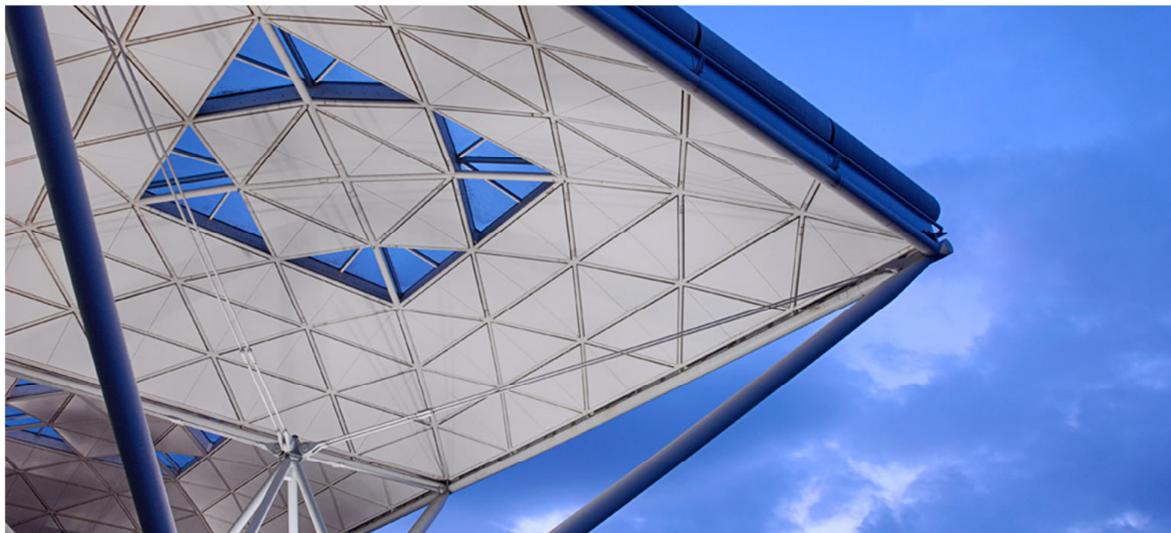


CAA Policy Update

Review of Price Regulation at Heathrow, Gatwick and Stansted (“Q6”)



Response from Stansted Airport Ltd

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Executive Summary

The context for the Q6 Review

The CAA faces considerable challenges in preparing for a Q6 review at Stansted, at a time of fundamental change and uncertainty in the UK airports sector. The most important issues currently facing airports are:

- macroeconomic instability;
- lack of clarity around UK airports policy;
- changes to the legislative framework governing airport economic regulation;
- the introduction of licence-based regulation;
- the effectiveness of the CAA's Q5 price controls;
- changes in airport ownership; and
- the intensification of airport competition.

In this context, it is important that the CAA provides as much clarity as possible to stakeholders about its approach to regulating Stansted in Q6 to address and help reduce the impact of these uncertainties. In this respect, we welcome the CAA's recognition in the Policy Update that regulatory uncertainty would not further the reasonable interests of users of UK airports.

Stansted's response to the CAA's Initial Views document identified the further work needed to complete the market power assessments. We believe this analysis will show that Stansted has significant spare capacity during peak periods, and that all the necessary conditions for airline switching are in place. On this basis, we are confident that the CAA will determine that Stansted has strong incentives to behave competitively, and meet the needs of airlines and passengers.

This response is submitted without prejudice to that position, and is intended to facilitate further discussion with the CAA and other stakeholders about the issues in the Policy Update ("theUpdate"). The submission is therefore based on an assumption that the CAA establishes that Stansted has substantial market power (SMP) and demonstrates that the airport requires a Q6 licence. However, none of the views expressed in this submission should be interpreted as Stansted's acceptance that the airport has substantial market power or that continuing regulation would be appropriate beyond the end of Q5.

The Policy Update provides little clarity on the key issues that affect Stansted

The purpose of the Policy Update was to provide an update on the CAA's thinking on the most appropriate regulatory arrangements for Heathrow, Gatwick and Stansted after the present price controls expire in March 2014. The Policy Update follows the Setting the Scene consultation in July 2011, in which the CAA recognised the importance for stakeholders of addressing regulatory uncertainty, in particular the uncertainty over future regulatory models for each airport.

Responding to this concern, the CAA intended for the Policy Update to present its initial assessment of the appropriate regulatory model for each airport. Stansted's response to the Setting the Scene consultation welcomed the CAA's commitment to providing clarity on this key issue at an early stage in the Q6 process.

However, continuing uncertainty around the extent of Stansted's market power has meant that CAA has not been able to narrow down the range of the potential models that might be relevant for Stansted in Q6. We understand the reasons for this but one consequence is that the range of options still on the table for Stansted currently spans the continuum of regulatory models, from RAB-based price caps through to ex-post price monitoring.

The lack of clarity around a potential Q6 regulatory model adds to the uncertainty for stakeholders as a result of not knowing whether Stansted will be regulated at all in Q6. Under the CAA's current programme, these issues would not be resolved until the very end of the Q6 process.

Action is required to address this high level of uncertainty

Stansted has proposed that CAA should explore with stakeholders ways to defer a "full scale" Q6 until such time that there is clarity on the need for a Q6 licence, and the CAA can properly engage stakeholders in the development of a proportionate and targeted regulatory model. This sequential approach will reduce the impact on stakeholders of the current uncertainty, and allow the CAA to follow a targeted and logical process.

We are supportive of the CAA's proposal to consider simple and pragmatic options that could apply during an interim period after the end of Q5. One such option would be to develop a provisional licence for Stansted that could be issued in April 2014, in the event that the CAA establishes that Stansted requires a Q6 licence.

