

easyJet response to CAA consultation on Q6 airport price controls

Introduction

1. easyJet welcomes the CAA's consultation on Q6 price controls. Constructive Engagement (CE) has now started at all three regulated airports. Now is the time to start defining how these airports will be regulated in Q6. It will be important that both airlines and the airports have a clear idea of how the airports will be regulated once the CAA starts consulting on Q6 outcomes next year.
2. easyJet is the largest operator at Gatwick, and the second largest at Stansted; in total we carry about 15m passengers through the two airports. We therefore have a significant interest in Q6, as it will affect a large number of our passengers.
3. This response is structured around the consultation questions set out by the CAA.

Summary

4. There is clear evidence that Gatwick and Stansted currently have market power. This means that they need to be economically regulated, with a tight price cap. Without this there is a real risk that passengers will face higher charges and/or worsened service outcomes. However, improvements are needed to the regulatory regime. In particular there is a need to ensure that capital infrastructure is regulated on a time scale that better reflects the timing of investment decisions, and that long-term incentives are in place for operating cost and commercial revenue improvements.
5. We also believe that regulation needs to better reflect the outcomes seen in competitive markets. In particular returns need to be profiled over longer periods, reflecting the financial structures seen in competitive markets, and the airport/customer relationship needs to be focussed around a Service Level Agreement focussed on key services and with real penalties for failure.

How should the CAA approach a strategy for airport licencing?

6. We believe that the CAA should focus on ensuring the airport licence structure delivers the intent of its regulatory decisions. The current legal framework provides the CAA with no tools to ensure that its regulatory decisions are delivered; for example on capital infrastructure and service. Instead the CAA can only try and regulate through a weak incentive regime (the SQR and capex triggers).
7. The licence is an opportunity for the CAA to ensure that if airports are not delivering the intent of its regulation, the CAA can use increasingly strong measures to take steps to require airports to deliver the regulatory requirements placed on them. The CAA should therefore put in place a licence framework that will require airports to deliver regulatory decisions, and provide the CAA with the ability to intervene if airports are not delivering.

How can the CAA ensure that its review of economic regulation is passenger focussed?

8. We believe it is important that the CAA focus on passenger outcomes. However, this should not lead to the CAA second guessing what passengers want. Instead the CAA needs to consider the evidence around what services passengers' value. Our underlying principle for Q6 is that we will support service levels (and infrastructure) that passengers value, and are therefore willing to pay for.
9. We believe that evidence from the airline market suggests that most passengers are focussed on value for money products; those that deliver efficient, safe and reliable services. However, some are willing to pay for more premium services on top of this, and we believe airport regulation needs to reflect this where possible.
10. We do not think that a passenger focus requires a significant change in approach by the CAA. But instead we think it requires the CAA to assess and justify its decisions on the basis of their end impact on passengers.

How can regulatory incentives towards service quality be improved?

11. The Service Quality Regime has brought significant benefits to passengers. However, it also has significant weaknesses. First, it is focussed on the 'averages' of service rather than the 'maximums', e.g. the security queue measure allows for queues to be over the standard for several periods every day. Second, it contains many measures, some very detailed, this makes it hard to address overall service at the airport. Third, the rebates provide limited compensation, even where service failures can have a significant impact on airlines and passengers.
12. We believe that three improvements are needed.
13. The **first** is to implement a Service Level Agreement (SLA) that is focussed on a small number of significant service measures.
14. The **second** is for the SLA to focus on 'maximums' rather than averages. For example we believe that it is of much more value to passengers to know that the security queue will never be over e.g. 15 minutes, rather than it will normally be five minutes, but could be over 30 minutes once or twice every day.
15. The **third** is that the SLA should carry real penalties on the airport when there are service failures. This would require significant compensation to be paid to airlines for when the SLA is breached.

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

16. While different airports may have different degrees of market power in theoretical terms, ultimately there is a legal judgement on whether or not an airport has market power. We believe the evidence shows that Gatwick and Stansted airports

have market power¹. This means that there is a real risk that they will abuse their customers, leading to passenger detriment.

