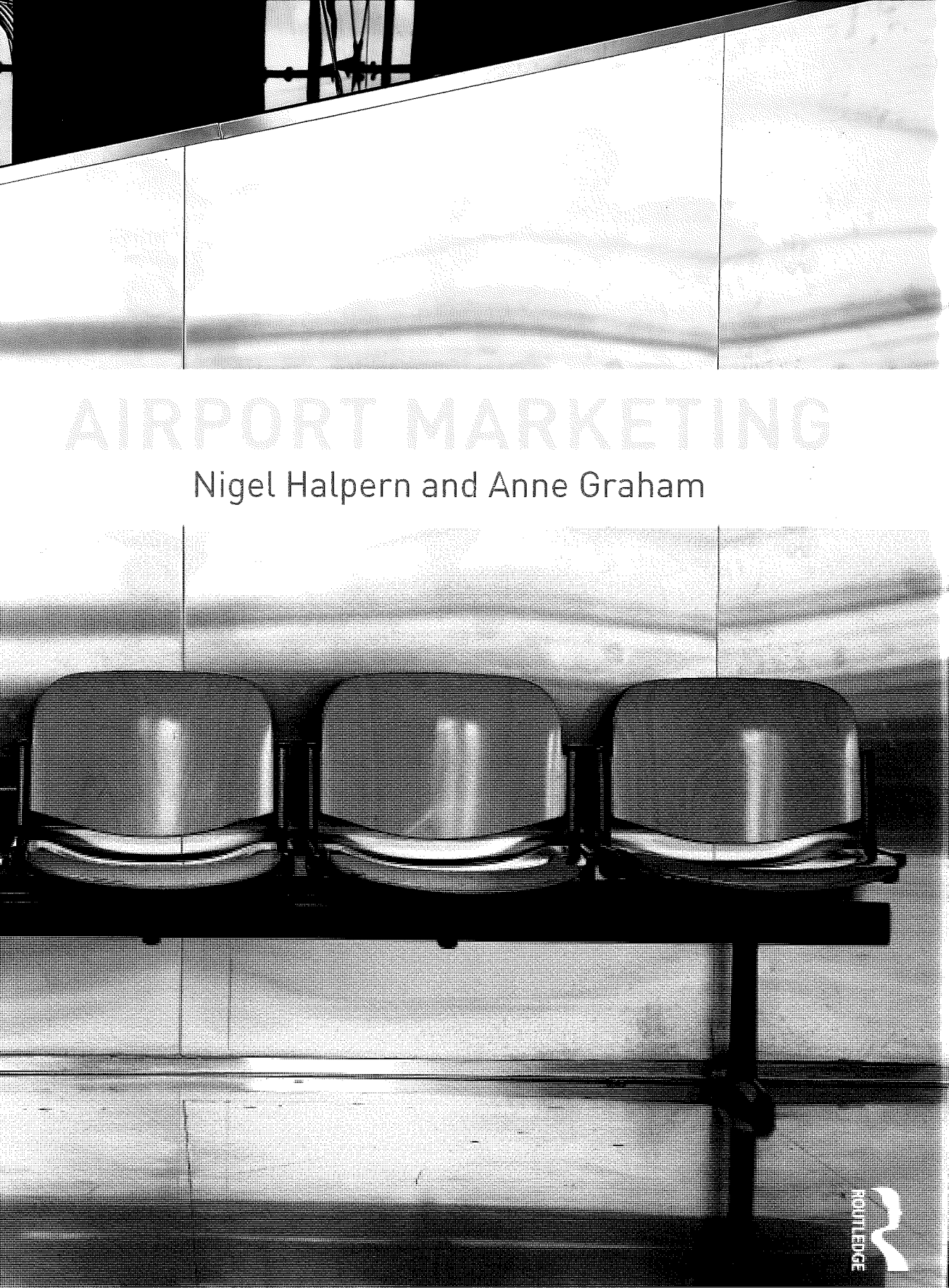
AIRPORT MARKETING

Nigel Halpern and Anne Graham



First published 2013
by Routledge
2 Park Square, Milton Park, Abingdon, Oxon OX14 4RN

Simultaneously published in the USA and Canada
by Routledge
711 Third Avenue, New York, NY 10017

Routledge is an imprint of the Taylor & Francis Group, an informa business

British Library Cataloguing in Publication Data
A catalogue record for this book is available from the British Library