By planning on the basis that a provisional licence could be issued "if required", the CAA would create the additional time needed to reach a decision on Stansted's market power and then develop clear proposals on the regulatory model to apply after the interim period. We look forward to engaging with the CAA and Stansted airlines on these issues.

Other key areas where CAA action is required

To help guide the CAA's approach to Q6, our response identifies eight further areas where action is required:

1. The CAA should commit to issuing its formal legal decision on Stansted's market power as soon as it has the powers to do so.
2. The CAA should extend Q5 by one year under the Airports Act 1986 to safeguard against the possibility that the Civil Aviation Bill does not become law
3. The CAA should minimise uncertainty and costs by using its 'minded to' assessment of market power to narrow down the range of regulatory options under consideration

4. The CAA should develop more comprehensive assessments of the sufficiency competition law and the costs and benefits of regulation so that the need for a Q6 licence can be established in parallel with the CAA's final decision on market power
5. The CAA should adopt a positive approach to assessing the costs and benefits of regulation, rather than a precautionary approach which favours leaving regulation in place 'just in case'.
6. The CAA should develop a Stansted Q6 licence (if required) from first principles rather than attempt to adapt or cut down a licence developed for another airport
7. The CAA should begin the process of developing demand forecasts for the London system as soon as possible to inform its assessment of Stansted's market power and to inform its views on passengers' priorities
8. The CAA should set out a comprehensive programme to identify the work that is planned between now and the publication of initial Q6 proposals

We look forward to supporting the CAA in delivering this Q6 work programme.

1. How should the CAA approach a strategy for airport licensing?

- **The CAA should extend Q5 by one year under the Airports Act 1986 to safeguard against the risk of the Civil Aviation Bill does not become law**

The Update highlights (para 2.1) that there is no guarantee that “the new regime will be fully in place by the time that the current price controls at Heathrow, Gatwick and Stansted expire at the end of March 2014.” The Update then emphasises (para 2.3) that “the CAA must be in a position to discharge its duties under those provisions [of the Airports Act] until they are repealed.”

In light of this risk and the CAA’s duty, the CAA should extend the Q5 period at Stansted by one year under the Airports Act to safeguard against the possibility that the new regime will not be in place by the end of March 2014. This will provide additional time for the CAA to implement, if required, a new regulatory settlement after Q5 expires.

Taking this action would be consistent with the recent removal of the CC from the Airports Act process, in the event that the CAA needs to conduct the Q6 review under the existing regime.

- **Regulatory uncertainty is not in the interests of users**

We agree with the CAA’s view (para 2.6) that “This uncertainty would not further the reasonable interests of users of UK airports and neither would it encourage timely investment to be made.”

It is clear from the Update that Stansted is currently subject to an exceptional level of regulatory uncertainty. In addition to the uncertainties associated with the new regime, there remains considerable uncertainty around the extent of Stansted’s market power, and consequently knock-on uncertainty around the form (if any) of the appropriate regulatory model.

The CAA should identify each of the significant sources of regulatory uncertainty and take positive steps to minimise these risks. As the Update makes clear, this would be in the interests of users. It would also be in the interests of investors and other stakeholders.

- **The CAA should commit to issuing its formal legal decision on Stansted’s market power as soon as it has the powers to do so.**

The CAA’s planning assumption is that the Secretary of State will lay the necessary orders to commence Part 1 of the Bill by April 2013. On this basis, the CAA will have the necessary powers to make market power determinations from this point onwards. However, elsewhere the Update comments (para 4.8) that from a legal perspective the CAA does not need to make its determination until late 2013 or early 2014.

Although we recognise that a formal legal decision is not strictly needed for the purposes of Q6 until later in 2013 or early 2014, the CAA should commit to issuing its formal legal determination as soon as it has the necessary legal powers under the new Act. The CAA should not wait until the 'last responsible moment'; making the decision at the earliest possible opportunity will minimise the period of uncertainty for stakeholders, and reduce the costs associated with the Q6 review.

- **The CAA's general licencing powers could lead to disproportionate regulation and introduce distortions to competition**

The Update emphasises (para 2.13) the CAA's powers to "oblige the licensee to encourage coordinated action and communication with other service providers at the airport".

While we accept that such action may be merited in some circumstances, the CAA must maintain a clear link between the risk of an airport abusing its substantial market power and the licence conditions it applies. For example, imposing onerous general conditions on an airport with limited market power could be disproportionate.

There is also a risk that competition could be distorted if the CAA imposes general conditions on a licensed airport that competes with other un-licensed airports where equivalent obligations do not apply.

- **Better Regulation principles**

Figure 2-7 highlights the CAA's duty to have regard to Better Regulation Principles, and the duty on the CAA not to impose or maintain unnecessary burdens by virtue of section 73 of the Regulatory Enforcement and Sanctions Act 2008.

We support the need for the CAA to have explicit regard to these duties in determining how it should best discharge its other duties. Of particular relevance to the current regulatory review for Stansted is the duty on the CAA not to impose or maintain unnecessary burdens, in association with the duty to promote competition. Taken together, these duties suggests that the CAA should adopt a positive approach to removing regulation, rather than adopting a precautionary approach which leaves regulation in place 'just in case'.

Although the Bill is not yet law, we would urge the CAA to commit to applying these principles to the way it conducts the Q6 reviews for Heathrow, Gatwick and Stansted. In particular, we would ask the CAA to ensure that its approach to conducting the review does not impose or maintain unnecessary burdens on Stansted. This would mean adopting a sequential and targeted approach to the Q6 process so as to reduce the costs and uncertainty on Stansted stakeholders.

- **The CAA should start from ‘first principles’ if it decides that Stansted requires a licence from April 2014**

The CAA should adopt a ‘first principles’ approach to developing an initial licence for Stansted, if it decides that one is necessary for the period from April 2014. This means that while some general conditions could be applicable to all licenced airports, the CAA should not seek to adapt or “cut down” a licence to fit the specific circumstances of Stansted.

