one, as there is no case of a major airport becoming bankrupt.
6 Haneda has been privately operated since 1952.
terminals. Toronto’s Terminal 3 is a widely cited example.⁷ Many of the recent BOT developments, especially in Asia, are for terminals within an otherwise government operated airport facility. Examples, among others, include Wuhan China and Suribaya Indonesia.

⁷ Terminal 3 started as a private sector operation at a Government (departmental) airport operation. With the transfer of the Toronto airport to a local airport authority, that non-profit independent authority has inherited a for-profit private corporation operating within its jurisdiction.
Table 2-2: Examples of Private Sector Operation of Airports

<table>
<thead>
<tr>
<th>Private Sector Operation</th>
<th>New Zealand</th>
<th>Auckland International Airport Co</th>
<th>Australia Privatization 1996-present</th>
<th>UK</th>
<th>Costa Rica</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Privatisation of federal shares to general market, some cities own minority shares</td>
<td>• first responsibility to shareholders</td>
<td>• Individual airports</td>
<td>• BAA privatised 1987</td>
<td>• Privatisation 1998 to consortium</td>
</tr>
<tr>
<td></td>
<td>• Sale of lands, terminals, etc.</td>
<td>• airport operation is 2nd</td>
<td>• Lease of lands, terminals, etc. to consortiums, not general market</td>
<td>• Stock float to general market</td>
<td>• Lease of lands, terminal, etc.</td>
</tr>
<tr>
<td></td>
<td>• No regulatory system in place but legislative authority exists</td>
<td>• no price regulation but required consultation</td>
<td>• Competition is preserved between airports</td>
<td>• Sale of lands, terminals, etc.</td>
<td>• Regulatory System in place (RPI-X)</td>
</tr>
<tr>
<td></td>
<td>• Airports not required to use land for airport use</td>
<td></td>
<td>• Regulation of prices and access</td>
<td>• No competition between LHR, LGW, STN, SOU</td>
<td>• Bidders included X in bid - low price but high X vs. high price low X</td>
</tr>
<tr>
<td></td>
<td>• Replacement (not historical) costs required</td>
<td></td>
<td></td>
<td>• Price cap regulatory system</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Proper economic signals</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

2.8 Choosing an Airport Governance Structure

Why have different airports chosen different governance policies? Here I put forth a person view as to the choices made by governments since the 1980s.

First, the UK privatised its airports in the context of a much broader policy of privatisation. This was a general (and major) philosophical thrust of the Thatcher government. Airport privatisation followed other privatisations and adopted their private for-profit governance structure. While not all privatised UK companies were subjected to subsequent price regulation, BAA (and Manchester) were price regulated utilising the price cap model employed in sectors such as telecommunications. There were two broad objectives of the privatisation program. First, the philosophical view that many government enterprises would be more efficient in private hands. Second, sale of these assets would generate proceeds for the national treasury. The latter favoured sale of rather than lease of the assets.

Canada was the next major country to transfer airports from federal operation. This was originally motivated by a combination of the desires of local communities for control of these
important economic assets and by the unavailability of treasury funds for needed investment. At the time, the only experience with transfer to private sector operation was the UK and this experience was only a few years in making. There were apprehensions as to whether private sector operation would be successful in Canada, hence the adoption of both an intermediate format of not-for-profit but private corporate format, and the decision to lease rather than sell assets. Generation of immediate funds for the treasury was not a motivation and pay-as-you-go leasing was acceptable. Regulation was not put in place as its role and effectiveness with not-for-profit governance was viewed as minimal.

Australia undertook a major privatisation program of its airports. By this time, the success of the UK model was apparent (but Canada’s experience was too short). As well, generation of funds for the treasury was desired. A for-profit structure was adopted with regulation. In a variation from the UK model, the decision was made to lease rather than sell the assets, but leases were to be pre-paid. This had the subsequent advantage of eliminating the opportunity for airports to advocate for changes in lease terms.

In countries such as New Zealand and Germany, airports had already been corporatised but with government ownership. Ownership was shared between levels of government. The consequence was that privatisation would involve sale of the federal shares of existing corporations. Like the UK and Australia, this produce a major up-front cash payment into the federal treasury.

In Latin America and in some other developing countries airport privatisation was essential due to the inability to finance needed expansion of infrastructure which was vital to national economic growth. This was not a philosophical undertaking as in the UK. Thus long term leases or outright asset sales were not favoured. The governments wanted to kick-start airport development but not surrender their long term interest and options. As a result the build-operate-transfer model was used, generally with terms in the 15 year range.

The United States has not yet embraced privatisation. There are a number of reasons for this. Perhaps of major significance is that privatisation would result in loss of tax free bond privileges. As well, in the U.S. airline users exercise considerable power over airport decisions and the potential loss of these with private sector operation results in strong opposition to privatisation. It is interesting that even the Airport Council in the U.S. opposes privatisation.
3.0 Alternative Governance Models and Capital Financing

In considering alternative airport ownership and governance structures, two key dimensions which should be considered are:

• the means by which airports are expected to meet their financial requirements and
• their degree of independence in setting prices.

Some models make it exceedingly difficult for airport management to find financing for capital investment. Some models require significant regulatory oversight with respect to prices. This chapter looks at airport financing issues, while chapter 4 examines airport price regulation.

3.1 Capital Financing Under Operation by Government Department or Agency

When the airport is the responsibility of the Department/Ministry of Transport, capital investments are financed via the regular government budget process. This places a significant financial burden on the government and its taxpayers, and may cause necessary airport infrastructure investments to be postponed as airport investment would be subject to other developments.

For the airport, capital financing becomes problematic. Needed investments must be considered in light of other government priorities. If airport priority is low relative to other needs, or if the government is under pressure from voters to reduce expenditures, then airport investment will suffer. This is especially challenging as air transport grows between double (passenger) and triple the rate of economic growth. Thus airports require ever increasing expenditures.

In Canada, the inability to finance needed expansion was a major factor in the 1987 policy to transfer airports to local airport authorities, on a voluntary basis. As well, it was a factor in the policy to allow private sector development of passenger terminals at Toronto’s Lester B. Pearson International Airport. Terminal 3 was built by a private sector consortium on a BOT basis, and plans were in place to have a private sector group redevelop terminals 1 and 2.

3.2 Capital Financing Under Not-For-Profit Airport Authority

Under this governance structure, how the financial requirements of the airport are met depends on whether the authority is established with any initial equity capital.
No initial equity provided by the government.\textsuperscript{8} If the Authority is established without an initial government equity infusion, then needed investment could be delayed due to a lack of funding. Lenders are uncomfortable (i.e., unwilling) to extend 100\% debt financing to a major organisation, especially one which is newly formed. In order to be able to obtain financing for a major project, the corporation/airport will first need to establish a base of equity capital. Since raising of equity capital via the issuance of shares is precluded by these two formats, the only source of equity financing is retained earnings.

The need to assemble retained earnings is somewhat paradoxical. In the absence of initial paid in equity capital, it can only be built from profitable operations. However, the authority is a not-for-profit organisation, suggesting that assembling retained earnings is, by definition, impossible. In Canada, not-for-profit status does not forbid the earning of a profit. Instead, it merely implies that any net earnings must be reinvested in airport infrastructure.

Nevertheless, the need to build a base of retained earnings can lead to postponement of necessary capital investment. Even in the best cases, it will take several years to build sufficient equity through retained earnings in order to establish the base needed to obtain partial debt financing. Even worse, if an airport authority is confronted with an initial situation of costs exceeding revenues, the delay of needed investment will be even longer. Ironically, the generation of new revenues may require new investment, and the lack of equity capital limits the ability to finance that investment.\textsuperscript{9}

One means to deal with this problem is for the airport authorities to increase fees on users in order to generate a much faster growth of profits and equity. However, globally established pricing principles for aeronautical charges (fees assessed on airlines for use of runways and terminal gate and ticketing facilities) prevent charges in advance of the capital being put into productive use.\textsuperscript{10} Thus charges on air carriers are not a source of an initial build up of equity.

In Canada, airport authorities have dealt with the problem by implementing charges directly on passengers in advance of capital investments being put to productive use. The Vancouver International Airport Authority was the first to do so, and called its fee an airport improvement fee (AIF). While the airport financial managers differ somewhat in the accounting treatment of these fees, in effect these are revenues collected with no offsetting cost. Hence they flow to profit and loss statements as a form of net profit. On the cash flow statement and balance sheets these net profits appear as increases in retained earnings (or as increases in a “reserve” account for future capital projects).

\textsuperscript{8} The Canadian airport authorities have all been established without any initial equity capital.

\textsuperscript{9} For example, the ability to open new retail concessions may require expansion of the terminal due to full utilisation of existing space.

\textsuperscript{10} IATA, ICAO and ACI all have airport pricing principles. While the three differ somewhat, all embrace the concept of cost based aeronautical charges. Cost based principles require that capital be put into productive use prior to entering the cost base.
While some are tempted to label these fees as taxes, others point out that they are really user charges -- taxes are inescapable, but airport fees can be avoided by deciding not to travel or using an alternative airport or mode of transportation. One economist described these fees as: “mandatory mutual society equity investment fees.”

Similar charges on cargo users have been considered by at least some airport authorities, but have been rejected due to the high degree of price sensitivity (elasticity) of shippers. It is observed that small differences in shipping costs per ton lead to trucking air cargo to alternate airports.

**Government provides some initial equity capital.** If the government provides the authority with sufficient equity, the airport is in a more favourable position to begin negotiations with potential lenders for financing needed investments. Even if not sufficient to launch large capital programs, it will shorten the time period or may allow some initial investment to take place.

### 3.3 Capital Financing Under Government Corporation

A government corporation could face similar constraints on its ability to finance its infrastructure investment program depending on willingness of the government to provide initial or subsequent equity capital. However, a government corporation generally has the advantage of being able to obtain government guarantee of its debt. This guarantee gives sufficient comfort to lenders to allow them to provide high amounts of debt.

### 3.4 Capital Financing Under Private-Government Corporations

The key advantage of mixed enterprise forms is that the private sector investor can provide all or part of the initial equity needed to kick-start the financing process. In return, the private sector investor must be given an opportunity to make a reasonable return on their investment in the airport. This allows the airport to proceed with investments without a burden on the government treasury. The key issue in mixed enterprise is the degree of risk to the private sector investor from government pursuit of non-commercial objectives.

### 3.5 Capital Financing Under Private Corporations

Private sector airport operation enjoys the ability to raise equity capital at any time (or at any time that is profitability and balance sheet supports it). The record is such that airports transferred to private sector for profit corporations typically have been able to immediately undertake significant capital programs. By raising equity via public or private placements, major capital projects have been undertaken. A good example is the Santiago (Chile) airport where the private sector consortium which won the bidding for the airport were immediately able to finance the construction of a major new international terminal. The consortium was established with adequate equity capital (a requirement of the bidding process).

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11 The Washington (D.C.) Area Airports Authority was established when the U.S. federal government transferred the only two airports it had operated. The government transferred the airport with an initial position of $50 million in equity. The Authority acquired the assets (including equity capital) for $1.
The principle risk to the private for profit corporation is from price regulation. If regulation is not designed or executed properly, the private sector operator will fail to earn a return sufficient to either build retained earnings or to attract additional equity capital. Price regulation is the topic of the next section.

**3.6 Sustainability and Airport Size**

An important question of airport economics is whether there is a minimum size at which an airport is self financing. This is a very difficult question to answer since airport markets have been severely distorted by government operation and subsidy. In the mid 1980s, for example, an internal task force set up within Transport Canada to examine whether airports should be privatised/transferred was confounded by the fact that Transport Canada had not maintained a set of accounts for individual airports which would have allowed such determinations. Capital projects, for example, were financed separate from operations. Some revenues accrued to the national treasury and not to individual airports. As well there were important cost categories which were centrally managed. The federal government self insures. Accounting, finance, training and some marketing services were centrally provided.

In most of the world, airports were operated as national systems until recently, with inadequate accounting to enable proper cost determinations. In the U.S., where airports were always locally operated, large subsidies (direct or via tax free municipal bond financing) airport accounts were distorted by the exclusion of important parts of capital investment.

The result has been a lack of meaningful data which would enable economists to conduct studies of economies of scale, minimum efficient size, etc. As well, there are many factors which a cost analysis would need to control for. Weather conditions differ thus affecting costs. Airports also differ in their degree of security. Municipally run airports are exempt from property taxes while authority authorities or for-profit corporations are not. In some jurisdictions, policy and fire fighting emergency services are provided by the community, while in others the airport self provides these services. As well, airports differ in the scope of services they provide. In Europe, a number of airports provide handling services, but many do not. In Asia airports may provide local air traffic control services.\(^1\)

For these reasons, little systematical empirical analysis of airport costs has been undertaken.

Nevertheless, some observations can be made:

- Research undertaken by Cranfield University revealed that unit cost per passenger declined steadily as airport size increased. There was no point at which unit cost

\(^{12}\) An excellent discussion of these issues can be found in *The economic performance of European Airports*, Research Report 3, Cranfield University Dept. of Air Transport, College of Aeronautics, Feb. 1995.
levelled off or started to rise again. This analysis was based on a comprehensive effort to control for many of the above listed problems with airport data.  

