

Mr Stewart Wingate
JSG Joint Chair
7th Floor
Destinations Place
South Terminal
Gatwick Airport
RH6 0NP

Mr Alan Peever
ACC Chair and JSG Joint Chair
4th Floor
Jubilee House
Furlong Way (G96)
PO Box 747
North Terminal
Gatwick Airport
RH6 0JN

05 October 2012

Dear Stewart and Alan,

Gatwick Airport Mid Constructive Engagement (CE) Review

Thank you for your letter of 15th September 2012 which provided an update on the progress of CE at Gatwick.

In April 2012, the CAA published a Mandate for Constructive Engagement¹ at Gatwick that had been agreed with Gatwick Airport Limited (GAL) and the ACC to start the formal CE process. In the CE Mandate the CAA announced that to enable it to take a fully informed view of the progress of and prospects for CE it would conduct one 'mid-term' review in September 2012.

On 20th July 2012 the CAA wrote to the co-chairs of CEWG to explain how it proposed to conduct the mid-term review. It stated that important aspects of this would be:

- a progress report requested from the two co-chairs by 15th September 2012 on the progress made within CEWG and the prospects for a successful outcome; and
- a meeting between the CAA and the co-chairs in late September.

Summary of CE to date

Based on your letter and the follow up meeting between GAL, the ACC and airlines, and the CAA, the CAA understands the progress of CE to be as follows:

The ACC and GAL have agreed a simplified consultation framework, with weekly constructive engagement meetings feeding into a monthly Joint Steering Group. The JSG is

¹ <http://www.caa.co.uk/docs/5/GatwickCEMandate.pdf>

the only decision making forum and is jointly chaired by the ACC and GAL. There has also been agreement on a facilitation process and a facilitator for this process, should it be activated. Meetings have been well managed and business like. The airport expressed a desire for more technical airport representation, although the airlines considered that this should be addressed by their appointment of external consultants.

The ACC and GAL have agreed that the base case traffic forecast is appropriate. GAL and the ACC have different views on the robustness of the high case traffic forecast, and whether it should be used as the basis of the capital expenditure plan.

The main focus of CE so far has been on capital expenditure. The ACC has welcomed GAL's use of the business case format in outlining proposed capital projects. The vast majority of capital expenditure has been the subject of an initial discussion at the CEWG, and further work is on-going on these projects. The ACC has supported GAL taking most of the capital projects to Tollgate 3, as further information is needed for the ACC to be in a position to take a view on these projects. There has not been any agreement on whether any of the proposed projects should be developed in Q6, nor has there been any agreement on whether any of the proposed projects should not be developed in Q6.

GAL has made good progress in setting out estimates of the costs of different service levels, through the service/traffic matrix. However there has not yet been significant discussion of the service quality regime for Q6, or the value of different levels of service, however detailed sessions have been agreed to be scheduled this month.

GAL and the ACC have disagreed over the level of detail that is needed for a CE discussion of GAL's forecasts for operating costs and non-aeronautical revenue in Q6. GAL has recently provided further detail on security costs and is considering providing more detail on staff costs and commercial revenues.

Relationship between CE and other airport-airline discussions

In GAL's July response to the CAA's May Policy Update on Q6, it proposed an alternative to traditional economic regulation. This foresaw all airlines using Gatwick being protected by Commitments from the airport, as well bilateral contracts between the airport and some airlines.

The CAA welcomes these proposals. In the right circumstances, bilateral contracts and airport Commitments could be capable of providing protection that is at least as good as what regulation can provide, while also allowing more diversity and flexibility of provision than regulation easily allows. At its best, such a system could be better than regulation, and therefore be in the interests of passengers.

Any commitments or bilateral contracts would need to comply with applicable laws, notably with non-discrimination requirements (of competition law and of the Airports Act 1986 as amended by the Airport Charging Regulations 2011).

If a commitment/contract regime were to be a main reason why a price control would not be put in place (when it otherwise would be), that regime would also need to be fair to airlines. This means the overall deal would have to be reasonable compared to a potential regulatory settlement, and that non-discrimination was observed.

The CAA's published Q6 timetable foresees it taking a view on initial price control proposals in April 2013. If a contract/commitment proposal were to be a basis for the CAA proposing not to impose price controls (when it otherwise would), obviously the detail of such a regime will need to be clear well in advance of April 2013. The CAA will also want other stakeholders to have had time by then to form an informed opinion, and to know their views. The CAA therefore looks forward to GAL bringing forward in the coming months clear and concrete proposals regarding commitments.

As of now, the CAA is preparing to impose price controls in Q6. This will remain the case unless and until the CAA has confidence that an alternative route is available and is a better response to its statutory duties. (Or if the CAA concluded that passengers are protected by competition because Gatwick does not have significant market power.)

CAA expectations for remainder of CE

In this context, the CAA appreciates the work undertaken by the airport and airlines as part of CE and the progress that has been made. Since we do not expect a fair and non-discriminatory contracts/commitments regime to be offered before the end of 2012, the CAA expects CE to continue in accordance with the agreed CAA mandate.

The CAA encourages airlines and the airport to try and reach agreement where possible for example on traffic, service quality and the choice of capital expenditure schemes, and where not, for example on operating expenditure and commercial revenues, to attempt to narrow the scope of disagreement.

As set out in the mandate the CAA expects the JSG to provide a final report in December 2012 recording all points and disagreement in relation to each element of a RAB based price control. The CAA envisages that the submission would include the supporting context, reasons and evidence for each of the inputs to the CAA's setting of the price control for Q6 providing full visibility of the range of reviews. In addition to the regulatory building blocks, other issues including the extension of the price control beyond Q6, and the indicative price paths for subsequent quinquennium should be included in the final CE report.