Library of Congress Cataloging in Publication Data
Halpern, Nigel.
Airport marketing / Nigel Halpern, Anne Graham.
pages cm
Includes bibliographical references and index.
1. Airports—Economic aspects. 2. Airports—Management.
3. Aeronautics, Commercial—Economic aspects. I. Graham, Anne. II. Title.
HE9797.4.E3H35 2013
387.7'360688—dc23 2012046166

ISBN: 978-0-415-52938-9 (hbk)
ISBN: 978-0-415-52939-6 (pbk)
ISBN: 978-0-203-11790-3 (ebk)

Typeset in Sabon and Frutiger
by Keystroke, Station Road, Codsall, Wolverhampton

MIX
Paper from responsible sources
FSC® C013056
FSC www.fsc.org

Printed and bound in Great Britain by
TJ International Ltd, Padstow, Cornwall

As shown in Table 7.2, retail concessions are particularly important to airports, although in North America it is revenues from car parking and rental car concessions that are most important. Charging practices for concessions vary by airport, as do approaches to concession contracting (see Chapter 9). Typically, airports charge concessionaires a fixed rent for the space provided or a variable rent that includes a minimum annual guaranteed rent and a percentage of the turnover. The percentage of turnover can vary dramatically depending on the size and scale of activity, location, products and services, and expected profit margins. It may range from as little as 5 per cent for concessions with lower profit margins to as much as 60 per cent for those with higher profit margins. A minimum level of capital investment (e.g. per square foot) may also be required from the concessionaire. In addition, charges will vary according to the type and length of concession contract, discussed in more detail in Chapter 9.

Antonio B. Won Pat International Airport launched a request for proposals (RFP) for its duty free and travel retail concession in 2012, offering a ten-year contract on 24,076 square feet of retail space, with an additional 1,719 square feet in the future. The previous concession generated sales of USD 34.8 million in 2011. The RFP stipulated the payment of a minimum annual guaranteed rent of USD 6 million and a rent rate of at least 25 per cent of gross revenue. A minimum capital investment of USD 250 per square foot was also required by the successful bidder. Other non-financial requirements were stipulated in the RFP, including five years' continuous experience within the last seven years, including operating a minimum of one single location with gross sales of USD 25 million per year for each of the five qualifying years, and experience of successful operations within a TSA or foreign equivalent environment for a minimum of five years. Specific categories of retail that had to be offered on an exclusive or non-exclusive merchandise basis were also listed in the RFP, including luggage, handbags, personal accessories, jewellery, cosmetics, skincare, fragrances, cigarettes, souvenirs and gifts, and packaged food (Moodie, 2012).

7.4 Economic regulatory environment

Airports often dominate their local geographic market, and at many of the world's larger airports demand exceeds supply, especially during peak periods. In these circumstances, airports may experience monopoly or near-monopoly conditions that allow them to set high prices for use of their facilities and services. As a result, many governments limit airports' ability to abuse their market power by restricting prices, especially for aeronautical facilities and services needed to facilitate the movement of aircraft and their passengers and cargo.

When airport charges are regulated, a decision will need to be made on how to treat the respective sources of aeronautical and non-aeronautical revenue. There are two main approaches (ACI, 2007). The 'dual till' approach splits the aeronautical and non-aeronautical sides of the airport business into two distinct parts. Revenue from the aeronautical side of the business (such as from the PSC, landing charges and security charges) is used for aeronautical expenditure (such as on runway maintenance and terminal development), and it is only the aeronautical side of the airport business that is regulated. Non-aeronautical revenue (such as from concessions) is then used for non-aeronautical expenditure (such as developing retail space or car parks) and contributes to company profits. The non-aeronautical side of the airport business is then allowed to operate under normal market conditions. The 'single till' approach does not distinguish between aeronautical and non-aeronautical revenue, meaning that all airport revenue is considered for the purpose of setting airport charges.

Under a single till, aeronautical charges are likely to be lower because non-aeronautical activities – which are often more profitable than aeronautical activities – will help to reduce the charges. That is why the single till is generally favoured by airlines. Their argument is that

passenger expenditure on non-aeronautical activities is a by-product of airline operations and should therefore be considered for the purpose of setting airport charges. The dual till is likely to result in higher aeronautical charges. It is generally favoured by airports because they are able to generate and retain higher profits from their non-aeronautical activities. Airports argue for the dual till on the basis that their non-aeronautical activities are a separate part of their business and should not be used to subsidise charges for aeronautical activities. Comparative approaches to the single and dual till are known as 'residual' and 'compensatory' in the US, and are discussed later in this chapter.