- Airports under one million passengers per year had dramatically higher unit costs than those larger than one million.

- In Canada, regional airports have been provided with a capital subsidy program (Airports Capital Assistance Program – ACAP). Generally, these airports serve fewer than 200,000 passengers per year. This suggests that airports below 200,000 passengers per year were determined by the government (and former airport operator) to be unable to finance their capital programs.

- Of the NAS airports in Canada (generally at least 200,000 passengers per year), the smallest often required a subsidy for capital programs for a period of time after transfer. As well, these airports are exempt from ground lease payments until 2015.

- An examination of the public financial records of regional airports in B.C. indicated that almost half still had not achieved break-even status by 1999. (Year 200 is expected to be worse due to traffic drops associated with airline industry restructuring.) A quarter had not even been able to cover operating costs.

- While small U.S. airports are sustainable, this is masked by substantial direct and indirect subsidies. It is common in the U.S. for state governments to provide funds for planning purposes and for the federal government to direct finance most capital programs and indirectly finance capital service costs through tax free bonds.

- The smaller NAS airports (those under 2 million passenger per year) are actively advocating that they be removed from the National Airport System, allowed to purchase their land and facilities for one dollar (thus eliminating future lease payment obligations) and in some cases, become eligible for capital assistance through the ACAP program.

- On the other hand, airports such as Regina (800,000 passengers) have been able to fully cover operating costs and undertake continuing capital programs.

- At least one airport of one million passengers (Victoria) has been able to make significant ground lease payments to the landlord, Transport Canada.  

From these and other observations as an economist actively supporting and serving a large number of airport clients in Canada and abroad, I have drawn the following tentative conclusions.

- Airports with traffic bases above one million passengers are generally fully sustainable, although there may be exceptions in special circumstances.

13 Ibid., p. 48.

14 The inequity of being the only airport of its size to be required to make such payments is a topic beyond the scope of this paper.
• Airports with markets of 500,000 to one million enplaned/deplaned passengers per year are generally sustainable, including an ability to self-finance routine capital programs. At the lower end of this scale, the ability to finance major capital programs and service ground lease payments may be problematic. Even when approaching one million passengers per year, the ability of an airport to make lease payments which provide a 15% return to the federal government on its historically invested capital may be challenging.

• Airports under 200,000 passengers seem to be unable to self-finance operations and capital without both relief from ground lease payments and capital subsidies.

• Airports in the range of 200,000 to 500,000 passengers per year are in a grey area. Financial viability depends on factors such as whether traffic is served by heavy (but narrow body) jets versus turboprops, the presence of a major air cargo carrier, land development opportunities, etc. These airports are not able to finance operations, capital programs and a lease payment which provides the government with a return on historically invested capital. They are able to finance operations in most cases, and may be able to finance routine capital programs, but not to pay a return on historical investment.

15 There are always exceptions, of course. Airports such as Gander, Stephenville, Iqualuit, etc. play critical roles in the global air transportation network as alternate airports. Air carriers achieve significant costs savings because of their existence, while not paying the airport any fees.
4.0 Price Regulation

4.1 Introduction
Traditionally, airports have, rightly or wrongly, been perceived as monopolies. As such, airport with private governance structures may be subjected to price regulation to protect their customers from overly high prices due to the exercise of potential market power. Typically such regulation controls only the price of aeronautical and non-aeronautical services offered to their customers.

This section lists alternative models of regulation. It covers not only traditional forms of regulation but also incentive, trigger and self regulatory forms.

There are four main types of regulation:

- Rate of Return Regulation
- Cost of Service Regulation
- Price Cap Regulation
- Intervention Regulation

Each of these is discussed in turn, along with two other regulatory options: self regulation and regulation by contract. First, a general discussion of the types of airport charges is provided.

4.2 Types of Airport Charges

4.2.1 Aeronautical versus non-aeronautical fees
Airports have two broad categories of costs: aeronautical and non-aeronautical. Aeronautical costs are those associated with providing a) runway services, and b) terminal services for ticketing and boarding passengers. Non-aeronautical costs are those associated with other terminal services, commercial land development, etc. Airports charge fees to carriers and other users for the provision of these services.

At most airports, separate accounts are kept for aeronautical and non-aeronautical cost categories. There are several reasons for this. One is that industry conventions require that fees for aeronautical services, such as landing and terminal fees, cover no more than their respective costs. In the United States, the Federal Aviation Act provides for regulations which enforce this provision. In most other jurisdictions, it is industry convention (strongly enforced by the countervail power of air carriers) embodied in policies of ICAO, IATA and

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16 Some costs associated with terminals, such as providing space for retail/food/beverage, airline business class lounges, etc., are non-aeronautical.
ACI which recommend that aeronautical fees be no greater than cost. Further, these policies recommend that carriers be consulted prior to implementation of any fees.

4.2.2 Typical Airport Charges

While each airport differs somewhat, most will assess the following types of fees and charges.

Landing fees. These are fees for use of the runway. Most airports charge fees based on the weight of the aircraft. Heavier aircraft pay more both because of the greater weight and because the fee per tonne of landed weight itself is often higher. In Canada, it is common for airport to have three “weight classes,” with the highest class capturing almost all jet aircraft. Landing fees are paid by passenger airlines, cargo airlines and non-commercial aircraft.\footnote{In Canada, military aircraft are exempt from landing fees, a residual of the era when the federal government operated airports. When airports were transferred to private airport authorities, a condition of the transfers were that military aircraft would continue to be exempt from landing fees. This has created a burden for a few airports, such as Gander, which are frequented by military aircraft. The latter make no financial contribution to the cost of the services provided to them by the private sector airport corporations/authorities.}

Terminal Fees. These are fees for use of the “common areas” of the airport terminal, such as boarding gates and queuing space in ticketing areas. These fees are typically assessed on the basis of the number of seats on the aircraft. A few airports assess fees based on the number of on-board passengers, but this requires more detailed data collection. Only passenger carriers pay terminal fees. Cargo carriers and non-commercial users do not require terminal services.

Other Terminal Fees. Some airports will have additional charges for terminal services. For example, the Vancouver International Airport has a “turn around fee” charged only to those carriers who use the transborder customs facility. This fee allows for cost recovery for space and facilities required for U.S. preclearance operations.

Security Charge. Prior to transfer of airports, security services were provided at no charge by federal security services. After transfer, these services were withdrawn and airports were required to provide their own security services. Most airports instituted a fee on air carriers to recover these costs. Generally this is a cost per seat or a schedule of fixed fees based on type of aircraft.

Emergency Response Fee. A few airports have separated emergency response services costs into a separate category and assess a separate fee.

The above are various types of aeronautical charges.

Airport Improvement Fees. These fees are assessed by not-for-profit airport authorities on passengers. These fees do not have direct costs associated with them. Instead they are fees intended to generate cash current with or in advance of construction projects. These
fees were discussed in Section 2. While airport accounting practice varies somewhat, these fees are not generally considered to be aeronautical fees.

**Commercial Fees.** These are charges for a large variety of non-aeronautical services. They include fees for space rentals for commercial activities, airline business class lounges, fees for advertising and other displays, land rentals for cargo and maintenance facilities, fees for provision of network/phone/electric services, curb use fees for commercial transportation vehicles, etc.

### 4.3 Scope of Price Regulation

Having described types of airport charges, I now turn to regulation of airport charges. In most jurisdictions in the world, only aeronautical fees are price regulated. Commercial services are considered to be provided in markets which have a degree of competition and thus regulation is not necessary. In Australia and New Zealand, for example, airport services are divided into contestable and non-contestable. The latter primarily embraces aeronautical charges. Court cases have tested the boundaries of what is and is not contestable, and have generally upheld that non-aeronautical services do not require price regulation.

### 4.4 Rate of Return Regulation

Historically, this has been the type of regulation used for privately owned electric and telecommunications utilities, as well as for pipelines. A firm is allowed to set prices so long as the overall corporate rate of return on the shareholder’s capital investment does not exceed a “fair” rate of return. As the firm cannot set prices too far above economic costs it cannot exploit its monopolistic position.

In practice, utilities spend considerable effort with the regulatory process. There are two main areas of dispute. The first is what constitutes a fair rate of return. While initially this was a source of much debate, most regulators have set reasonable rates of return recognising the debt-equity ratio of the firm, the underlying riskiness of industry financial performance and what return is required to attract and sustain equity investment.

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18 For example, some airports include AIFs in revenues, while others put these proceeds “below the line” as a non-operational income statement item.

19 Airports will charge land rentals at different rates depending on the use. Convention is generally to provide land at cost recovery for those services such as aircraft maintenance which have no alternative but to be contiguous to the airfield. Other facilities, such as catering and cargo, may prefer to have airside access, but do not absolutely require it, and may be charged a somewhat higher rental. Land that is available but not essential for airport operations may be rented at full commercial rates to non-aviation related uses such as shopping centres, in order to generate additional revenue for the airport authority. Because airport authorities in Canada are not-for-profit organisations, any profits will eventually be reinvested into airport infrastructure.

20 These are fees to recover the costs of curb space, taxing or bus holding areas, dispatch services, etc.

21 The UK Monopolies and Mergers Commissions provides a discussion of what charges are to be regulated. See, for example, “A report on the economic regulation of Manchester Airport plc: presented to the Civil Aviation Authority”, 1997.
A second area of dispute is determining the capital investment. A major concern is whether capital investment is to be measured in historical costs versus replacement costs. The record in practice is a lack of consistency. Some industries and countries allow use of replacement costs while others do not.

Another second major concern involves whether new capital investments will be “allowed” into the “rate base.” A utility would not want to invest several billion dollars in capital only to find that the regulator felt it was not necessary and thus a return on that investment not being allowed. Thus regulators are requested to approve all capital investments prior to the utility company’s commitment of financial resources.

This regulatory form is complex, unresponsive, and expensive. Any time the airport operator wishes to change a charge or fee, a detailed regulatory application must be developed and submitted.

An interesting twist is that some economists believe that over time the regulatory agency is captured by the utility. The concept is that over time the regulated spends so much time educating the regulator that the latter comes to adopt the “religion” of the utility company. The utility thus receives favourable decisions on a consistent basis.

### 4.5 Cost of Service Regulation

Historically, this has been the regulatory type used for airlines, rail and other transportation carriers. This is a much more intrusive regulatory format, as the regulator must approve every price change and, in some cases, service decisions.

As applied to transportation carriers, approval of each price change requires documentation of cost increases. If the carrier can demonstrate that its costs have risen, then the requested price increase is approved.

In practice, regulators are good at examining documentation of price increases, but poor at discerning whether the cost increase was required or not. Carriers were often able to pad costs or over-invest without effective constraints on prices they could charge. It was somewhat like having an unlimited expense account: if you could produce a receipt, you would be reimbursed. Regulatory economists generally have been of the view that cost of service regulation results in inefficient (high cost) operations by carriers. Deregulation was largely concerned with restoring cost efficiency pressures to those industries.

This regulatory form is expensive, unresponsive to changing market conditions, and at least in the view of some economists, has not served consumers particularly well.\(^{22}\)

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\(^{22}\) It may be important to distinguish the record of cost of service regulation in the distant past versus over the past 30 years. There is no question that in 19th century, railroads in the U.S. were engaging in monopoly and discriminatory pricing. The initial record of price regulation seems to be one that was beneficial. In the latter third of the twentieth century, however, the value of regulation in many industries came into increasing question. A number of sources of poor performance were cited. One is that while regulation may produce short term consumer benefits, the long term effects in terms of producer response to regulatory signals was
4.6 Price Cap Regulation

In the past few decades, a new set of approaches toward price regulation have arisen. These attempt to provide an effective discipline on firms with monopoly power, but at a lower regulatory cost, and in a form which preserved incentives for firms to be cost efficient.

The most widely known, and now widely adopted regulatory type is price cap regulation. This format has two dimensions. The first is the cap itself. The format allows a firm to increase prices whenever there is inflation or an increase in costs. Prices can be increased up to the cap. Usually the cap is set at inflation, less a provision for efficiency gains expected to be achieved by the firm. This is usually shown as CPI-X or RPI-X, where CPI stands for the consumer price index (or retail price index, as it is called in the U.K.) X represents efficiency gains. Most firms become more efficient at what they do over time. Thus even if your unit labour costs rise, because fewer labour hours are required to produce the same output, you don’t have to increase your prices as much as the inflation rate.

The second dimension of price cap regulation is the price basket. The price cap does not have to apply to all goods the firm sells. Some goods are allowed to have greater price increases than the cap – provided other goods have price increases under the price cap. It is only the average increase in prices of all goods in the “price basket” which must not exceed the price cap. This allows the firm considerable flexibility to change prices within its product or service line without the need for regulatory approval. It enables desirable long term shifts in relative prices of different services which cost based regulation might prevent.

Price caps have typically been set for periods of time such as 5 years. Once every five years, the regulatory does an audit and review. It then sets a new price cap for the next five years. Thus the firm is free of regulatory proceedings and costs for a considerable period. So long as the firm stays within the cap, it is free to change prices at will.