CAA consultancy work

If the CAA considers that economic regulation is still required then the CAA will need to publish its initial proposals for the regulation of Gatwick in April 2013. These proposals will need to cover the form of regulation for Gatwick and any proposed price cap and associated service quality and incentive regime.

In parallel to CE the CAA is undertaking its own work to inform its initial proposals. The CAA has commissioned or is in the process of commissioning the following consultancy studies which cover Gatwick Airport.

Title	Consultants	Expected completion date
Comparing and capping airport charges at regulated airports ²	Leigh Fisher	October 2012
Heathrow, Gatwick and Stansted employment cost study ³	IDS	October 2012
Gatwick Q5 capex review	ITT issued, awaiting tenders	January 2013
Passenger satisfaction of arriving, departing and connecting passengers	Being undertaken by CAA's own survey team	January 2013

Based on the progress identified in the mid CE review the CAA intends to commission consultancy in the following areas over the remainder of 2012. The CAA expects airline and airport discussions to continue while the CAA undertakes this work. The CAA would expect to update its consultancy work following the publication of the Airport Business Plan in January 2013 and undertake further consultancy work as required as part of the Q6 review. Where possible and appropriate the CAA expects to consult on the draft terms of reference of consultancy with relevant stakeholders.

Title
Benchmarking of airport central costs
Maintenance and renewal costs
Other operating expenditure
Top down operating expenditure benchmarking
Commercial revenues
Enhancement expenditure
Cost of capital review
Long run incremental costs

Timetable for Q6 review

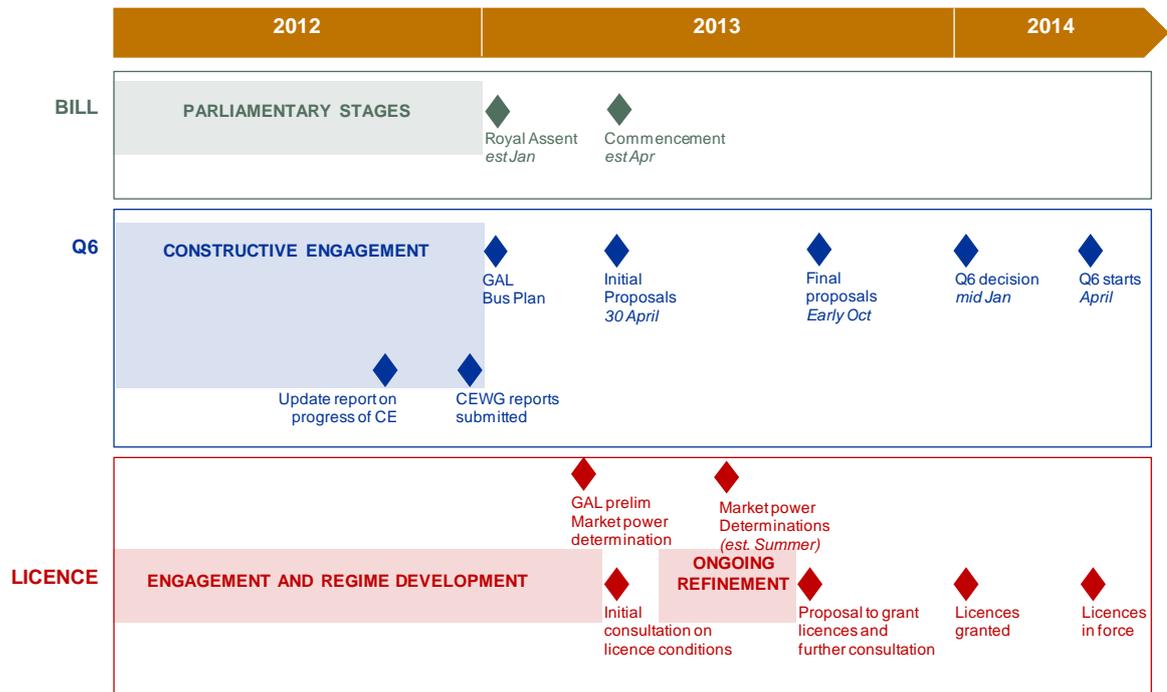
Based on the progress of the New Civil Aviation Bill and work so far on the Q6 review the CAA envisages the following updated timetable for the remainder of the review. In October

² The terms of reference for this study is at: [http://www.caa.co.uk/docs/78/1387SO25Spec%20\(2\).pdf](http://www.caa.co.uk/docs/78/1387SO25Spec%20(2).pdf)

³ The terms of reference of this study is at: <http://www.caa.co.uk/docs/78/1387SO26Spec.pdf>

2012, the CAA expects to write to each of the airports to set out its requirements for the January Q6 business plan and the process for submitting updated information during the Q6 review.

The CAA intends to adopt the timetable set out in the diagram.



Apart from the consultancy studies mentioned above and the market power assessments, the CAA has no current intention to publish material ahead of its initial proposals in April 2013. The CAA will, however, keep this under review and will consider publishing further information or analysis if to do so would inform or assist the CE process.

On the timing of consultations during 2013, the CAA would publish its initial price control proposals for consultation at the end of April 2013, followed by stakeholder meetings with the CAA Board in July.

The CAA will then prepare its final proposals for publication in October 2013. The CAA requires any information that is likely to have significant implications for the price control such as changes in traffic or capital or operating expenditure forecasts to be provided by 20 July 2013 so that it can be taken into account in the final proposals. All parties should assume that any substantive new information provided after this date, will not generally be taken into account, especially if could have been generated earlier and other parties have not had the opportunity to comment.

Yours sincerely,

K Cheong

Ken Cheong
Head of Price Control Regulation