The economic regulatory environment varies. Some airports are not regulated; this is often the case where governments own a national network of airports and subsequently set the charges themselves (e.g. with the 67 airports in Brazil operated by the state-owned airport operator Infraero). It is also the case in Canada, where airports are operated on a not-for-profit basis and are therefore not in a position to abuse market power. Elsewhere, regulatory mechanisms may be used, especially at main airports, and although a range of mechanisms for regulating airport charges are used worldwide, they can generally be grouped according to three broad types (see Figure 7.4).

Commercial negotiation is a largely market-based mechanism. It involves the negotiation of charges between airports and their users. Governments or regulatory bodies may play a passive role in the negotiations, monitoring or reviewing the prices set and relying on the threat of regulation as a deterrent for monopolistic pricing. This model is currently used at major airports in Australia (Sydney, Melbourne, Brisbane, Perth and Adelaide), where the Australian Competition and Consumer Commission monitors prices. It is also used in New Zealand (Auckland, Wellington and Christchurch), although the government may ask for an ad hoc review of prices by the Competition Commission.

Many publicly owned and operated airports set their charges on a cost-recovery basis. This method is common in the US, where many airports are owned and operated by local or national government. Airports set charges following consultation with airport users, and federal

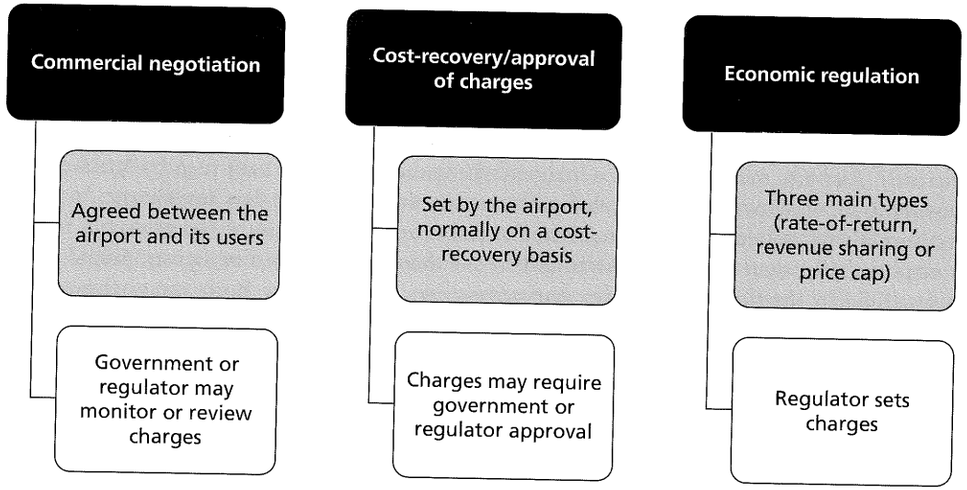


Figure 7.4 Main mechanisms for regulating airport charges
Source: compiled by the authors

government may intervene if necessary. Airports in the US may take one of two main approaches: residual (e.g. at San Francisco International, Miami International and Dallas/Fort Worth International) or compensatory (e.g. at Los Angeles International, Tampa International and Boston Logan International). With the residual approach, airlines pay charges related to the net costs of running the airport (including non-aeronautical activities). This is similar to the single till approach taken by airports outside the US, but there is one key difference: the airlines need to guarantee that the level of charges will always allow the airport to break even. The airport may levy lower charges as a result of including revenue from non-aeronautical activities but will have lower risk as it is largely passed onto the airlines. With the compensatory approach, airlines pay agreed charges related to the costs of facilities and services they use. This is similar to the dual till approach taken by airports outside the US. Airports may be able to levy higher charges but will assume a greater degree of risk. There are also a number of airports in the US that use a hybrid approach, combining elements of the residual and compensatory approaches (e.g. at Orlando International, Washington Dulles International and Reagan National).

In other countries, charges are set – or need to be approved – by the government or regulatory body. For example, charges in Japan are set by the government, which takes into consideration the overall cost of the 28 airports under its control. Other airports in Japan (Narita International, Kansai International, Central Japan International Airport Centrair and airports controlled by local governments) are also required to obtain approval from the government when setting charges. Most apply the same landing charges, except for Narita, Kansai and Centrair. These airports have traditionally experienced high levels of debt and are not supported by the same funds allocated to national or local government airports (e.g. the airport development special account that collects revenues from all airports before being re-distributed). As a result, charges levied by the three airports have traditionally been high.

Economic regulation represents the most formal and heavily regulated approach to setting airport charges. With this mechanism, the government or an independent regulator has an active role in setting airport charges. There are three broad approaches to economic regulation: rate-of-return, revenue cap or price cap.