This regulatory method is low cost for both the firm being regulated as well as the government regulator. It provides a high degree of flexibility for a price regulated firm. It also provides incentives for innovation and efficiency. If the firm figures out a way to lower costs, it is not forced to lower its prices until the next five year review. The review process also recognises the need for above inflation price increases to cover the costs on new capital investment.

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negative. Second, industries and the conditions of competition changed. In the rail sector, for example, the emergence of competition from trucking and publicly financed roads removed much of the market power of rail carriers. Third, some economists believed that in the long term regulatory capture took place, leading to regimes in which regulation served producers and not consumers.

23 There are other incentive regulation forms which are not discussed in this document. These include yardstick competition (prices are allowed if they are consistent with prices adopted by firms in competitive markets); automatic rate adjustment mechanisms (which automatically increase all prices when costs increase); and sliding scale plans (a variant of price cap regulation whereby efficiency gains of the firm are shared between the firm and its customers). See R.L. Mansell and J.R.Church (1995), *Traditional and Incentive Regulation*, Van Horne Institute University of Calgary, for a discussion.
Two popular versions of the price cap approach in use at various airports around the world are the single-till price cap and multi-till price cap.

**Single-till price cap.** In this version, all airport activities are included together when applying the price cap. This includes activities for which the airport operator faces competition as well as activities which are non-contestable. Effectively, any gains made in contestable activities must be transferred in full to the aeronautical users.

The strictest version of this regulation is referred to as residual pricing and incorporates the costs and revenues of all of the airport’s activities. Total operational costs, both aeronautical and non-aeronautical, are subtracted from the non-aeronautical revenues. The difference, or residual cost, is then divided by the number of aircraft landing units yielding the aeronautical fee. With residual pricing, all gains accrue to aeronautical users (removing all incentives from the airport operator), and all financial risk of operating the airport is shifted to the aeronautical users, with the airport company bearing little risk.

**Multi-till price cap.** Under the multi-till approach the aeronautical areas of airport operation are not subsidised by the non-aeronautical sources of revenue. This retains incentives to develop commercial activities at the airport, and more consistent with economic principles in congested conditions. This model is not favoured by the airlines as it generally results in higher charges.

### 4.7 Trigger Regulation

This is a regulatory format which relies on the threat of regulatory intervention to constrain monopolists from unfairly increasing prices. With trigger regulation, the government has a power to intervene and set prices. However, there is no exercise of the regulatory powers until a complaint is received and determined to require a response. The concept relies on firms “behaving themselves”, knowing that unreasonable price increases would not be allowed.

There are considerable advantages of this regulatory format. Neither the firm or the regulatory incurs costs of regulatory procedures (unless the trigger is pulled). The firm has considerable freedom for setting and changing prices. The firm has incentives to be efficient, as it is able to keep all or a portion of its efficiency gains.

Typically trigger regulation will have some provision to prevent indiscriminate use of the trigger. Some variations on this are:

- There are minimum and costly application requirements. This prevents nuisance complaints.

- If the regulator finds for the target firm, then the applicant who had invoked the trigger pays for the costs of the regulatory procedure.

- Final offer arbitration is used. The applicant must submit their best proposal for what the price should be. The defendant then has time to respond. The arbitrator
can only choose one of the “offers”, and cannot “split the difference. Here the applicant could end up with nothing.

- The applicant must show material harm before the application will be considered. This prevents use of the trigger for minor disagreements on prices.
- The applicant must show “public interest”, a costly burden.

### 4.8 Self Regulation

Here the industry or firm adopts a set of standards or code of conduct which is acceptable to customers. Provided the firms stays reasonably within the code, customers will neither dispute price changes or pressure governments for a regulatory regime.

This is the most flexible and least costly regulatory mechanism. The challenge is to find a set of standards which the customers find acceptable yet provides the firm with the required flexibility. As well, for this to be effective, all firms in the industry must discipline themselves to adhere to the code, otherwise the one exception runs the risk of inducing a formal regulatory regime.

Airport pricing guidelines by ICAO and ACI are examples of codes which can be used for self regulation. (These specify, for example, that prices must be based on costs.) The ICAO/ACI price guidelines are very powerful in that they have become convention throughout the world. Deviations from these principles are rare. In part, this is because air carriers have strong interests in seeing that all airports adhere to the cost based principles contained in the guidelines. An airport which deviates is the target of massive pressures from the airlines collectively in order to ensure continued worldwide compliance with the principles.

Airlines have significant countervail powers vis a vis airports. They are, for example, able to delay or deny payment. In some U.S. cases, airlines have paid fees to trust funds rather than to an airport directly. Often, airlines have veto powers over airport capital programs. In the US, the bond guarantees provided by the airlines give them veto over capital programs through majority-in-interest clauses. In Canada, many airports have entered into agreements with air carriers (through the Air Transport Association of Canada) for collection of airport improvement fees (AIFs) on airline tickets. These agreements give carriers initial veto power over airport authority capital programs, which allow delay of capital programs by up to 3 years. In fact, the countervail power of the air carriers is so strong that when Air Canada and Canadian merged, the Competition Bureau required that the AIF veto powers be reduced so as to prevent a single carrier from controlling airport capital decisions.

### 4.9 Regulation by Contract

An often overlooked mechanism for constraining monopoly power is by contract between the firm and its customers. This type of “regulation” is possible where a firm has a small number of customers, and these customers are able to enter into a long term contract. Airports may be excellent candidates for this type of relationship. Many airlines enter into long term
contracts for terminal services or usage. The approval process for major capital programs and their accompanying changes to rates and charges provides an opportunity to enter into long term contracts regarding rates and charges.

The concept here is that airport users (airlines) enter into contracts with full knowledge of the economics and dynamics of the industry. If a customer freely enters into a long term contract with a service provider, then that contract would normally contain pricing provisions which would prevail for the duration of the contract. Typically these will include provisions for cost adjustments.

In such cases, there is no need to protect the customer by imposing a government price regulation regime. The same end is achieved by contractual agreement.

### 4.10 Price Regulation of Airports: Practice

#### 4.10.1 Price Cap Regulation in the U.K.

The United Kingdom has been the earliest and strongest user of price cap regulation for a whole range of industries. When the British Airports Authority and Manchester Airports were privatized in 1987, price cap regulation was immediately applied to their activities. Note that for BAA separate price caps are established for each airport.

Smaller airports in the U.K. are subject to trigger regulation. At present they are unregulated. However, upon complaint or on the initiative of the Government, the price cap regulation regime may be applied. Currently there is some consideration of extending regulation to some of the smaller airports.

The UK regulatory regime for airports is characterized by the following:

- A regulatory determination is made once every five years, at the beginning of the five year period. Once the determination is made, airports have complete pricing freedom, provided they stay within the cap.

- The regulatory determination is a public process conducted by the Monopolies and Mergers Commission (now the Competition Commission). Any interested party may make representation to the MMC.

- The MMC makes recommendations to the Civil Aviation Authority. It is the CAA which actually regulates the prices of the airports. The CAA may accept, reject or vary the MMC recommendations. In practice, the CAA has made some variations in the MMC recommendations.

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24 Note that the CAA also is empowered to impose conditions on airport companies on any matter on which the MMC finds an airport has acted against the public interest.

25 The requirement for price regulation by the CAA after review by the MMC is contained in the Airports Act of 1986.
• The price cap is set at the Retail Price Index less an adjustment for productivity. In recent years, the productivity adjustment (the X in RPI-X) has been quite large and exceeds the inflation rate. This results in a requirement for the airports to lower prices.

• At the five year review the airports are allowed special price increases to deal with a) new capital and b) other extraordinary items. Thus when a new terminal or runway is planned, the CAA allows the airport to increase its prices above RPI-X to reflect the increased cost of the new facilities. An example of an extraordinary adjustment is an upward adjustment in prices to compensate BAA when intra-Europe duty free sales are no longer allowed.

• The price cap only applies to airfield and terminal charges. Retail, land rents, etc. are not regulated during the five year period.

• However, when the five year reviews are done, non-aeronautical revenues are considered. This means that during the five year period, the airport company is free to charge what it will for concessions, parking, etc., and it is allowed to keep any and all profits. At the end of the five years, if non-aeronautical revenues have grown, then there will be a downward adjustment in aeronautical fees for the next five years. In other words, non-aeronautical fees are never regulated, but if they are profitable, once every five years landing fees will be reduced by the amount of increased profits from non-aeronautical activities.

• There is no regulation of the prices of BAA subsidiaries. BAA has entered into a wide range of businesses via subsidiaries, including purchasing and developing off airport land, investing in and/or operating other airports, consulting, etc.

Here is an example: in October 1997, the CAA made its ruling on the price cap for Manchester for the third 5-year period (1998-2003):

• airport charges are limited to RPI-5% in each of the next five years

• this was computed as RPI-11.5% but with an offset of 6.5% per year for the loss of intra-EU duty free sales.

• this was a slight variation from what the MMC recommended. (MMC recommended RPI-6.6% for first year and RPI-5 for years 2-5).

A final comment: during the MMC five year reviews there are large numbers of submissions. A frequent theme is “lack of consultation”. This has been dealt with by requiring the airport companies to submit a report to the CCA every year on consultations.

4.10.2 Other Use of Price Cap Regulation

A number of other jurisdictions are now using price cap regulation for private airport companies:
**Australia.** The privatized airports in Australia are subject to price cap regulation by the Australian Consumer and Competition Commission. The ACCC follows a model very similar to the UK with reviews at the beginning of the five year period. Unlike the UK which splits review and regulation between agencies, in Australia the ACCC does both. Only aeronautical charges (landing and terminal fees) are regulated.

Note that the Sydney airport continues to be owned by the federal government (although with crown corporation governance). It is not regulated by a price cap, however, the ACCC must approve all price increases on aeronautical services.

**Costa Rica.** In the privatization of the capital airport, bidders were informed that price cap regulation would be imposed. In an interesting twist, bidders submit the value of X as part of their bid. In other words, one may bid a lower lease payment with a higher X (hence lower airport charges in the future) versus a higher lease payment and a low X.

**Mexico.** Mexico has just completed the first stage of privatization and is establishing a price cap regime modelled largely on that of Australia.

**Chile.** The Santiago airport is government owned. The international terminal is operated by a private company, but the airfield and domestic terminal are operated by the government. The private operator is limited in the lease document with the Federal government in terms of fees charged to airlines for space. The private operator also manages commercial airport lands. Here, there is a price limit on land leased to air carriers, but not land leased or developed for other purposes.

### 4.10.3 Benchmark Regulation

This is a type of incentive price regulation where charges are limited by what others are charging. There are some examples we are aware of:

**Macao.** The private airport operator in Macao, Societade do Aeroporto Internacional de Macao, must receive approval every year for its fees. The proposed fees are evaluated based on fees at surrounding airports.

**Montevideo Uruguay.** Fees are limited by comparison to charges at airports within 500 km handling at least 2 million passengers (e.g., Buenos Aires).

### 4.10.4 No Regulation

Some airports are unregulated. An example:

**New Zealand.** At present, all airports in New Zealand are unregulated in terms of fees and charges. This includes the three privatized international airports (Auckland, Wellington and Christchurch).

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26 The private operator also receives a portion of the passenger tax.
4.11 Revisiting Price Cap Regulation for Airports

In the past one to two years, a number of eminent transportation economists have been calling into question the desirability of price cap regulation at airports. The debate was stimulated by Michael Beesley. As the economic advisor to the government of Margaret Thatcher, Beesley played a key role in the design of the privatization of airports in Britain and establishment of the accompanying price cap regulation regime. In 1999, Beesley claimed that he had reconsidered price cap regulation of airports and concluded that it was distorting the market and providing seriously incorrect price signals.\(^{27}\)

David Starkie, another prominent UK transportation economist, undertook to study the matter and has recently published a major peer reviewed paper on the subject. Starkie too concludes that price cap regulation, as applied in the UK, is bad economics and undesirable.

A key to understanding the alleged perversions of price cap regulation in the UK is the use of the single till approach, which is reviewed every 5 years. The London airports are required by the single till to reduce their charges by the amount of commercial (non-aeronautical) revenues earned. The consequence is that prices to airlines at these airports have declined continuously. So strong has been the price decline, that it is expected that at the next review landing fees could be ordered to be set at zero.\(^{28}\) But London Heathrow and Gatwick are two of the most congested airports in the world, especially the former. A zero price for use is the wrong price signal to give to carriers at a severely congested facility. This is very bad economic policy.

Both Beesley and Starkie conclude that prices at the London airports should be rising with congestion, not declining. The issue then becomes one of whether an alternative pricing approach should be used, such as dual till. With dual till price regulation, the airport operator is limited in how high its aeronautical fees can rise based on inflation and productivity, but there is no "give back" of non-aeronautical revenues earned. These revenues are considered to be provided in competitive markets and thus do not need to be regulated.\(^{29}\)

Starkie,\(^{30}\) however, investigates the economics of airports further. He observes that the degree to which non-aeronautical revenues can be earned is primarily dependent on the

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\(^{28}\) The two large London airports had peak period pricing at one time. However, due to challenges by U.S. carriers under terms of a bilateral air services agreement, BAA plc (the London airports operator) was ordered to cease peak period pricing, in spite of the near universal consensus among economists that this was an appropriate and desirable policy. However, with landing fees likely being order to be zero, the peak period pricing issue becomes moot. Peak period pricing is supposed to be revenue neutral.)