The specific conditions in Stansted’s licence must be targeted specifically towards addressing the airport’s market power, and reducing the risk of abuse. The application of general conditions from a Heathrow or Gatwick licence could well be disproportionate or completely unjustified in a Stansted context.

For this reason, we would encourage the CAA to adopt an approach to developing an initial licence for Stansted which starts with the minimum conditions needed to make the licence operable, and only adds those conditions that are required to address the risk of Stansted abusing its market power.

The conditions in the licence should, initially at least, be drafted in high level terms that identify the broad outcomes that the CAA is seeking to achieve. The CAA must resist the temptation to draft detailed licence conditions that specify precisely the process or inputs that an airport should use. Only if airports do not respond to these general conditions should the CAA consider making the conditions more specific.

- **New licence conditions, and time to prepare**

Figure 2-7 emphasises the need for time to be given for airports to prepare for the introduction of new licence conditions, where these introduce new obligations on the airport. We support the general principle that appropriate time should be given for airports to prepare for the imposition of conditions in the new licence.

However, we are not aware of any current performance issues at Stansted that would merit the imposition of new licence conditions, let alone any that would require significant time for the airport to adapt prior to their introduction. We would ask the CAA to set out any specific areas where it believes such conditions would be merited.

2. How can the CAA ensure that its review of economic regulation is passenger-focused?

- **Stansted's customers are generally satisfied with the level of service they receive**

The overall perception created by the Update is that there are important service quality issues that need to be addressed by the CAA at all airports in Q6, for example:

- “The CAA is committed to ensuring that passengers get better outcomes in terms of their aviation journey. Q6 is one of a number of work programmes through which the CAA aims to deliver this.” (para 3.1)
- “Continuity of service is a key passenger priority, as demonstrated by the events surrounding the snow disruption at the London airports in December 2010. One of the key benefits of the Bill is that the CAA can introduce licence provisions aimed at strengthening a licensed airport's operational resilience.” (para 3.13)
- “The CAA's approach comprises four key elements, Improving regulatory levers on airports aimed at delivering better service quality outcomes in the most effective manner.” (para 3.20)

We do not accept that this is the case for Stansted. For example:

- In terms of overall performance, Stansted has been voted by passengers as the ‘Best Low Cost Airport in the World’ in the Skytrax Awards for both 2011 and 2012;
- In terms of punctuality, Stansted had the best record of any major UK airport in 2011 measured in terms of the percentage of departing flights leaving within 15 minutes of the scheduled departure time;
- In terms of resilience, Stansted's runway was closed for only a relatively short time during the period of severe winter weather in December 2010; and
- In terms of SQR, Stansted has achieved a good level of performance during Q5, with only a very small percentage of rebates paid to airlines.

This position is supported by Ryanair's comments at the trilateral meeting with Stansted and the CAA on 15th November 2011, where the airline said that it was generally satisfied with Stansted's operational performance.

It should be noted (para 3.34) that Stansted has also “undertaken passenger research to identify key drivers of satisfaction and where there may be gaps in performance” and we are in the process of implementing a programme of measures

to improve performance in the most critical areas. However, our primary focus at the current time is to deliver the current level of service in the most cost-effective way.

Hence, there does not appear to be a service quality 'problem' at Stansted for the CAA fix through the Q6 process. However, we agree with the CAA's view that there is likely to be a case for continuing with some form of service quality regulation at Stansted if the airport remains subject to price controls in Q6.

In addition, we would welcome discussions with airlines and CAA about how a service quality regime could continue to operate in the event that Stansted is de-designated. There would also be merit in exploring how a service quality regime might form part of a package of safeguards for passengers and airlines to enable the airport to be substantially de-regulated.

- **The CAA must allow airlines and airports to lead in defining service levels**

We agree with the CAA's view (para 3.3) that "Defining passengers' interests is a complex task.... because there may be competing aims between different passenger groups giving rise to trade-offs." There is considerable value in engagement between airport and airlines on service quality, regardless of whether the airport is regulated or not.

Given the complexity of the task, airports and airlines are generally best placed to evaluate and discuss these trade-offs and identify the best approach. This process is likely to be made easier at Stansted by virtue of: the relative homogeneity of airline and passenger characteristics; the high market share of Ryanair and easyJet; and the modest capital programme in the next five to ten years.

For these reasons, the CAA should step back as much as possible from these discussions to make sure there is full opportunity for airports and airlines to develop a shared view of the services to be provided to passengers. There is a risk that premature CAA involvement could distort or frustrate these discussions by introducing a regulatory dimension to a bilateral commercial process.

The Update states (para 3.23) that the working assumption that airlines will want the price and quality of services to reflect their passengers' requirements "implies that the CAA can place some weight on the outcomes from CE between airports and airlines." If CE produces airport/airline consensus, the CAA should place considerable weight on the outcomes. In this instance the CAA's role should be limited to one of assuring that the agreement is likely to meet passengers' needs.

- **Support for the CAA's engagement with stakeholders on cargo requirements**

We support the CAA's intention (para 3.17) to engage with stakeholders on the issues relevant to the cargo market. The cargo market at Stansted has very different characteristics to the cargo markets at Heathrow and Gatwick. For example, Stansted cargo is carried almost exclusively by dedicated all-cargo aircraft. At

Heathrow and Gatwick a significant amount of cargo is carried in the holds of passenger aircraft.

Stansted operates in a globally competitive market for dedicated cargo services. To enable Stansted to compete in this market we have recently invested in new infrastructure to enable cargo operators to operate the new Boeing 747-800F freighter aircraft from the airport.

We agree that it is important for the CAA to engage with stakeholders to understand better the cargo market in which Stansted operates. This work should explore the implications of the differences between airports on the rationale for continuing to regulate Stansted's cargo activities, and the most appropriate form of regulation if any is necessary.