Rate-of-return is the least heavy-handed of the three approaches. The basic principle is that airports can charge prices that will cover costs and earn a normal rate-of-return on capital. The rate-of-return method is used in the Netherlands to regulate charges at Amsterdam Schiphol Airport under a dual till approach, where the rate-of-return is determined by the regulator taking the weighted average cost of capital as the asset base. The obvious issue with this approach is that there is little incentive to reduce costs because the rate-of-return is set, irrespective of efficiency. Airports may therefore be inclined to expand their asset base (e.g. by 'gold-plating') in order to increase cost of capital, and subsequently the prices that they can charge.

Alternatively, regulators may use revenue or price caps to determine charges that can be levied by airports. A revenue cap limits the total revenue that can be earned in a given period while a price cap limits the price that can be charged within a given period. Both approaches subtract expected efficiency savings (X) from a measure of inflation such as the retail or consumer price index. Revenue caps offer airports stability in terms of total revenue. They also offer reduced risk to changes in demand because unit charges are inversely related to growth in demand. Price caps allow airports to retain profit; they offer an incentive to increase efficiency because when X is zero per cent or greater, airports can only improve financial performance through efficiency such as increased traffic or better productivity, and not through price increases. The problem with price caps is that they may also encourage cost-cutting and reduced service quality as a means of generating increased profit.

Price caps are widely used to regulate airport charges. For instance, single till price caps are used in the UK (London Heathrow, London Gatwick and London Stansted), Ireland (Dublin),

South Africa (Airports Company South Africa's nine airports) and Argentina (Airports Argentina 2000's 33 airports). India recently adopted a price cap regulation for its major airports (Bengaluru International, Cochin International, Delhi Indira Gandhi International, Hyderabad Rajiv Gandhi International and Mumbai Chhatrapati Shivaji International). The incentive-based regulation uses a single till approach and is reviewed every five years (five-year review periods are fairly standard, although some regulators review after between three and four years). The price cap takes into account the fair rate-of-return in addition to other factors such as the regulatory asset base, capital investment plans, depreciation, traffic forecasts, and expected operation and maintenance expenditure. The regulator also takes into consideration the quality of service provided by airport operators, according to specific service parameters, when determining the price cap and uses a mechanism that reduces charges for under-performance by way of rebates to airport users.

7.5 Incentive mechanisms

7.5.1 The need to share risk

As discussed earlier (e.g. Chapters 1 and 2), the airport business environment has changed dramatically in recent years. Demand for air transport has grown exponentially; air transport markets have become increasingly deregulated, meaning that airlines are freer to choose where they fly to and from; and LCCs have emerged and offer considerable opportunities to grow new and existing markets, including to and from relatively small airports. Deregulation and LCCs have also had an impact on existing airline business models, encouraging increased competition and a focus on cost-reduction.

In parallel with these changes in the airline industry, the airport business has transformed from being considered a public utility to a commercial business, sometimes with corporatised or private owners or operators that want to see growth at their airports. In addition, airports are increasingly viewed as engines for regional economic development, meaning that there is a growing level of local support and desire for airport growth. Changes in the airport business environment offer opportunities for growth, especially at uncongested regional airports; however, in order to compete, airports increasingly need to demonstrate a willingness to share in the financial risk associated with establishing new routes or growing existing services at their airport by offering incentives to airlines, especially during the early stages of establishing a new route, because the start-up cost for an airline can be particularly high.

One of the earliest and most significant examples of airport incentives was an agreement between BSCA and LCC Ryanair. BSCA is located 46 kilometres south of Brussels. It served around 50,000 passengers per year between 1990 and 1996, mainly on charter flights. Ryanair began to operate at the airport in 1997 and grew passenger demand to about 200,000 within one year. Ryanair then decided to create its first continental base at the airport in 2001 and had established 12 routes and 21 daily frequencies by 2004, serving almost 2 million passengers (Jossart, 2004). Airport incentives were central to Ryanair's expansion at the airport, and details of the financial agreement between BSCA and Ryanair became public in 2001 (see Table 7.9).

After receiving complaints about the agreement between BSCA and Ryanair, the EC launched an investigation and subsequently ruled that the airport owner – the Walloon regional government – was not behaving in the same way a private operator would have under the same circumstances. Some of the aid towards the start-up cost of the new routes was considered acceptable by the EC, but many of the payments made were not. In addition, the EC believed that the deal between BSCA and Ryanair was not conducted in a transparent and non-discriminatory manner because