\(^{29}\) For example, there is competition from off airport parking operators, competition from off airport land developers, etc. Even airport retail is believed to be competitive. This is because most travellers in an airport at any given time are repeat users. They become familiar with airport prices and service offerings and this results in planning expenditures based on in-city alternatives.

number of airport passengers. The economic model he puts forth is one of casual complementary demands. The demand for non-aeronautical service offerings depends on the demand for aeronautical services, but not vice versa. If the quantity demanded of the latter can be increased (i.e., if there are more passengers using the airport) then demand for non-aeronautical services (such as parking, food/beverage/retail, land development for airport services such as catering, etc.) will increase proportionately.

Starkie says that airports have natural incentives to stimulate aeronautical demand, in part by constraining their aeronautical prices. Regulation is not needed.

Starkie then looks at the issue of whether rents can be earned. He distinguishes the two broad types of rents: those arising from monopoly exploitation and those arising from increasing land values. The former are regarded by economists as undesirable while the latter are desirable (as they reflect increasing productivity and value of the land). An operator who undertakes conduct which increases the level of non-aeronautical airport traffic is creating land rents. The only issue is who reaps the land rents: the landlord, the operator (if different from the landlord), the airline or the passenger. But this is an issue of the distribution of income and not one of economic efficiency. Economic regulation of industries arose as a remedy for addressing economic inefficiencies, and was never intended (and is not suitable for) addressing income distribution issues.\(^\text{31}\)

The solution put forth by Starkie (and by Beesley) is that airports in the UK should no longer be price regulated.

\(^{31}\) It is interesting to note that the UK imposed a windfall profits tax on BAA plc, although the rationale was that the previous government had privatized BAA at a price which was too low.
5.0 The Canadian Experience

This section provides some comparison between the governance models used in Canada to operate airports, marine ports and aviation navigation. The relevant models with respect to airports are the Local Airport Authority (LAA) and the Canadian Airport Authority (CAA). The Canada Port Authority (CPA) and the St. Lawrence Seaway Management Corporation are the governance structures of marine facilities in Canada and NAV CANADA is the organisation that governs aviation navigation. The comparison of these organisations is primarily based on characteristics such as corporate structure, transparency, regulation and accountability. Appendix C provides a set of tables comparing governance of these corporations.

5.1 Local Airport Authorities (LAA)

In 1992, the Airport Transfer Act (1992) enabled four Local Airport Authorities (LAAs) to be established at Vancouver, Calgary, Edmonton and Montreal. The transfer of the federal assets was predated by a federal policy change in 1987. The new policy, announced in A Future Framework for Airports in Canada, emphasised the commercial re-orientation of airports as the government intended to transfer them to local parties. LAAs are not Crown agents. A copy of the policy statement is attached as Appendix A.

Corporate structure. The LAAs are non-share capital corporations (not-for-profit) incorporated under Part II of Canada Corporations Act or pursuant to provincial legislation. The Board's of Directors are composed of representatives of local business and community interests, excluding elected officials and government employees. Directors are appointed by a process acceptable to municipalities and Federal Government and there is no requirement for federal, provincial or user representation. Collectively, the Board is chosen to have skills in specified disciplines (e.g., air transportation, commerce, law, and engineering).

Transparency. The LAAs have few requirements to ensure the transparency of their decision making to users and other stakeholders. The ground lease requires that certain documents are made available to the public and that public meetings are held after each year-end. Otherwise, there is no requirement for the LAAs to make service contracts available for public tender, undertake public consultation, submit business plans to the

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32 Calgary, Edmonton and Vancouver each have two federal appointees on their boards.
Minister or to disclose remuneration. Calgary and Edmonton LAAs are the exceptions in some cases.33

**Regulation.** The prices set by LAAs are not subject to external review, approval or appeal processes. The ground lease prohibits charges on state aircraft, however, and obliges the LAAs to respect Canada's international agreements on aeronautics.

LAAs are free to determine service levels within the safety regulatory framework. The ground lease contains a broad requirement to operate the airport "in an up-to-date and reputable manner befitting a First Class Facility and a Major International Airport."

**Accountability.** By rights granted by the ground lease, Transport Canada may, at any time, audit the LAAs' financial and other business records and procedures to ensure the LAAs' compliance with the ground lease and the LAAs' and other airport tenants compliance with other applicable laws.34 The LAAs are to submit to performance reviews every five years and the results are provided to Transport Canada and nominating entities.35

**Other.** Conflict of interest provisions are found in each of the LAA's by-laws and the code of conduct is consistent with the rules set out in the Canada Business Corporations Act. LAA's are free to undertake ancillary activities in Canada and abroad. Non-aviation activities should be compatible with the broad socio-economic interests of the adjacent communities and the province. There is no limit placed on LAA's revenues and they are explicitly exempted from income tax.

### 5.2 Canadian Airport Authorities (CAAs)

The commercialisation of airports in Canada continued to progress following the establishment of the LAAs in 1992. In 1994, the *National Airports Policy* was introduced along with Canadian Airport Authorities (CAAs). (See Appendix B.) The principle differences between the LAAs and the CAAs were in public accountability provisions and in the lease. Neither are agents of the Crown.

**Corporate structure.** The CAAs are non-share capital corporations (not-for-profit) incorporated under Part II of Canada Corporations Act or pursuant to provincial legislation. Directors must be appointed to the Board by a process acceptable to municipalities and the

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33 The City of Calgary may request a special meeting under the Calgary Articles of Incorporation. Calgary and Edmonton have agreed to give 60 days advance notice of increases in airport user charges. Alberta regulation requires that annual financial statements include notes on aggregate remuneration paid to directors and officers. Furthermore, Calgary and Edmonton have adopted the CAA disclosure requirements. Calgary and Edmonton have also adopted the CAA public tender requirements and make contracts over $75K (1994$) available for competitive tender.

34 Calgary and Edmonton have adopted the broader audit provisions applicable to the CAAs.

35 Calgary and Edmonton's performance results are also made available to the public.
Federal government. Unlike the LAAs, there are specific requirements with respect to the composition of the CAA Boards. They must include two or more Federal nominees, one Provincial nominee, one representative from each of the business community, organized labour and consumer interests while the majority of the directors are nominated by local/regional government. The Board itself may name no more than three Directors.

Transparency. There is a slightly higher degree of transparency mandated for the CAAs than the LAAs. With sixty days advance notice, price increases, including justification, are required to be published in local media. A Community Consultative Committee, including aviation industry representatives, must meet twice a year "to provide dialogue on matters related to airport" and a general public meeting must be held after each year-end. The public is allowed access to more documents than with the LAAs, including the airport transfer agreements. Contracts over $75K (1994$) must be available to competitive tender and exceptions must be disclosed with reasons. The ground lease requires that the annual reports disclose remuneration of Directors and salary ranges of senior officers. Like the LAAs, the CAAs are not required to submit business plans to the Minister.

Regulation. Just like the LAAS, the prices set by CAAs are not subject to external review, approval or appeal processes. The ground lease prohibits charges on state aircraft, however, and obliges the CAAs to respect Canada's international agreements on aeronautics.

CAAs are free to determine service levels within the safety regulatory framework. The ground lease contains a broad requirement to operate the airport "in an up-to-date and reputable manner befitting a First Class Facility and a Major International Airport."

Accountability. The ground lease gives Transport Canada the right, at any time, to audit the practices and procedures of CAAs as they relate to the lease, the Demised Premises, and the CAA's business affairs. Transport Canada may have access to any information or document to determine the extent of the CAAs compliance with the lease and the CAA and airport tenants' compliance with applicable laws. The CAAs are subject to independent review of their management, operation and financial performance every five years. The findings are made available to Transport Canada, nominating entities and, to the public on request.

Other. The CAA Director's code of conduct is consistent with the rules set out in the Canada Corporations Act. Changes to the code must be approved by the Minister. Conflict of interest on contracts is also addressed in the Canada Corporations Act. CAAs are free to undertake ancillary activities in Canada and abroad. CAA revenues are not capped and they are exempted from income tax.

36 During a period of subsidisation, the Federal Government may nominate a third Director.
5.3 Canada Port Authorities (CPAs)

In 1995 Canada introduced its National Marine Policy and later, in 1998, the Canada Marine Act. The purpose of the national policy was to provide for the disposition, by transfer or otherwise, of certain ports and port facilities provincial, municipal or other local interests. The Canada Marine Act is the legislation that enables the transfers of land and assets to Canada Port Authorities. The Minister of Transport has authority to issue Letters Patent of incorporation, which specify the activities that can and cannot be undertaken by the new port authority.

As of December 31, 2000, a total of 382 of the 549 Port Programs & Divestiture facilities, across Canada, had been transferred, demolished or had their public harbour status terminated. Out of this process, the following Canada Port Authorities emerged:

- Fraser River Port Authority
- Halifax Port Authority
- Hamilton Port Authority
- Montreal Port Authority
- Nanaimo Port Authority
- North Fraser Port Authority
- Port Alberni Port Authority
- Prince Rupert Port Authority
- Quebec Port Authority
- Saguenay Port Authority
- Saint John Port Authority
- Sept-Îles Port Authority
- St. John's Port Authority
- Thunder Bay Port Authority
- Toronto Port Authority
- Trois-Rivières Port Authority
- Vancouver Port Authority
- Windsor Port Authority
Canadian Port Authorities remain agents of the Crown when it engages in Port activity. Wholly owned subsidiaries are not agents of the Crown.

**Corporate structure.** The Canada Port Authorities are non-share capital corporations (not-for-profit) governed by a Board with 7 to 11 directors. The composition of the Board is set by the Canada Marine Act with the Governor in Council appointing one individual nominated by Minister and 4 to 8 individuals nominated by Minister in consultation with users. The remaining Directors are appointed by municipalities (one each) and provinces (one or two each) mentioned in the Letters Patent. Individuals appointed are to have generally acknowledged and accepted stature within transportation industry or business community. In addition, appointees must also have relevant knowledge and experience related to management of a business, operation of Port or maritime trade.

**Transparency.** The Canada Marine Act requires at least 60 days notice to the public of the port authority’s intent to fix a new fee or revise some existing fees (harbour dues, wharfage and berthing fees). Notices to be published in local print media and posted on Internet. In addition, notice must be sent directly to organisations whose members will be affected by the new or revised fee, and those who previously requested such notification. Notices or advertisements for requests for proposals are not required, however. A five year business plan is submitted to the Minister annually for information, not approval. The CPAs are subject the Access to Information act and certain corporate records, including audited financial statements and remuneration to officers and employees above a certain threshold, are available to the public. The Canada Marine Act requires that public meetings be held annually.

**Regulation.** With respect to price, the Canada Marine Act sets out a few principles to be followed by the CPAs when establishing their own charges. An external review of CPA charges would occur through a legislated public notification process. Complaints may be filed with the Canadian Transportation Agency if users feel there is unjust discrimination in a fee set by CPA. Following a complaint, the Agency is to “consider the complaint without delay and report its findings to the CPA, and the CPA shall govern itself accordingly”

The CPAs are not regulated with respect to services and are free to determine service levels within a safety regulatory framework.

Canada Marine Act gives Governor in Council authority to make regulations concerning order and safety. The Act requires that “port authority shall take appropriate measures for the maintenance of order and safety of persons and property in the port.”

**Accountability.** Financial accountability is achieved though special examinations of the CPA’s books, records, systems and practices carried out by an auditor at least once every 5 years. The audits may occur at any additional times that the Minister may required to determine whether the CPAs are in compliance with legislation. A summary report of findings is made available to public. In addition, the Letter Patent of each CPA permits the Minister to require audit or inspection of Gross Revenues.
Other. The Letters Patent of incorporation contain codes governing the conduct of Directors and officers of the CPA. The CPA model lends itself to some commercial flexibility with respect to ancillary activities, however these activities will be limited to those required to support port operations. There is no cap on CPA revenues and they currently are exempt from income tax although subsidiaries are not. The exemption is not explicit in the Act and the CPA may eventually be required to pay income tax.

5.4 NAV Canada

NAV CANADA was incorporated on May 26, 1995 under Part II of the Canada Corporations Act and took over the Canadian air navigation system under the Civil Air Navigation Services Commercialisation Act in late 1996. This corporation continued to receive financial support through the Air Transport Tax until 1998, until it began to support itself fully with user charges. NAV CANADA is not an agent of the Crown.

Corporate structure. NAV CANADA is a non-share capital, not-for profit private corporation that owns and operates Canada’s civil air navigation service (ANS). NAV CANADA is governed by a 15-member Board of Directors. Ten directors are nominated by stakeholders representing aviation users (4), bargaining agents (2), and the federal government (3), general aviation (1). There are four independent directors and NAV Canada’s President and Chief Executive Officer.