- **Identifying passenger priorities**

A core part of ensuring Q6 is passenger focused will be an understanding of passenger demand during the relevant period. At a fundamental level, a view of demand will be needed for the CAA to discharge its supplementary duties "to secure that all reasonable demands for airport services are met".

Without a view of future demand, the CAA will not be in a proper position to determine whether airports' plans are likely to meet the needs of passengers, or determine the impact on consumers of failing to meet demand for air travel.

In addition, the importance of spare capacity in assessing the degree of competitive pressure on an airport means that an informed view of the likely traffic levels at Heathrow, Gatwick and Stansted will be an important consideration in the CAA's market power determinations.

In view of these requirements, we would encourage the CAA to begin the process of developing demand forecasts for the London system as soon as possible.

3. How can regulatory incentives towards service quality be improved?

- **Stansted's SQR scheme should remain focused on the most important areas for passengers**

The Update asks (Fig 3.10) stakeholders to consider whether “a large number of targets with relatively small amounts of money on each at stake is preferable to a smaller number of targets with more highly geared financial incentives.”

In principle, the relative priorities of passengers should be reflected in the way that incentive mechanisms are structured to ensure management incentives are aligned with passenger interests.

The current SQR scheme at Stansted is a hybrid of the two alternatives identified by the CAA. There are a large number of measures with relatively small rebate amounts against each individual measure, combined with a single measure (security queuing) with a highly geared financial incentive. The current structure and weighting of incentives was agreed between the airport and airlines during the Q5 review to reflect the importance that airlines attach to knowing that their passengers will be able to pass through security in a given amount of time.

In principle, we see no reason to change this overall structure where the weighting of incentives responds to airline priorities, and a high proportion of rebates are set against a small number of SQR measures. We expect to engage airlines in discussions about the relative weights for each of the measures as part of CE.

One option we will discuss with Stansted airlines is the possibility of reducing the number of SQR measures (from the current 18 measures) to a smaller number overall. This could be accompanied by a commitment to report performance against a range of other measures, but without attaching a rebate to any failure to achieve the specified standard. This could be beneficial in creating a sharper focus on a smaller number of measures. At the same time, the airport would publish its performance across a wider range of metrics to enable passengers to compare performance between different airports.

- **Stansted's SQR scheme should be amended to remove measures that are not relevant to passenger experience**

The Q5 SQR scheme incorporates a measure for the availability of air jetties. This measure is not relevant for most Stansted passengers because the biggest airlines have chosen not to use jetties for operational reasons. The inclusion of jetties in the Q5 scheme reduces the focus on other measures that are more relevant to the majority of passengers. It also increases the risk of regulation distorting normal commercial behaviours.

We would propose removing jetties from any future SQR. If airlines want assurance around the availability of jetties it would be more appropriate for the airport to enter into a direct SLA.

- **Some SQR measures should be restructured to create incentives for the airport that are aligned with passenger interests**

The framework should create appropriate, consistent and proportionate incentives for the airport to deliver a good quality of service to all passengers. Under the current scheme, when the airport fails to meet the specified standard of service, it pays the full amount of the rebate irrespective of the actual level of performance. The rebates are "knife-edge" penalties because they do not take into consideration how close the airport was to achieving the standard, and the rebate is the same whether the standard is missed by 1 per cent or 50 per cent. In this respect the rebate structure is not proportionate because it fails to reflect the service level provided to customers: a 'good miss' is the same as a 'bad miss'.

In principle, passengers attach value to higher levels of service, and the fact that SQR penalties are calculated in a way that does not reflect the actual level of service that passengers receive is inconsistent with this. Not only does the current scheme fail to penalise performance that is significantly sub-standard, it also fails to give due recognition to performance which is delivered at a level that is very close to the specified standard.

This rebate structure also has the potential to create perverse incentives for the airport. For example, once it becomes clear the standard will be missed for a particular month, the scheme provides no incentive to raise service levels for the remainder of the period, and the scheme could incentivise management to redirect resources to other areas of the business where rebates are still "at risk".

- **There should be transparency around the performance of all parties involved in delivering customer service to passengers.**

Passenger experience is determined by the quality of service provided by a wide range of different organisations, including the airport, airlines, handling agents and control authorities. Increasing transparency will drive improvements in passenger experience by highlighting aspects of good and poor performance, thereby informing passenger choice and improving competitive outcomes for passengers.

The SQR scheme is focused on the level of service provided to passengers and airlines by the airport; there are no equivalent arrangements to monitor performance by other parties operating at the airport. As a result, there is a lack of transparency around the performance of parties involved in delivering customer service to passengers, and relatively weak incentives for different parties to collaborate across the end-to-end journey to improve passenger experience.

In the context of the CAA's information powers, the CAA should consider the most effective of collecting and reporting service performance data from the various parties involved in delivering the end-to-end experience. We are proposing to airlines and other service providers at Stansted that as part of the Passenger Charter we should collect and report service performance across a wide range of measures

- **Careful thought must be given to the design of any incentives mechanisms applied to reliability and punctuality**

The CAA is considering (Fig 3.10) introducing changes to the SQR scheme to encourage airports to deliver reliable and punctual services to passengers. Stansted has a strong record of performance in these areas. Resilience and punctuality measures should not become standard features of SQR schemes; the need for the CAA to intervene should be assessed on an airport-by-airport basis. The CAA should only introduce resilience-related measures where there is a clear need to protect users interests.

The CAA must also give careful thought to the design and operation of any measures in this area to be confident that the SQR scheme does not lead to unintended consequences for users or expose the airport to penalties where it is not able to influence sufficiently the performance of third parties. For example, punctuality depends on a range of service providers, and the airport may not be in a position to influence the performance of these parties to be able to achieve the levels of performance in the SQR scheme.