Transparency. NAV CANADA must give the public 60 days notice and justification for rate changes and proposed changes to the level of services offered. Users may appeal the manner by which the new or revised charges were set, if they feel that it was not in accordance with the set out principles, but not on the charges themselves. NAV CANADA prepares an annual business plan that goes to all stakeholders including Transport Canada. As well, NAV CANADA’s annual reports, safety plan and customer guide to charges are available to the public.

Regulation. Transport Canada is NAV CANADA’s safety regulator. NAV CANADA’s prices and level of service are only regulated inasmuch as proposed changes undergo process of public notice and regulatory approval. Proposed service terminations or reductions in remote or northern areas may be rejected by users and upheld by the Minister under certain circumstances.

Accountability. Operation performance is subject to facility audits by Transport Canada and irregularities are investigated by the Transportation Safety Board. Annual reports are subject to an external financial audit.

Other. Each Director (and officer) of the company is required to execute, keep current and abide by a comprehensive corporate Conflict of Interest and Code of Conduct Guidelines. NAV CANADA’s revenues are not capped and it is exempt from income tax as long as the Company carries on operations without monetary gain to its members.
5.5 St. Lawrence Seaway Management Corporation

The St. Lawrence Seaway Management Corporation, established under the Canada Marine Act, came into existence on October 1, 1998. The Corporation operates the Canadian portion of the St. Lawrence Seaway under a commercialisation agreement with Transport Canada. Its American counterpart, the Saint Lawrence Seaway Development Corporation, is responsible for two of the fifteen locks in the system and their related facilities in the Montreal/Lake Ontario section of the waterway. The St. Lawrence Seaway Management Corporation is not an agent of the Crown.

Corporate structure. The St. Lawrence Seaway Management Corporation (SLSMC) is a not-for-profit corporation established by Seaway users and other interested parties. The Board has nine Directors in total; seven are representatives from industry (Steel and Iron Ore, Domestic Carriers, International Carriers and Grain) and other interests and there is one federal government representative and one provincial representative. The Directors are appointed by their respective organisations.

Transparency. A business plan must be developed every five years of the SLSMC’s 20 year agreement. The Annual Report is public. The remuneration of Directors and Officers (excluding the President and Chief Executive Officer) is made public. The SLSMC is not required to make any other documents public. The tender is competitive for all work that is contracted out. Some exceptions may be made for very small contracts (less than $5,000). Minimum rate increases are entrenched in the commercialisation agreement and therefore there are no public consultations with respect to rates.

Regulation. The commercialisation agreement stipulates that tolls must increase by a minimum of 2 percent per year for at least the first three years of the initial five year business planning cycle. The SLSMC is obliged to contribute to a notional reserve if the SLSMC meets its targets and has funded a notional reserve it may lower the rate of increase in the tolls to 0.5 percent.

Section 99 of the Canada Marine Act regulates the SLSMC’s practices and procedures.

The SLSMC is committed to the Asset Renewal Plan by the commercialisation agreement to invest $126 million in infrastructure maintenance and capital in the first five years of operation. The Asset Renewal Plan is overseen by the Capital Committee which is comprised of two members from Transport Canada and two members from the Board.

The SLSMC is not regulated with respect to service levels, however there are internal standards that are met. Transport Canada regulates overall safety on the locks as they remain the owners of the land and infrastructure.

Accountability. Every year, the financial statements of the SLSMC are subject to external audit as part of the preparation of their annual report at the end of the fiscal year. Otherwise, if Transport Canada has cause, they may be subject to unscheduled financial auditing. SLSMC is not subject to performance reviews unless operations fall short of business plan targets.
Other. There is no limit to SLSMC's revenues and it is exempt from income tax.

5.6 Common Trends
Some common trends emerge from the survey of these quasi non-government organisations:

- Governments, especially the Federal Government, are being given greater powers to nominate directors to Boards than was the case of the original LAA policy.
- Formal public notification processes are now stipulated prior to making changes to fees.
- Formal appeal mechanisms are provided to resolve disputes between the authorities and their stakeholders.
- More stringent audit requirements are being placed on authorities.
- Some restrictions are being placed on the ability of authorities to create subsidiaries and undertake ancillary activities.
6.0 Airport Network Competition

6.1 Challenging the Traditional View: Competition Between Airports

The traditional view is that airports are natural monopolies. If this were true, then there would be little an airport can do to create new demand for airport services or to divert demand from other airports.

This view is incorrect. There are many markets where airports provide services in competitive markets, and when taken collectively, for many airports the majority of their services are in competitive markets.

**Connecting Traffic.** At most major airports, 35-50% of total traffic is making a connection. For almost all connecting traffic there are alternative connecting points. A traveler flying from Los Angeles to Nepal can get there via Singapore (and other Asian connecting points) or London (and other European points). A traveler from Albany to Los Angeles can get there via New York (LGA), Chicago, Detroit, etc. A traveler from Lansing to Des Moines similarly has a choice of connecting hubs. A very large percentage of the small and medium sized communities in the U.S., Canada, Australia, New Zealand, etc., are served by more than one airline, and in many of these cases, the competitive service is via alternative hubs. In Canada, there are choices as well. A traveler from Winnipeg to London may utilize a direct seasonal charter service, a connection via Toronto, or a connection via Minneapolis. A traveler in Penticton may get to Toronto via a connection in Vancouver or in Calgary.

**Cargo Traffic.** Cargo traffic, often comprising up to 15% of an airline’s or airports traffic base, is also competitive. Today, much of the courier traffic to the Greater Toronto region flies to the Hamilton Ontario airport, and is trucked to/from Toronto. The private sector Alliance Airport outside of Dallas is yet another example. If cargo rates for direct service from Tokyo to Amsterdam are too high, or if capacity is limited, then the cargo can be flown via Hong Kong, Vancouver, San Francisco, etc. Air cargo is notorious for being “gateway competitive”, and airports must view much of their cargo traffic, even O-D cargo traffic, as being subject to competition.

**Surface Diversion to Other Airports.** Residents of London Ontario are within driving distance of airports in London, Windsor, Hamilton and Detroit. Should local air services be limited, prices too high, or the airport experience undesirable, then the travelers will either drive or bus to the bigger airports. Interestingly, Milwaukee had recently taken to calling itself “Chicago’s third airport”, a clear indication that it perceives airport traffic as having some competitive opportunities via ground transportation.

Prior to Canada-U.S. open skies, Vancouver (YVR) had only a single authorized air route to the U.S. east of the Rocky Mountains. A consequence was that roughly one-half of the total

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Vancouver-U.S. market was traveling by car or bus to the Seattle-Tacoma airport (SEA). This was a trip of roughly 3.5 hours (plus an uncertain border crossing). The superior service (at that time) out of SEA resulted in a major competitive diversion of traffic from YVR. Open skies has dramatically changed that traffic pattern. Non-stop services out of Vancouver have allowed it to recover the surface diversion, and no longer are DC-10s operated on the 25 minute SEA-YVR route.

**Diversion to Other Modes.** The opening of the TGV (train a grande vitesse) resulted in a major loss of traffic, both for the Paris and Lyon airports and their air carriers, on this primary route. The success of price and service competitive Southwest Airlines in diverting traffic from auto/bus to air is a reverse example of the competitive impact of other modes.

**Destination Competition.** Airports even compete in some types of destination markets. Nice and Marseilles compete as to which airport will be the port of embarkation for Western Mediterranean cruise ships. Similar levels of air service are available. Cruise line decisions as to embarkation point will often depend on factors such as how well integrated the airport is with the port. In the Alaskan cruise market, for example, Vancouver may soon face significant competition from Seattle. To improve its competitive position, its new international terminal is the first in the world designed to incorporate cruise ship logistics right into the airport process. Further, the airport has developed common use check-in facilities at the various cruise ship terminals, to better facilitate returning cruise passengers.

Yet another example of destination competition is in the convention market. Convention planners consistently rank air service to a community as one of the top two criteria in choosing a site for a convention. Through programs of air service development, airports can have effects on convention locations. Canada-U.S. open skies has had a major impact on a number of cities on both sides of the border in developing convention business.

**Retail/Food/Beverage.** The one area where many would claim airports have a monopoly is in retail/food/beverage service. After all, if a passenger is in airport for a few hours and gets hungry, it is unlikely that he or she will take a cab into town to purchase a meal. However, careful market research reveals that this view of airport retail markets is naive. Surveys conducted at airports reveals that the average passenger in the terminal is an airport patron roughly five times per year. These repeat customers come to know what products and services are offered at the airport and what prices are charged. Further, these passengers engage in planning.

Consider an example. A business executive working downtown has a 1:30pm flight. He or she faces a decision as to whether to a) get a bite to eat downtown prior to going to the airport, or b) go to the airport a bit early, check-in, then get some lunch. This decision is made knowing what prices are charged, what types of food are available, etc. A diabetic would plan to eat downtown if they are not aware of any healthy food choices at the airport. “Rip-off” prices induce travelers to plan ahead an eat prior to coming to the airport. Even connecting passengers have choices. At the Vancouver Airport, for example, it was discovered that connecting Japanese business travelers do make choices of connecting airports based on prices of duty free cognac and availability of Japanese food.
The success of the British Airports Authority (BAA) and others with “street pricing” underscores the competitive nature of airport retail/food/beverage. This pricing policy requires retailers to charge no more for goods and services at the airport than they do at outlets elsewhere in the city. The policy resulted in a dramatic increase in sales and greater profits for BAA. If the market for retail/food/beverage were in fact a natural monopoly, then the former (very high) airport prices should have generated the maximum profit possible. Street prices should have resulted in lower profits. The fact that profits increased must imply that the market is competitive.

In the vernacular of the economist, the success of street pricing in increasing revenues and profits unambiguously shows that the retail/food/beverage markets have elastic demands. Monopoly prices are always in the inelastic range of consumer demand, and reducing prices must lower revenues and profits. The increase in revenues and profits when BAA lower prices for food/beverage/retail proves that these are not monopolies, but rather are competitive with other choices that travelers can make. This is an excellent case of how incorrect theoretical reasoning (airports as monopolies) led an entire industry (airports) to adopt uneconomic pricing policies with the consequence that profits and revenues were lower than was possible.

**Conclusion:** Airports operate in some competitive markets. Putting these points together, I argue that airports provide services in many markets which are competitive. While there certainly are some airports and some services of all airports which leave no other choice for a traveler, there are airport services which are demonstrably subject to competition. For many airports (and especially for the largest airports) connecting and cargo traffic comprise over half the economic base of the airport and these are clearly airport competitive services. Even large segments of the retail/food/beverage services are subject to significant competition.

### 6.2 The Four P's of Marketing

Now let us turn to the issue of marketing. Students of programs in business administration are taught the four P’s of marketing:

- Product
- Price
- Promotion
- Physical distribution

The first area of marketing is defining the market to produce and sell. For an aircraft manufacturer, this might entail the decision as to whether to produce a stretched longer range version of the 747 (Boeing), whether to produce any future large aircraft at all (McDonnell Douglas), whether to offer a complete family of aircraft products (Airbus), or whether to produce aircraft which utilize “western” engines (Tupolev).

Price is the second dimension of marketing. Here the marketing decision is made as to what price the chosen products will be sold at, or alternatively, what price segments of the market
to pursue. Pricing too high could result in loss of sales to less expensive products which are reasonable substitutes. For example, if a burger chain prices too high, it may lose sales to other lower price burger chains, to alternative products (e.g., sub sandwiches) or lead to a substitution to meals at home.

Promotion, the third area, deals with creating awareness of the product and price with potential consumers. Some claim that promotion itself can create “image” value, such as the image created by advertisements for certain sports cars.

The last “P”, physical distribution has to do with getting the product to the consumer. A manufacturer may have a great product, at a great price, have succeeded in creating awareness in the consumer, and gets the consumer to commit to a purchase, but if the product cannot be delivered where and when the consumer wants it, the sale will be lost. Traditionally this has been thought of as “place” value, but today the time value must also be considered. Physical distribution is relevant not only to manufacturing industries, but also to service industries. For example, in the airline industry, the product is made available to the consumer where and when he/she wants it via computer reservation systems.

### 6.3 Airports and the Four P’s

Airports must apply the four P’s to their commercial business, just as any other enterprise would. Whether or not there is significant runway capacity affects the product the airport has to offer, as does the design, capacity and expandability of the terminal. Prices charged by airports affect the level of their traffic. High landing fee tourism destinations find that in low seasons carriers have a stronger incentive to cut back services than to low landing fee airports, such as Bermuda. The well know promotion of Schiphol airport as a connecting point, business meeting centre, shopping centre, etc., has had very positive impacts on its level of traffic over time.

### 6.4 Airport Network Complementarity

Having discussed how airports are subject to competition and compete with each other, let us now consider network complementarity.

Airports are nodes in networks -- logistical networks for moving people and goods in geographic space. A node cannot function without other nodes in the network. Thus airports are mutually dependent.

However, this complementarity and dependence may not be symmetric. This is because of airport competition. A specific example may be useful. Fort St. John and Dawson Creek B.C. are communities in the beautiful Peace River region with separate airports, roughly one hour driving time apart. These are not the only two airports in Canada with overlapping catchment areas. There are many other examples in all regions of Canada. As one former Deputy Minister of Transport once said, the airport system was built for an era when both aircraft and automobiles had limited range.

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38 These are not the only two airports in Canada with overlapping catchment areas. There are many other examples in all regions of Canada. As one former Deputy Minister of Transport once said, the airport system was built for an era when both aircraft and automobiles had limited range.
somewhat overlapping) travelling publics. Vancouver, on the other hand, does not require access to each of these airports. Access to both is desirable, of course, but if Vancouver only has a network to link to one, part of the other’s market can be diverted through the one available link. In the parlance of the economist, Fort St. John and Dawson Creek are partial substitutes for each other in the network.

A question which arises is whether the large airports in the aviation networks have a pricing advantage. For example, suppose that a traveller is willing to pay up to $25 in total airport fees for a trip to/from the Peace River region to Vancouver. Beyond $25, the traveller will decide not to travel. Will the Vancouver airport be able to charge all or most of the $25 and leave the Peace River airports with little or no ability to impose charges? The answer depends on the degree to which the Peace River airports are substitutes for each other in the mind of the travelling public.

Consider the case where only one airport exists in the region. In this case, Vancouver will be limited in its ability to charge the full $25 willingness to pay. Vancouver requires the existence and continuing operation of the one Peace River airport in order to be able to serve the traveller. If it charges a too high a portion of the $25 such that the Peace River airport is not sustainable, then it (Vancouver) will lose all the revenue. Similarly, the Peace River airport must leave enough of the $25 to enable Vancouver to be sustainable.

A challenge comes about when there are two airports serving overlapping catchment areas. The two regional airports may attempt to use price to compete for those passengers who are willing or able to utilise either airport. In this case, the competing airports will be limited in their ability to undertake capital programs, thus undermining long term capital sustainability.

As well, there is the issue as to whether the combined financial needs of the three airports (Vancouver and the two Peace River airports) exceed the collective willingness to pay of the travellers on the route.

It should be pointed out that the agent for resolving issues of competition and complementarity between airports may well be the airline(s). An airline will likely have better information on the three nodes and demand for service along the links than any of the airports. If there is a dominant carrier, it could decide to rationalise the network to fewer nodes. While it may lose some traffic which was unique to the specific node that was terminated, the overall cost savings may provide a net benefit. This, of course, is not necessarily undesirable. Communities whose airports have highly overlapping catchment areas may need to address how their regions should best be served. These are cost and optimisation issues which are beyond the scope of this paper.

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39 This is the same as a case where the two airports have no overlap in their catchment regions.
40 In the terminology of the economist, in the extreme case there is a bilateral monopoly market structure. In such cases, each principle will allow the other to recover marginal costs.
7.0 Conclusions

7.1 A Strong Growth Industry With Continued Need For Investment Capital

This paper has looked at alternative models of airport governance and regulation. These were discussed in a general format and then information on the specifics regarding Canada were put forth. Here some conclusions are drawn.

- First, it must be noted that aviation is a strong growth industry. Passenger traffic grows at double the rate of the economy, while cargo traffic grows at triple the rate.

- The consequence of the continuing strong growth of aviation is the need for ever increasing financial capital for airport infrastructure expansion.

- Government financing of the continual need for airport investment clashed with public priorities in the 1980s and 1990s. Limitations on demands on federal treasuries led governments around the world to solve the problem by privatization of airports, thus transferring the financing burden to users and private capital markets.

7.2 Governance Models

Like other nations, Canada transferred its airports from government to private sector operation. The transfer model chosen was to private but not-for-profit airport corporations (referred to as airport authorities) which were locally based and controlled. Some comments:

- Canadian airport transfers to private not-for-profit and locally based corporations was part of a global trend to privatize airports.

- The specific model chosen by Canada has been unique. All other airport privatizations have been to for-profit corporations. No subsequent nation has adopted a not-for-profit format.

- The use of a lease of airport assets rather than sale is not unique. Australia and much of the developing world has adopted this format while the UK, New Zealand and Germany have sold the airport assets.

- Canada is unique is relatively requiring on-going lease payments. Most other airports used either out right sale (UK, Germany, NZ, etc.) or prepaid leases (Australia and much of Latin America). As a result, ongoing public debate about the level of lease payments is not present with other privatized regimes.

- A consequence of the not-for-profit format chosen in Canada was the introduction of airport improvement fees (AIFs). Canada’s airport authorities have no ability to
raise equity via share sales. This would have limited their ability to undertake major capital projects. Long established pricing policies prevent raising charges on airlines prior to investments being put into productive use. Hence, charges were placed on passengers in advance of deployment of new productive capacity in order to generated needed equity capital (retained earnings). The UK and Australia, for example have in general not been compelled to adopt such fees. AIFs are likely to continue in Canada until airport authorities have amassed a sufficiently large retained earnings base to enable the debt markets to fully finance incremental airport investment in infrastructure.

7.3 Price Regulation

In many, but not all cases, airport privatization was accompanied by the introduction of a price regulation regime to control what was perceived to be potential monopoly power.

- To date, Canada has not put a price regulation regime in place for airports. With airports operated by not-for-profit corporations, it is not clear that price regulation would achieve any improvements in economic efficiency. If anything, the record in Canada is one of airports seeking to expand traffic rather than restrict it in order to achieve monopoly profits.

- Elsewhere in the world, price regulation has often, but not always (e.g., New Zealand) been put in place to curb potential monopoly power of airports. Where regulation has been introduced it has been of the price cap regulation form which has been employed with other infrastructure industries.

- The UK has the longest record with price cap regulation of airports. There, a new view is emerging among its leading transport economists that such regulation (single till format) has not been beneficial. To the contrary, it has resulted in perverse outcomes where highly congested airports have declining prices which are approaching zero. Economic efficiency would dictate the opposite: prices should rise to discourage use of congested facilities. Two leading UK economists, including the one who was instrumental in the design of UK privatization and price cap regulation are of the opinion that economic efficiency would be better served with no regulation of airport prices. They argue that airports have the incentive to develop non-aeronautical commercial revenues. But these revenues depend primarily on the level of traffic an airport has. Airports thus have incentives to hold price increases for aeronautical services to a minimum in order to encourage traffic development.

Part of the debate on airport price regulation recognizes a number of other characteristics of modern airports:

- There is an emerging view, put forward here, that airports have important segments of their traffic base which is subject to competition.
• Airlines have significant countervail powers. They have withheld payments of fees and have (varying degrees of) veto power over airport capital programs.

• As well, a global industry standard has emerged (self regulation) that aeronautical charges should be cost based. Airlines have strongly pursued any airport which attempted to deviate from this industry standard, one that has been adopted by the airport industry itself.

It is my conclusion that any consideration of the introduction of airport price regulation should be done carefully. There are significant countervail powers of the airlines, criticism by leading economists that single till price cap regulation in the UK has produced economically perverse results, and a strong industry standard (self regulation) that aeronautical charges should be cost based. Combining these with the not-for-profit governance of airport authorities in Canada raises the question as to what, if anything the introduction of a price regulation would achieve.

While there may be some elements of airport services which have monopoly elements, major portions of their revenue base are subject to some form of competition. The monopolistic elements are subject to strong countervail powers of the airlines. In Canada, airlines have strong capital project veto or delaying powers via the AIF collection agreements that many airports have entered into with their airline customers. All but the largest airports in Canada are struggling with achieving break even and capital investment self sufficiency. For these, price regulation would have no effect as prices are at or below costs.

If price regulation is contemplated, it should focus only on the largest airports. But even here, the following questions would need to be examined:

• Do the airlines have countervail power?

• Have the airport and its airlines entered into long term contractual relationships which embrace fees and charges principles and procedures?

• Does the airport adhere to the industry standard that aeronautical charges be cost based?

• Is the airport behaving in a which results in higher charges and restriction of traffic to achieve monopoly returns, or is its behavior such that it seeks to expand its traffic base and raise aeronautical charges only when absolutely necessary.

Only if the answer to all of the above are “no” should a price regulation regime be considered.
NEW MANAGEMENT FOR CANADIAN AIRPORTS

OTTAWA – Transport Minister John C. Crosbie announced today a new policy allowing provincial, regional or local authorities to assume direct management of the country’s airports.

“The federal cabinet has approved this new policy so that provinces, regional and municipal authorities will have the opportunity to play a major role in the operation of local airports if they wish” said Mr. Crosbie.

“A key objective of this initiative is to make airports serve local community interests better and to allow our national airport system to operate in a more cost efficient and commercial manner,” he added.

Mr. Crosbie said that by opening the door to discussion on airport transfer, he is adopting many of the recommendations of the Airports Task Force report (The Future of Canadian Airport Management), that was released last September. Key recommendations included turning over management of airports to individual airport authorities where feasible and a more commercial orientation for these facilities.

The Minister noted that proposals will be welcome from small municipalities, towns or cities, local authorities or commissions as well as from provincial governments. Proposals may range from a complete transfer for ownership and operation by a local authority, to leasing arrangements.

“Several communities such as Vancouver, Edmonton, Calgary and Montreal have already shown interest over the last few years to have this opportunity to run airports as local businesses and to serve local needs.” said Mr. Crosbie.

The minister said the decision to make a proposal is left entirely up to the judgement of potential eligible bodies and that no one is compelled to do so.

“I do not expect this to result in a wholesale transfer of Canada’s airports but where the interest exists my department is willing to initiate discussions leading to a form of local airport authorities” the minister said.

Transport Canada will retain the mandate to ensure a safe, secure and accessible national system of civil airports. Accordingly, the department will continue to be directly responsible for air navigation, air traffic control and air regulation activity, including certification of aerodromes.

Mr. Crosbie said the transfer mechanism will follow a certain path: proposals are submitted to Transport Canada’s Airports Authority Group; they are reviewed and given to the minister with recommendations; the minister’s approved proposal will then be sent to cabinet.
Following cabinet approval, talks will begin between Transport Canada and the proponents of the transfer and a plan of divesting ownership or operation will be worked out. Following this process, final cabinet approval will be required.

Airports that are not transferred will remain the responsibility of Transport Canada’s Airports Authority Group. The group will bring a more business-like approach to managing airports it retains by emphasizing commercial ventures, enhancing local participation in airport matters and appointing local/regional airport advisory boards.

The minister said that discussions with any local, regional or provincial authority, will be based on the following guidelines:

1. Safety and security will continue to be regulated by the federal government.
2. The federal government will negotiate an equitable package for transfer of its employees.
3. There will be opportunities for negotiating capital works funding and cost-sharing.
4. The federal government will retain revenues from the airport ticket tax.
5. There will be no long-term increase in federal funding requirements.
6. There will be reasonable compensation to the federal government, whether the transfer is by sale or by long-term lease.
7. Transfer of ownership to a private business is not envisaged at this time by the government, but leasing proposals may be considered.

Mr. Crosbie noted that changes have been under way for some time within Transport Canada’s Airports Authority Group to streamline airport operations and improve business opportunities at the local and regional levels.

The minister also stressed that Transport Canada’s senior management will keep all employees and their unions informed of any possible changes that could affect them as a result of proposed transfers of airport ownership or operation.

To ensure an equitable transfer package for employees, discussions will be held on salary protection, pensions, benefits, continuity of service and other terms and conditions where applicable.

Mr. Crosbie said that interested parties across Canada who wish to make a proposal are invited to write to the Executive Director, Airports Authority Group, Transport Canada, Ottawa.
A NEW POLICY CONCERNING A FUTURE MANAGEMENT FRAMEWORK FOR AIRPORTS IN CANADA

1. GENERAL

The new policy regarding a future management framework for airports is comprised of two parallel, yet distinct thrusts:

a) discussions regarding airport ownership or operation by others, where there is a reciprocal interest, and

b) a new approach toward managing airports retained by Transport Canada that emphasizes their commercial orientation, potential contribution to economic development and responsiveness to local interests and concerns.

2. OWNERSHIP AND OPERATION OF AIRPORTS BY OTHERS

The Minister of Transport is prepared to receive proposals for transfer of ownership and/or operation of federal airports by other interested bodies. Transport Canada would continue to be responsible for ensuring a safe and efficient airport system, but this role may be exercised through regulation and financial support, not necessarily ownership and operation. The Federal Government’s mandate with respect to safety and security, including air navigation services, air traffic control, and airport certification will remain unchanged.

In the long term, the transfer of ownership and/or operation is possible in order to provide for increased responsiveness to local commercial and economic initiatives and to reduce the involvement of the Federal Government in airport management. The exact form of organization accepting a transfer could vary to suit local circumstances and interests. Options in this regard would include provinces, municipalities, local Authorities or Commissions authorized by federal or provincial legislation. In addition, private sector leasing would be considered.

As there will be no pressure on the part of the Federal Government, any potential transfer of ownership and/or operation will require substantial interest and initiative on the part of potential eligible bodies to assume responsibility as well as obtain appropriate provincial agreement.