- **Competitive equivalence – Airport Charges Directive requirements**

The CAA is considering (Fig. 3.10) how the SQR scheme could be amended to reflect differential levels of service provided by airports. The Update identifies examples of the some of the issues that would be experienced in implementing such measures.

A further example of an issue that would need to be addressed is the obligations placed on airports by the Airport Charges Directive where they provide differential service levels. For example, airports need to establish criteria for the allocation of these facilities where airline demands cannot be met.

- **Licence conditions relating to Conditions of Use**

The Update sets out the CAA's view (para 3.56) that airport/airline relationships may be improved by the inclusion of a licence provision requiring the airport's Conditions of Use to be fair, non-discriminatory, transparent and subject to appropriate consultation requirements.

We agree that an airport's Conditions of Use should be fair, non-discriminatory, transparent and subject to appropriate consultation requirements. However, these are examples of general obligations on airports; they do not need to be the subject of specific licence provisions.

The CAA's overall approach to developing the licence should be to set out high level obligations on airports, and rely on these provisions to drive the right behaviours. The CAA should not include restatements of general obligations in the licence in relation to specific issues.

4. What is your view on the rationale for economic regulation at Heathrow, Gatwick and Stansted?

- **Test A: the CAA should minimise uncertainty and costs by using its ‘minded to’ assessment to narrow down the options for further consideration**

The CAA’s Initial Views document for Stansted, published in January 2012, highlighted the relatively high degree of uncertainty around the nature and extent of Stansted’s market power. This initial assessment does not provide a satisfactory basis for the CAA to conduct the Q6 review, and we have recently proposed that the CAA should explore ways to defer the Q6 review until there is clarity on the rationale for continuing to regulate Stansted.

We welcome the CAA’s decision to issue a ‘minded to’ view on Stansted’s market power in December 2012. The CAA’s decision to bring forward its assessment in response to a consensus from the airport and its main airlines on the need to accelerate this work will provide more clarity on whether there is a rationale for continuing to regulate Stansted in Q6.

In advance of issuing its ‘minded to’ view, the CAA should set out what implications its assessment will have on its work programme in 2013. For example, if the CAA’s view in December 2012 is that Stansted does not require a Q6 licence, extensive further work on a conventional RAB-based price cap would be likely to have very little benefit. Alternatively, a view that Stansted does require a licence but its market power is such that it would not merit a conventional RAB-based price cap, should lead the CAA to narrow its work in 2013 to a relevant subset of regulatory models. Further detailed work beyond this point on the inputs to a RAB-based price cap would be highly resource intensive and not justified by the very limited benefit of having an additional comparator.

The CAA should also set out as soon as possible the timetable for issuing its formal determination on Stansted’s market power. Although we recognise that a formal legal decision is not strictly needed for the purposes of Q6 until later in 2013 or early 2014, the CAA should plan on the basis that it will issue its formal legal determination as soon as it has the necessary legal powers under the new Act. The CAA should not wait until the ‘last responsible moment’ to make its decisions; making the decision at this point in time will minimise the period of uncertainty for stakeholders, and reduce the costs associated with the Q6 review.

- **Test A: Stansted did not ask the CAA to conduct a comparative market power assessment for Luton**

The Update states (Fig 4.3) that Stansted considered that a “market power assessment for Luton should be undertaken so this can be compared to Stansted”. The CAA’s has also suggested that Stansted’s request for a market power

assessment of Luton might have been motivated by an interest in conducting a comparative analysis of the two airports. This is not the case.

Stansted's request for the CAA to undertake a formal market power assessment of Luton was made to ensure that any differences between the CAA's regulatory treatment of the two airports is justified by reference to contemporaneous assessments of market power. These assessments will provide the evidence base for the CAA to discharge its duty to promote competition wherever possible, and ensure that any regulation that is applied in the future minimises the distortions to the competition that exists between the two airports.

- **Test B: the CAA is required to assess whether Competition Law provides sufficient protection against the risk of substantial market power being abused**

The Update describes (para 4.2) Test B as “whether general competition law is better than sector specific regulation for remedying potential harm that could be caused by the airport's substantial market power”.

By suggesting that the CAA must choose between regulation and competition law, the Update mischaracterises the test that the CAA must apply to establish whether competition law provides sufficient protection for consumers. The test requires the CAA to focus on establishing whether competition law provides “sufficient protection” against the risk of the airport abusing its substantial market power.

This is a fundamentally different test to the one suggested by the Update. It is important to be clear that the CAA is not required to choose between continued economic regulation and competition law. This is important because the level of protection provided by competition law establishes the starting point for thinking about what additional economic regulation is necessary to address the risk of an airport abusing its substantial market power.

In other words, even if competition law is not sufficient, it still provides a base level of protection that should be taken into account in considering the design of a proportionate and targeted regulatory model. Similarly, the CAA should take into account the considerable additional protection for consumers established by the Airport Charges Directive which came into effect in 2011.

Taken together, our view is that competition law and the ACD would provide sufficient protection for consumers, given the very limited nature of any market power that the CAA might identify at Stansted.

- **Test B: the CC's 2009 Final Report does not provide relevant guidance on the sufficiency of competition law**

The Update reproduces (para 4.13) an extract from the CC's Final Report in 2009 which it claims sets out the CC's thinking on “the extent to which reliance could be placed on competition law as part of its market inquiry into BAA”. The Update goes

onto to assert (para 4.14) that because Stansted is not yet in separate ownership “it might be argued that it would not be appropriate for the CAA to conclude that reliance should be placed on competition law at each of the three airports at this time”.

However, the extract from the Report does not deal with the extent to which competition law can be relied upon to protect against the risk of substantial market power being abused; it deals with the issue of whether common ownership is an adverse effect on competition, and whether “competition between separately owned airports was sufficiently effective to substitute for regulation”.