Where local interest is expressed, the Minister of Transport will consider the transfer of ownership or operation of those airports with interested parties, within the following guiding principles:

A. Federal Funding Requirements

The government would not expect its funding requirements to increase in the long term. Although there might be incremental start-up costs or initial capital expenditures required as part of the divestiture package, the government would expect to recover such costs within a reasonable period, perhaps ten years.
B. Fair Commercial Value

The federal government would expect to obtain reasonable compensation for any facility transferred whether by outright sale or by long-term lease. In the case of sale, compensation in the form of a lump sum payment or in annual instalments, should consider historical investments as well as future earning potential. In the case of a lease, value would be received in the form of rental payment.

C. Employee Transfer

The federal government would want to negotiate an equitable package for the transfer of its employees. The package would include pay, pensions, benefits, continuity of service and other terms and conditions of employment to be negotiated with any new authority.

D. Airport Operation

The receiving authority would be expected to operate the airport (or airports) under the terms and conditions of the operating certificate and according to the safety and security regulations prescribed for the type of aircraft activity at the facility. The terms and conditions of the transfer would require conformity with the philosophy of the economic regulatory reforms embodied in the National Transportation Act. All air carriers, new as well as existing ones, would be allowed to compete openly and freely and to receive equitable treatment in obtaining access to airport facilities and services. The new operator would also be expected to respect Canada’s international obligations and agreements with other countries and agreements with other Transport Canada components, other federal government departments, provinces or municipalities as may be in the national interest.

E. Existing Leases and Licences

The receiving agency will be required to honour the leases, licences, and commercial contracts which are in existence at the time of transfer.

F. Existing Federal Initiatives

Special federal programs and initiatives, e.g., Official Languages, Transportation of the Disabled, will continue to apply.

G. Future Financial Arrangements

The receiving agency would have to be made aware that all revenues from federal taxation including the Air Transportation Tax will be retained by the federal government. However, in the case of non-profitable airports, the federal government would be prepared, on a case-by-case basis, to negotiate cost-sharing agreements with incentives and/or sunset clauses.

H. Competition
Any new owner or operator would be subject to the federal Competition Act. Due consideration would also be given to the economic regulatory measures or processes of the particular province where the airport(s) is located.

Where agreement can be reached on the terms and conditions of transfer, the necessary federal government approvals will be sought on a case-by-case basis.

3. CONTINUING OPERATION OF AIRPORTS BY TRANSPORT CANADA

A new approach to airport management named the Transport Canada Airports Authority Model has been developed to enhance the potential of all airports for transfer as well as to serve as an improved form of management for those airports not transferred. Objectives to be achieved would be:

a) to manage the existing airport system in a consistent, safe, secure and business-like manner, and to recover the costs of the system;

b) to operate individual airports in the most efficient, effective and safe manner;

c) to maximize airport revenue generation opportunities from commercial development, and to involve the private sector in such opportunities; the purpose being to narrow the gap between revenues and expenditures in the long term;

d) to support the economic development objectives of the government as outlined in the National Transportation Act as well as those of provincial and municipal governments.

To achieve these objectives, attention will be given to areas such as:

1) Commercial Development

Plans have been developed for all of the Transport Canada owned and operated airports. Implementation of these plans can generate a significant increase in revenues.

2) Increased Local Involvement

In order to demonstrate more sensitivity to local interests and concerns, it is the intention to establish a local Airport Advisory Board comprised of business persons at each major airport. As advisors to the airport manager, the Board would bring business acumen to airport affairs, would enhance the focus of the airport as a business entity and would foster a community appreciation of the economic impact of the airport.

The Board would review the annual business plan and all other plans for future development, as well as identify and assist in developing promotional opportunities for the site. Board members would be given the opportunity to participate in major initiatives and project evaluations. Advisory Board chairpersons would comprise a National Board, meeting with the Executive Director, Airports Authority Group, annually.
The existing Airport Consultative Committees at major airports, now made up of municipal leaders and organized interest groups would continue as the traditional forum for information exchange and coordination with the community. At smaller sites there would be a renewed emphasis on the consultative process with such features as an annual meeting, on a regional basis, of Committee chairpersons or representatives.

3) Opportunities for Private Sector Involvement

Almost all commercial activities on airports are carried out by the private sector. Transport Canada will continue to act as a catalyst to enhance these opportunities through cooperative marketing efforts as well as with other levels of government.

In addition, all avenues for private sector investment in traditional and non-traditional airport services would be continually explored and fostered to the maximum extent possible. The Airport Advisory Boards, discussed previously would be expected to assist in identifying, exploring and promoting new initiatives.

3. IMPLEMENTATION

Proposals received by Transport Canada will be reviewed and interested parties will be provided with more detailed information on how to proceed. Departmental officials will be available to provide briefings as necessary, prior to entering into more detailed discussions.
AIRPORTS TRANSFER – CHRONOLOGY

Management of airports by entities other than the central government is not a new concept in North America or other parts of the world. It would be relatively new in Canada for major airports. It has been discussed in:


“In view of its analysis, the study team recommends to the Task Force that the government consider making a fundamental change in airport policy from ownership and centralized public service operation to one of non-federal ownership and operation. (Paper on Real Property – Section II)

- The May 1985 federal budget.

“The government will pursue the development of a new management structure for the federal airport system in Canada. Options will be presented for consideration this year to provide for a self-sustaining system, incorporating the principle of cross-subsidization of smaller airports, which will allow for the independent operation of local airports.”

- The government’s July 1985 position paper, called Freedom to Move.

“The Department will make every effort, consistent with safety and security requirements, to reduce the administrative burden of its operations on carriers and to ensure that existing facilities are being efficiently used before new capital expenditures are made. Operational activities will be conducted in a more commercial manner and will encourage freer competition among carriers. For example, as announced in the May budget, options for a new self-sustaining system for managing federal airports are being developed.”

- The previous Minister’s appointment, in October 1985, of Airports task force to consider new management structures for the federal airport system.

- The release of the task force report itself in September 1986. The task force recommended establishment of local airport authorities wherever possible.
Appendix B: National Airports Policy

THE NATIONAL AIRPORTS POLICY

A Strategy for the Future of Air Transportation

- The federal government is taking positive steps to bring Canada’s transportation system in line with our nation’s needs as we move into the 21st century. These actions are designed to promote safety, efficiency, affordability, service integration, innovation and commercialization.

- Two initiatives are being taken to bring the air transportation system into the next century. One initiative involves changes to Canada’s air navigation system. By exploring options for commercialization, by taking advantage of new technologies, and through structural changes to air traffic services facilities, Transport Canada will develop an efficient and up-to-date air navigation system that maintains high safety standards and benefits all Canadian.

- The second Initiative is the National Airports Policy. This commercialization initiative represents a vision for airports that will ensure a safe, secure and viable National Airports System that will serve Canada in the 21st century.

- The National Airports Policy, for the first time, provides Canada with a comprehensive framework that clearly defines the federal government’s role regarding airports.

- The National Airports Policy will enable the federal government to structure an air transportation system that supports and promotes Canada’s competitiveness and meets the needs of all Canadians—taxpayers, the travelling public, shippers, carriers and those who earn their living either directly or indirectly from the aviation industry.

- The backgrounder outlines the main elements of the National Airports Policy.

The Current Situation

- There are 726 certified airports in Canada.

- Transport Canada currently owns, operates or subsidizes 150 of these certified airports, which range from Lester B. Pearson International Airport to grass strips. (The majority of airports in Canada are locally-owned and operated).

- 94 per cent of all air passengers and cargo are handled at 26 airports.
• There is no statutory, regulatory or policy framework that defines a clear role for the federal government in the operation of airports in Canada.

• The absence of a clearly-defined policy for the operation and/or funding of airports has led to ad hoc decisions. It has led the federal government to assume increased responsibility for airports over more than 60 years with no consistency or focus on a clearly-defined system or role to guide these decisions.

• It has also led the government to assume a wide variety of roles related to airport operations, including direct operator, financier, landlord, regulator, and advisor. However, the federal government is not ideally suited to all of these roles. Federal policies, applied nationally, are at times inconsistent with the needs of communities served by local airports.

• As a result, national and regional imbalances have developed with respect to facilities and funding. The 26 airports that handle 94 per cent of the travelling public and cargo cover their operating expenses with earned revenue, while considerable federal resources are used to support a large network of airports that serve only six per cent of air passengers.

• Expenditures on under-used facilities have unfairly burdened both taxpayers and users.

Overview of The National Airports Policy (NAP)

• Canada requires a national airport system comprised of airports that are safe, commercially oriented and cost-effective. These airports must meet the needs of users and the communities they serve, while those who benefit most directly from the services or facilities provided must pay a fair share of the cost.

• To develop such a system and ensure its ongoing viability, the government has introduced the National Airports Policy (NAP). Under the NAP, the federal government will maintain its role as regulator but will change its current role from airport owner and operator, to that of owner and landlord.

• The federal government will retain ownership of the 26 airports identified as part of the National Airports System. However, under the NAP they will be leased to Canadian airport authorities. These local operators will be responsible for financial and operational management.

• Ownership of regional/local and other smaller airports will be transferred to regional interests.

• Remote airports which provide exclusive, reliable year-round access to isolated communities and which currently receive federal assistance will continue to be supported.
The federal government will continue to be responsible for all aspects of aviation safety.

Locally-owned and operated airports are able to function in a more commercial and cost-efficient manner, are more responsive to local needs and are better able to match levels of service to local demands. Recent experiences of the four existing airport authorities and the numerous airports that have existed without federal support since their inception clearly demonstrate these realities.

To facilitate the changes proposed under the NAP for the national airport system and regional/local airports, the federal government will introduce measures to make its airports more cost-efficient and thus make local operation and ownership more attractive.

Among other things, current levels of service will be adjusted to meet demand and existing user fees and charges will be applied more widely. New user fees for specific capital projects at larger airports as well as for capital and operating requirements at regional/local airports may be introduced by the federal government or the new operators. These measures will be necessary to assist airports in becoming self-sufficient and in remaining viable in the longer term.

The National Airports System

The 26 airports that currently handle 94 per cent of air travellers in Canada comprise a core network known as the National Airports System (NAS). NAS airports include those in the national and provincial and territorial capitals as well as airports that handle at least 200,000 passengers each year. These airports link the country coast to coast as well as internationally, and are considered essential to Canada’s domestic prosperity and international competitiveness.

By retaining legal ownership of NAS airports, the federal government will be able to guarantee the integrity and long-term viability of the vital NAS system.

The federal government will transfer the airports it currently operates to Canadian airport authorities under new, enhanced accountability principles. (Although airport authorities were incorporated at Toronto and Winnipeg, transfer negotiations have not taken place. New authorities will have to be constituted in accordance with the refined CAA principles.)

Local operation and commercialization of these airports will promote cost-efficiency and the provision of services matched to user needs. This commercialization of the NAS will begin immediately. As soon as CAAs are incorporated in accordance with the new public accountability principles, transfer negotiations will commence.

Although NAS airports are self-sufficient as a group, some individual sites are not. Efficiency measures will ensure these airports are viable and operationally self-sufficient within five years.
Regional and Local Airports

- Regional and local airports serve scheduled passenger traffic but handle fewer than 200,000 passengers each year.

- Ownership of these airports will be offered to provincial and local governments, airport commissions, private businesses or other interests, in that order. New owners will be free to establish ownership and management arrangements best suited to community needs.

- The federal government will remove its operating subsidies from these airports over a five-year period beginning April 1, 1995. If a case can be made by a new operator that a continued subsidy may be required for a period slightly longer than the five years, it will be considered. At the same time, measures will be taken to help these airports move toward self-sufficiency.

- An *Airport Capital Assistance Program (ACAP)* will be introduced for regional/local airports. This program will provide financial assistance for safety-related airside capital projects, such as runways and taxiways. It will be funded, in part, by lease revenues from NAS airports, since they benefit from passengers and cargo passing to and from the regional and local airports.

- Local ownership and operation will enable these airports to provide services that are tailored specifically to local community needs. Local interests will be able to make operational decisions based on local needs.

- If the proposed operator can demonstrate that the airport can be self-sufficient and serves interprovincial or international flights, and is prepared to forgo access to the Airports Capital Assistance Program, application can be made for inclusion in the National Airports System.

Small Airports

- In addition to the regional and local airports described above, the federal government owns 31 small airports that do not have scheduled passenger service. Many of these are used for recreational flying.

- These airports will be transferred to local interests through appropriate government processes within the next two years. Local interests will be able to purchase and operate these facilities according to their own needs.

- Federal funding for these airports will cease March 31, 1997, or upon transfer of title, whichever comes first.

- Small airports that are satellites of international airports may be transferred to the airport authority that operates the international airport. Operational assistance will be phased out over five years.
Remote Airports

- Remote airports provide the only reliable, year-round transportation link to isolated communities. Those that currently receive federal assistance will, in the short term, continue to be supported by the federal government. Measures will be taken at these sites to increase operating efficiencies.

- During the next few years, the federal government will review its long-term role at remote airports.