- **Test B: the CAA’s assessment of the sufficiency of competition law should take into account a range of other factors**

In any event, the CAA should not rely on the CC’s 2009 Report to help it assess the sufficiency of competition law for the following reasons:

- there have been material changes in circumstances since the publication of the CC’s 2009 Report that have a bearing on the question of whether competition law can be relied upon; and
- one of the material changes relates to the increase in spare capacity at Gatwick and Stansted since the 2009 Report which will affect the extent of market power enjoyed by these airports, and the sufficiency of competition in these changed circumstances; and
- Gatwick is now in separate ownership.

The CAA’s appears to have overlooked these factors in assessing the sufficiency of competition law. In the context of a significant fall in traffic at Stansted, it is clear that the increased availability of spare capacity will have increased the extent to which competition law can be relied upon, other things being equal, because it will have reduced the strength of any market power at Stansted. In this context, the sale of Gatwick will also have increased the extent to which competition law should be relied upon.

The Update cites the change in Government policy towards runway development as a factor that point against reliance on competition law, on the basis that “capacity constraints are likely to continue for some time before effective competition might emerge”. We note that Stansted does not currently have capacity constraints at any time, and we are not projecting to be constrained for many years to come. We also note that the CAA has not reached a view on whether Stansted is subject to effective competition to enable it to judge whether this is a relevant factor in assessing the sufficiency of competition law.

We would also note that of the four factors cited by the Update (para 4.15) to suggest that reliance on competition law might be difficult, at least two of the factors are not

issues that are specific to airports. In other words, these are issues that are also faced by other sectors that rely on general competition law.

The changes in circumstances affecting Stansted since 2007 provide strong support for the CAA to place reliance on competition law. The CAA's preliminary analysis of these issues is incomplete and skewed towards an overly cautious approach to relying on competition law.

The CAA will need to develop a more comprehensive assessment of the sufficiency competition law as it finalises its views on Stansted's market power. In addition to the points identified above, the CAA should attach weight to the CAA's duty to promote competition between airports, and be particularly conscious of its potential duties under section 73 of the Regulatory Enforcement and Sanctions Act 2008 not to impose or maintain unnecessary burdens.

To minimise uncertainty this work should be conducted to a timetable that will enable it to decide whether Stansted requires a Q6 licence, at the same time as it makes its final determination on the airport's market power.

- **Test C: Regulation does not always have benefits**

The Update states (4.20) that "Regulation always has costs and benefits". We agree that regulation always has costs. However, it is not true that regulation always has benefits. We do not raise this point to be pedantic. Our view is that in circumstances where competition provides effective protection for consumers, the imposition of regulation will have no benefit, only costs.

The CAA's Initial View of Stansted's market power was that the airport did not have SMP in off-peak periods.¹ During these periods, competition with other airports provides sufficient protection for consumers and regulation is not necessary. The introduction of regulation during periods where competition is effective will risk distorting competition between airports and impose unnecessary costs on consumers and other stakeholders.

For these reasons, the CAA should specifically target regulation towards addressing any SMP that it finds; regulation should not be applied in a 'broad-brush' manner where competition is effective.

- **The CAA's preliminary analysis of costs and benefits is incomplete and skewed towards factors which may have reduced the costs of regulation**

The CAA will need to develop a more comprehensive and balanced assessment of the costs and benefits of a range of regulatory models. For example, the CAA's preliminary analysis presents a partial assessment of costs and benefits associated

¹ The CAA did not define what it meant by off-peak periods. Our view is that the off-peak periods at Stansted are the entire winter season (October to March), and most hours in the summer season.

with the new licensing regime, and a positive view of the reduced scope for investment incentives to be distorted at Stansted.

In contrast, there is no discussion of the potential for a licensing regime to increase costs (compared with the current framework) or an analysis of the reduced scope of benefits from regulation given the CAA's views concerning the absence of SMP at Stansted during off-peak periods.

- **Test C: the CAA should develop and refine its assessment of the costs and benefits associated with a narrower set of regulatory options relevant to Stansted**

The Update states that "It is difficult to reach a firm conclusion on Test C in the absence of a clear package of measures developed for regulating each of the airports". We agree that attempting to assess costs in the abstract is not a particularly productive exercise.

For this reason, we would urge the CAA to develop its assessments of costs and benefits based on a narrower set of regulatory options for Stansted. These options should be aligned to the CAA's Initial Views of Stansted's market power, and subsequently to the CAA's 'minded to' on the same issue. To minimise uncertainty this work should be conducted to a timetable that will enable the CAA to decide whether Stansted requires a Q6 licence, at the same time as it makes its final determination on the airport's market power.

As above, the CAA should attach weight in doing this assessment to the CAA's duty to promote competition between airports, and be conscious of its potential duties under section 73 of the Regulatory Enforcement and Sanctions Act 2008 not to impose or maintain unnecessary burdens.

5. What do you think is the most appropriate form or model for price regulation at each of the airports?

- **Continuing uncertainty around Stansted's market power makes it difficult for the CAA and other stakeholders to identify an appropriate regulatory model**

The Update discusses the merits of potential forms of price regulation that might apply from April 2014, and purports (para 5.9) to have “[narrowed] down the options further in relation to Heathrow, Gatwick and Stansted”. We firmly support the CAA's intention to use the Update to provide stakeholders with greater clarity on the form on regulation that could apply to each airport from April 2014 onwards.

This intention is consistent with the expectation created by the CAA's Setting the Scene consultation (page 22) which stated that the Policy Update would set out its views of the appropriate model of regulation at each airport” to help address regulatory uncertainty for stakeholders. Stansted's consultation response welcomed the CAA's commitment to providing clarity on this key issue at an early stage in the Q6 process.

However, the Update does not in fact manage to narrow down the options under consideration for Stansted.² This is acknowledged in the Update (para 5.65) “the CAA does not consider it appropriate at this stage to narrow down its options too far”. The reason the Update gives (para 5.65) for taking this approach is the “uncertainties surrounding Stansted”.

It should be noted that the CAA's objective (para 4.7) in initiating its market power assessments for each airport was to “reduce uncertainty about its views”. However, the level of uncertainty about Stansted's market power has prevented the CAA focusing on narrower range of regulatory models.

Consequently, the CAA is proposing to take forward a very wide range of regulatory models for Stansted for further consideration, spanning the regulatory continuum from RAB-based regulation at one end, to ex-post price monitoring at the other. This contrasts with the CAA's clear views on Heathrow where it considers the degree of market power held by the airport supports the application of a RAB-based approach.

- **The CAA should address the significant uncertainties by developing proposals for a “provisional” licence for Stansted**

We firmly support the CAA's proposal (para 5.66) in the Update to consider “simple and pragmatic” options that could apply during an interim period after the end of Q5, in the event that the CAA establishes that Stansted needs a Q6 licence.

² The only options that the CAA is proposing to rule out from further consideration are volume regulation and the separate regulation of different airport assets – options that had little relevance to Stansted in Q6.

Our view is that the approach provides a “practical solution” to address the high levels of uncertainty that currently exists in relation to Stansted. By planning on the basis that a provisional licence could be issued “if required” the CAA would have the time to reach a decision on Stansted’s market power and then develop clear proposals on the regulatory model that should apply after the interim period.

To implement this approach, we would expect the CAA to start by conducting a formal assessment of the feasibility and merits of a provisional licence. Following consultation on this assessment, the CAA would be in a position to confirm that it intended to develop a provisional licence for Stansted, which would only be issued if Stansted required a licence from April 2014. Under this approach, the CAA’s initial proposals planned for April 2013 would focus on the conditions for the provisional licence, and further consultation would follow as necessary on final proposals later in the year.

The CAA expects to issue its final determination on Stansted’s market power in 2013. In the event that Stansted did not require a licence from April 2014, the CAA would stop further development of a provisional licence at that time. As such, we would encourage the CAA to issue its final determinations as soon as it has the necessary powers to do so under the Civil Aviation Bill. Alternatively, if the CAA decided that Stansted required a Q6 licence, the provisional licence would be issued in April 2014, and then followed in due course by a “full” licence at the appropriate time.

The provisional licence could take a number of forms, for example:

- a one-year licence – this could simply roll-forward the Q5 regulatory arrangements at Stansted into a provisional licence, and replicate the price cap, service quality regime, public interest conditions and other obligations in the form of licence conditions; or
- a transitional licence – rather than simply roll-forward the Q5 settlement by one year, a transitional licence could be for a longer period and include conditions that were different to those applying in Q5, for example in the form of different price caps.

To be clear, the interim licence would only be adopted if the CAA decided that Stansted required a licence after the end of Q5. Our support for this option should not be interpreted as an acceptance that Stansted has SMP or that such a provisional licence would be necessary.

We agree with the CAA’s suggestion that a short-term price control could be based on simple benchmarks. This approach would have clear benefits in terms of:

- providing effective price protection for consumers;
- providing greater clarity

- the speed with which it could be implemented;
- not involving significant costs or the risk of significant amounts of potentially nugatory work;
- “[avoiding] the complexities of scrutinising the bottom up cost and revenue information required by price controls based on RAB and LRAIC type methodologies” (para 5.21)

We welcome the opportunity to discuss these issues with the CAA and Stansted airlines in the coming weeks. Depending on initial progress with these discussions, we intend to develop preliminary proposals for the price caps and other conditions that might be contained in a provisional licence.

- **The CAA’s consideration of a provisional licence should not be contingent on reaching agreement with airlines**

The CAA has highlighted the importance it attaches to securing airline agreement to this approach. While we recognise the value of proceeding with agreement between stakeholders, this should not be a condition for the CAA to take forward the proposal for a provisional licence.

With reference to its duties, the CAA should determine the appropriate course of action in the interests of users of air transport services, in this case passengers. In particular, it cannot be the case that additional work would be required to implement a provisional licence if agreement cannot be reached with airlines.

The CAA should conduct the work it considers is necessary to establish whether such a proposal would be in the interests of users, taking into account its other duties. Our view is that the adoption of a provisional licence in 2014, in lieu of a full licence, would further the CAA’s proposed primary duty to consumers and be consistent with the principles of Better Regulation. In particular, adopting this approach would:

- allow the CAA to maintain a clear and logical focus throughout the Q6 review on the issues of Stansted’s market power, the need for a licence, the appropriate regulatory model and the form of that licence;
- provide greater clarity and increase transparency for stakeholders, creating the potential for more effective engagement;
- reduce the potential for nugatory work on regulatory models and licence development that are subsequently not required;
- reduce the costs of regulation for stakeholders.

- **Based on current evidence the CAA should discontinue work on a RAB-based price cap and focus on identifying a narrower range of regulatory models for Stansted**

Current evidence suggests that it is highly unlikely that the CAA will apply a RAB-based approach to setting price caps at Stansted for Q6. This view is based on a wide range of evidence, including:

- the CAA's view that the price increases resulting from the application of a RAB-based approach are unlikely to be viable (para 5.61), and airlines' concerns about the level of these price increases (5.61);
- the high level of uncertainty associated with key inputs to a RAB-based model for Stansted would make it difficult for the CAA to be confident that Q6 price caps would be capable of providing the airport with a reasonable return;
- the negative bias that RAB-based price caps introduce into long-term rates of return when applied in competitive markets;
- applying a RAB-based price cap would not be a targeted or proportionate regulatory approach in circumstances where SMP only existed during peak periods; and
- the CAA's view of the difficulties with applying a RAB-based approach to setting a peak-period price cap (5.63).