Arctic Airports

- Federal airports in the Arctic will continue to be offered to the respective territorial governments for operation as a system under the existing Arctic Airports transfer program.

Regulations

- The federal government will continue to set safety and security standards for all Canadian airports. The means to accomplish this are already in place and include policy-setting, airport transfer agreements, airport certification and regulation.

Advantages/Rationale

- The National Airports Policy clearly defines the federal role in airports.

- Changes proposed under the policy establish a national airport system that is safest, effective, efficient, secure and viable for the long term.

- The National Airports Policy will shift the cost of running Canada’s airports from taxpayers to those who actually use the facilities.

- The policy will impose market discipline on the development and operation of airports and make all airports more responsive to the needs of their customers and communities.

- It will ensure that Canadian air travellers continue to be protected by appropriate federal safety and security standards.
THE NATIONAL AIRPORTS POLICY AND THE NATIONAL AIRPORTS SYSTEM (NAS)

• The federal government’s National Airports Policy (NAP) provides a framework that clearly defines the federal government’s role with airports. That role will be defined through two main levels of federal involvement in airports with scheduled passenger traffic: nationally-significant airports that will form a National Airports System (NAS) and regional/local airports. The NAS comprises 26 airports that link the country from coast to coast and internationally. The NAS includes those airports considered essential to Canada’s air transportation system, supporting both domestic prosperity and international competitiveness.

Criteria for the NAS

• The NAS includes airports in all national, provincial and territorial capitals, as well as airports with annual traffic of 200,000 passengers or more. (See Appendix A). Currently, the 26 NAS airports serve 94% of all scheduled passenger and cargo traffic in Canada and are the points of origin and destination for almost all interprovincial and international air service in Canada.

• Airports maintaining annual passenger levels of 200,000 for three consecutive years are candidates for inclusion in the NAS. Conversely, airports other than those serving national, provincial or territorial capitals, whose traffic falls below 200,000 passengers for three consecutive years, will no longer be considered part of the NAS.

• The criteria for NAS airports – traffic levels and/or location in a national, provincial, or territorial capital – will be applied in a clear, consistent and equitable fashion.

Significance of the NAS

• The development of the NAS reflects a commitment on the part of the federal government to the viability of a national system of safe, commercially-oriented and cost-effective airports. While the federal government will guarantee the ongoing viability of the NAS as a whole, this does not necessarily mean its continued direct operation or funding. The government will commercialize the National Airports System through the transfer of responsibility for the operation, management and development of NAS airports to Canadian Airport Authorities (CAAs). Local operation is preferable since it has proven to be more cost-effective, more responsive to local needs and better able to match levels of service to local demands.

• As a general rule, airports within the NAS will be required to become financially self-sufficient (operating and capital costs) within five years beginning April 1, 1995. For certain NAS airports, it is recognized that undercapitalization in the past or future capital requirements may result in some adjustments to this principle.
Local Operation of NAS Airports

- While local operation of NAS airports is the preferred approach, the federal government will retain ownership of these nationally significant airports to guarantee the integrity and long-term viability of the NAS. Ownership is retained through the long-term leasing of airports to CAAs.

- The federal government has examined the principles under which the previous local airport authorities (LAAs) were created and has revised them in the areas relating to the CAAs’ accountability to the communities they serve. Agreements with the existing four LAAs will be honoured, and the authorities will be invited to consider the enhanced principles. The new principles address issues such as the appointment of directors, conflict-of-interest requirements and community consultation.

- CAAs are not-for-profit corporations headed by boards of directors. Those directors are nominated by different levels of government and other participating organizations such as boards of trade and labour organizations. The federal government may also appoint up to three directors. Directors cannot be elected politicians or government employees.

- CAAs will lease NAS airports from the federal government. Through this commercialization of the NAS airports, each individual NAS airport will be operationally self-sufficient within five years. Collectively, these lease arrangements with CAAs will improve the federal government’s financial position.

- Transport Canada will continue to operate NAS airports until a suitable airport authority assumes responsibility. If the transfers of the Yellowknife and Whitehorse airports are not completed with the governments of the Northwest Territories or Yukon as part of the transfer of Arctic airports program, they may be transferred to CAAs.

- Starting immediately, the federal government will take steps to move the NAS airports towards self-sufficiency and thereby enhance the viability and attractiveness of these airports to local operators. Details on the steps to be taken are outlined below.

Operational Efficiencies for NAS Airports

- To make NAS airports attractive to CAAs, the federal government will initiate a number of measures to move each airport toward operational and capital self-sufficiency with five years.

- These measures include adjusting current levels of service to reflect demand and a wider application of existing user fees and charges.
• Once a local operator assumes responsibility for an NAS airport, there is greater potential to generate commercial opportunities and identify operational efficiencies (e.g. – reduction to overhead costs, timely capital investment, quick response to local commercial initiatives).

Regulatory Amendments

• The federal government will continue to set safety and security standards for all Canadian airports. The means to accomplish this are already in place and include policy-setting, airport transfer agreements, airport certification or regulation.

• Regulations will be introduced that will ensure specific levels of emergency response services at qualifying airports.

Satellite Airports

• Several of the larger international airports within the NAS group are complemented by “satellite” airports. These airports help ensure the safe and efficient operation of the larger international airports they serve by diverting small, general aviation (recreational and training aircraft) away from the larger airport.

• Initially, these satellites will be included as part of the NAS and will be offered to those airport authorities wishing to assume the operational responsibility of the corresponding satellite airports. These airport authorities must recognize, however, that federal funding to satellite airports will be withdrawn during the next five years. If the airport authority does not wish to assume responsibility for the satellite, the satellite airport will lose its “sub-set” status and other transfer alternatives for that airport will be explored.

Other Transport Canada Services

• In addition to airport operation, the federal government also provides air navigation services and facilities at Canadian airports. Provision of these services is based on airport traffic volumes, not airport ownership. The federal government is reviewing these services to ensure they match the needs of the local aviation communities while maintaining safety. The government is also consulting with the aviation community and affected parties on the potential for commercializing the air navigation system.

• Aviation security measures at NAS airports are provided under existing security regulations. These regulations apply to certified airports, regardless of who owns or operates the airport. Regulatory consultation on security regulation is being undertaken by the federal government.
APPENDIX AA
AIRPORTS IN THE NATIONAL AIRPORTS SYSTEM

KELOWNA, B.C.
PRINCE GEORGE, B.C.
VANCOUVER, B.C.
VICTORIA, B.C.
CALGARY, ALTA.
EDMONTON, ALTA.
REGINA, SASK.
SASKATOON / JOHN G. DIEFENBAKER, SASK.
WINNIPEG, MAN.
LONDON, ONT.
OTTAWA / MACDONALD-CARTIER, ONT.
SUDBURY, ONT.
THUNDER BAY, ONT.
TORONTO / LESTER B. PEARSON, ONT.
MONTREAL / DORVAL – MIRABEL, QUE.
QUEBEC CITY / JEAN LESAGE, QUE.
FREDERICTON, N.B.
MONCTON, N.B.
SAINT JOHN, N.B.
HALIFAX, N.S.
CHARLOTTETOWN, P.E.I.
GANDER, NFLD.
ST. JOHN'S, NFLD.
YELLOWKNIFE, NWT
WHITEHORSE, YUKON
THE NATIONAL AIRPORTS POLICY AND REGIONAL/LOCAL AIRPORTS

Overview

The federal government’s National Airports Policy (NAP) provides a framework that clearly defines the federal government’s role with airports. That role will be defined through two main levels of federal involvement in airports with scheduled passenger traffic: nationally-significant airports that will form a National Airports System (NAS) and regional/local airports. Those airports that handle schedule passenger traffic but are outside the criteria for the NAS are important in terms of their regional or local significance. The federal government will actively promote local airport ownership and operation of these regional/local airports and will create a federally-funded Airports Capital Assistance Program to assist with safety-related capital infrastructure.

The government is currently involved in the operation of 71 non-NAS airports that have regional or local significance. It will be withdrawing from any ownership or financial/operational involvement in these airports during the five years beginning April 1, 1995.

If a case can be made by a new operator that a continued operational subsidy may be required for a period slightly longer than the five years, it will be considered.

The federal government will be offering the ownership and operation of regional/local airports to local entities. These entities can better determine and provide the level of service needed by the local community. Operation and ownership will be offered to provincial and local governments, airport commissions, private businesses or other interests, in that order. While Canadian airport authorities (CAAs) are the preferred option for managing NAS airports, owners of regional and local airports will be free to decide their own preferred management options in accordance with community needs.

In a five-year period beginning April 1, 1995, the government will introduce measures to increase the viability of regional/local airports by reducing the variance between costs and revenues at each site. This will be accomplished by increasing efficiency and revenues at the airports as well as by streamlining policies and regulations. Local entities may find it advantageous to assume responsibility for an airport before the end of the five-year period. This would allow them to introduce enhanced efficiency measures not possible under federal control and make them eligible for capital contributions under the Airports Capital Assistance Program (ACAP).

The ACAP, to be introduced April 1, 1995, will contribute funds toward safety-related airside projects. To be eligible for ACAP, airports must not be owned, operated or subsidized by the federal government and must have regularly-scheduled passenger service. Airside projects are those relating to infrastructure such as runways and taxiways.
If the proposed operator can demonstrate that the airport can be self-sufficient and serves interprovincial or international flights, and is prepared to forgo access to the Airport Capital Assistance Program, application can be made for inclusion in the National Airports System.

Criteria for Regional/Local Airports

Regional//Local airports are defined as those sites:

- whose scheduled passenger traffic is less than 200,000 a year for three consecutive years;
- not the national capital or a provincial or territorial capital;
- not classified as Arctic or remote airports; and
- where there is currently some form of ongoing federal financial involvement relating to the ownership or operation of the airport; and
- with scheduled passenger traffic.

(See Appendix AA for a listing of Regional/Local Airports).

Local Orientation of Regional/Local Airports

At regional/local airports, passengers usually begin or end their trips at that airport. Passengers fly from regional/local airports to busier “hub” airports for connections to larger domestic or international centres.

In total, regional/local airports serve six per cent of the total annual passenger/cargo traffic in Canada.

Local Ownership and Operation of Regional/Local Airports

The federal government will be withdrawing from operational and financial involvement in regional/local airports within five years, beginning April 1, 1995.

During those five years, regional/local airports will be offered to provincial and local governments, airport authorities, private businesses or other interests, in that order.

This transfer provides for a variety of local management options. For example, a province may wish to obtain title to airport lands, yet have the airport operated by a local airport commission.

Experience has shown that local airport operation has been more viable, more responsive to community needs and better able to match service levels to local demands and resources.

Operational Efficiencies for Regional/Local Airports
To make regional/local airports more attractive for local operation and thus ensure their viability, the government will initiate a number of measures to improve airport self-sufficiency within the five-year period beginning April 1, 1995.

These include adjustments to current levels of service and a wider application of user charges and fees.

Once a local operator assumes responsibility for a regional/local airport, there is significant potential to generate commercial opportunities and identify operational efficiencies (such as reductions in overhead costs, timely capital investment and quick response to local commercial initiatives).

**Airports Capital Assistance Program**

An **Airports Capital Assistance Program (ACAP)** will be established to help regional/local airports finance safety-related capital projects. Funding will be limited to safety-related airside projects such as runways, taxiways, and aprons and to those airports not owned, operated or subsidized by Transport Canada. Subject to the financial situation of each airport, local operators will be required to contribute a maximum of 15 per cent toward project costs. ACAP recognizes the role that regional/local airports play relative to the national airports system and it serves as a means of providing project-specific financing to these airports. Passengers originating or concluding their travel at regional/local airports contribute to the revenues of larger national or international airports as they pass through these larger facilities. ACAP provides an indirect means of returning revenues to the regional/local airports because lease revenues paid to the federal government, by CAAs operating the larger airports, will fund the ACAP program. ACAP will be established April 1, 1995.

**Regulatory Amendments**

The federal government will continue to set safety and security standards for all Canadian airports. The means to accomplish this are already in place and include policy-setting, airport transfer agreements, airport certification and regulation.

At certain larger regional/local airports, standards for emergency response services will be regulated to ensure that current standards are maintained as the federal government withdraws from the operation of these airports. At the remaining regional/local airports, emergency response plans will be mandatory under the airport certification process, as is currently the case. Local operators of these airports will be in a position to establish emergency response services that reflect the capabilities of the surrounding community.

**Other Transport Canada Services**
In addition to airport operation, the federal government currently provides air navigation facilities and services at Canadian airports. Provision of these services is based on airport traffic volumes, not airport ownership. The federal government is currently reviewing these services to ensure they match the needs of the local aviation communities while maintaining safety. The government is also consulting with the aviation community and affected parties on the potential for commercializing the air navigation system.

Aviation security measures at NAS airports are provided under existing security regulations. These regulations apply to certified airports, regardless of who owns or operates the airport. Regulatory consultation on certain aspects of security regulation is being undertaken by the federal government.
Appendix C: Comparisons of Governance of Transportation Infrastructure Operators in Canada

<<provided in separate file>>