However, the CAA is proposing (paras 5.55 and 5.65) to continue to develop a RAB-based price cap for Stansted so that it can provide:

- a fall-back option in case it turns out not to be possible to implement other options;
- a reference comparator for other ways of establishing price caps; and
- useful information about the costs of service provision.

The CAA is unlikely to experience significant difficulties in implementing relevant regulatory models for Stansted. Most of the options that are relevant to Stansted would be straightforward to implement. Even as a fall-back option, the CAA would still need to demonstrate that adopting a RAB-based approach would be a proportionate approach given Stansted's market power.

Developing a RAB-based price cap is a hugely time consuming and expensive exercise. In addition, to make the comparator relevant the CAA and stakeholders would need to identify which version of the RAB-based model should be used and which enhancements should be incorporated for comparative purposes. Compared to the significant costs of developing a RAB-based price cap, there would be relatively

little benefit from the outputs; indicative price caps could be developed without needing to go to the expense of conducting a full-scale exercise.

Similarly, information about the costs of service provision can be obtained without incurring all the costs, time and complexities associated with a RAB-based review.

Given the low likelihood of the CAA adopting a RAB-based approach for Stansted in Q6, and the considerable costs and complexities associated with developing an inputs-driven price cap, we would urge the CAA to discontinue any further work on this option at this stage.

Instead, the CAA's work should focus on developing and evaluating a narrower range of options. Of the options identified by the CAA, we would support further work to evaluate:

- price caps based on pegging to comparator airports;
 - price monitoring; and
 - voluntary undertakings (see below).
- **Low levels of SMP could be addressed via a combination of general competition law and voluntary undertakings from the airport**

Building on the protection provided by general competition law and the Airport Charges Directive, voluntary undertakings have the potential to provide an effective and proportionate way of addressing the risk of an airport abusing its market power. Undertakings may also provide a transitional option where more effective competition is expected to develop over time.

Undertakings could be given by an airport to the CAA or directly to airlines, and the airport's compliance could be monitored either by the CAA or directly by airlines. Failure to comply with the undertakings could trigger further regulatory action or defined penalties in specific cases.

Undertakings could be offered across a wide range of issues, for example:

- the level of service quality;
- the maximum and minimum size of the investment programme;
- consultation obligations;
- transparency and reporting obligations;
- dispute resolution;
- the future level of the price cap;

- charges for ancillary services (non-regulated charges).

This approach was used by the Competition Commission at Aberdeen Airport as a remedy to the market power it identified in its 2009 Final Report.

The CAA should give detailed consideration to the potential role of undertakings, either on a standalone basis to address the risk of an airport abusing its market power, or as part of an ex-post monitoring regime.

6. What are the priorities for improved efficiency incentives within the price control settlements?

7. How should the CAA interpret its new financing duty?

- **Issues associated with incentives, risk and cost of capital will only become directly relevant to Stansted if the CAA uses a RAB-based approach to setting Q6 price caps**

The detailed incentive-related issues discussed in the Update are relevant to airports where the CAA intends to apply a RAB-based approach to setting price caps. We acknowledge that the incentive issues covered by the Policy Update will be of central importance to Heathrow, and potentially to Gatwick if the CAA decides to apply a RAB-based approach to setting Q6 price caps.

In our view, it is unlikely that the CAA will apply a RAB-based approach to setting price caps at Stansted for Q6. The reasons for this view were outlined in the previous section. Given the low likelihood of the CAA adopting a RAB-based approach to setting price caps at Stansted in Q6, our response to the Policy Update does not provide detailed comments on incentive-related issues at this stage.

For example, given the degree of uncertainty over Stansted traffic levels during Q6, there would be little value in engaging in detailed discussions on the design and application of risk-sharing mechanisms. Similarly, the low level of capital expenditure we foresee over Q6 period would not merit a detailed assessment of the various proposals set out in the document.

In the context of Stansted's financial performance during Q5, the priority for the CAA and other stakeholders at this stage needs to be to identify a regulatory model that corresponds with the Stansted's market power and provides the airport with a reasonable prospect of earning a reasonable rate of return over time.

- **Financing duty**

We note the CAA's comments (para 7.15) that:

- the need to assess financeability of price caps is independent of the form of regulation;
- the CAA expects to satisfy itself that the price caps can be financed even if price caps are set on a basis other than RAB-based; and
- the CAA's precise method of assessing financeability of a non-RAB price cap will reflect the form of the price cap.

We look forward to working with the CAA to develop an approach to assessing the financeability of prices that are not RAB-based once there is appropriate clarity on the regulatory model that will apply to Stansted in Q6.

As part of this work further consideration will need to be given to how the CAA would assess financeability in circumstances where it does not set a Q6 price cap, but continues to regulate Stansted, for example, under an ex-post monitoring regime.

8. Comments on the Process Update

- **The CAA should set out an integrated programme to identify the work that is planned between now and the publication of initial Q6 proposals**

The Update provides a useful high-level summary of the key milestones in the Q6 process, but there is currently little visibility of the process that the CAA intends to follow in preparing its initial proposals for publication in April 2013.

To help us contribute effectively to the work programme, we would welcome a detailed overview of the nature and timing of the work that the CAA is planning to carry out in the following areas:

- the assessment of Stansted's market power;
- the development and evaluation of regulatory models that might be applied to Stansted;
- a more detailed assessment of the sufficiency of competition law;
- a more detailed assessment of the costs and benefits of regulation;
- the development of an initial licence for Stansted;

We would also welcome clarity on the CAA's intended approach to developing its initial Q6 proposals which are planned for publication in April 2013, given the wide range of potential regulatory models that may still be under consideration at that time.

Similarly, we would welcome clarity on the CAA's intended approach to developing an initial licence for Stansted, given the wide range of potential regulatory models that are still under consideration.