17. We note that under the new Airport Economic Regulation Bill the CAA has to address three tests before it decides to economically regulate an airport. We believe that the critical test is the first one; that the airport has market power. If an airport has market power the second and third tests are likely to be passed.
18. The second test, that the benefits of regulation outweigh the costs, will be met at any significantly sized airport. If a significant number of passengers are likely to see higher prices and/or reduced service outcomes it is unlikely that the costs of regulation (direct or indirect) will be greater.
19. The third test, that competition law is not sufficient to address the risk of abuse, is also likely to be met if an airport has market power. Competition law only applies after the event, so an airline would have to prove that an airport had abused its market power. There are two weaknesses with this approach. The first is that it seems unlikely that the threat of competition law would be sufficient to stop an airport abusing its customers. There is plenty of evidence from other regulated sectors that the risk of competition law does not stop market abuse². Secondly, there is very little case law on airport competition. This makes it very hard to show that airports are abusing their market power, as regulators (and courts) have no benchmark against which to assess abuse of dominance claims. We have seen this in several regulatory regimes across Europe.
20. The rationale for economic regulation must be that without it passengers face a real risk of higher prices and/or poor service outcomes. Without regulation it would take many years for an abuse of market power to be reversed. Consequently, we believe that where airports have market power, economic regulation is almost always necessary to protect passengers.

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

Gatwick

21. easyJet remains of the view that airport regulation should look to separate airport terminal infrastructure from runway infrastructure, creating room for terminal competition within the airports. However, we recognise that the timetable for Q6 makes it difficult to implement this option in time for the next regulatory period. We therefore support the application of RAB regulation at Gatwick for Q6, but believe significant improvements need to be made to ensure it delivers efficient outcomes for passengers.
22. Our underlying approach is that regulation should seek to reflect the outcomes that are seen in competitive airport markets. We believe this is the fundamental test of any regulatory regime.

¹ easyJet has not assessed the evidence on Heathrow

² For example the financial services sector

23. We support the CAA's view that it should use forthcoming powers under the Airport Economic Regulation Bill to introduce more flexible forms of RAB regulation. We see this as the only way of ensuring that regulation provides airports with the right incentives to deliver efficient services to airlines and their passengers.
24. We support further consideration of the concept of regulating for core services, with additional services being negotiated for on top of this regulated offering. This will help address the variety of airline and passenger demand seen at Gatwick, and it is also consistent with the economic logic of airlines paying for the services they use and value, but not for those they do not. It will be important for the CAA to determine what types of services can be regulated in this way.
25. We also support further work on the potential for regulating for a revenue cap, or an average price cap, rather than a maximum charge. However, this approach would need to ensure that it leads to prices that are consistent with competitive outcomes. In other words that it does not provide an opportunity for the airport to charge more to captive, but large, customers and offer discounts to small marginal customers.
26. However, we continue to believe that a Long Run Average Incremental Cost (LRAIC) price cap is inappropriate for airports, for two reasons. The first is that we do not think it has any theoretical foundation for long-term capital intensive industries. These sectors, including airports, do not set prices at LRAIC, as competition ensures that historic assets are priced at levels needed to earn reasonable returns on those assets; i.e. below LRAIC. So in practice prices are a blend of LRAIC and historic costs. Secondly, the difficulty of calculating LRAIC for an airports makes the methodology unworkable.
27. We have similar concerns over other approaches, such as benchmark pricing and price monitoring. We believe price monitoring is inconsistent with a finding of market power. If an airport is found to have the ability to abuse its customers, we do not think price monitoring provides adequate protection for passengers. Not only does it imply that while the airport may have market power the CAA expects it not to rationally increase prices when it can, it is also very difficult to show abuse after the event.
28. Our concern with benchmarking pricing is that given the many differences across airports it is unclear how a benchmark could be constructed, and where a particular airport would be placed on that benchmark. We see this at our competitive airports, where while we recognise that they are competitive, there is no consistency in prices across these airports. This is consistent with the structure of the sector, as each airport has its own unique set of assets, and different types of catchment area

Stansted

29. We recognise that at Stansted RAB regulation creates significant issues. These mainly arise from distortions created in the past. It is clear that prior to Q5 the RAB value applied to Stansted bore no relation to the economic value of the airport. For many years it achieved prices that were significantly below its notional price cap.

However, the notional RAB value was carried forward through successive regulatory periods.

30. The recent fall in traffic at Stansted has highlighted one of the main failings in RAB; the odd outcome that as demand for an asset falls, the regulatory formula forces higher prices.
31. We believe the CAA has two options at Stansted.
32. The first is to reflect competitive market outcomes by profiling returns across regulatory periods. This would ensure that prices did not increase in Q6, but would allow Stansted to 'recapture' returns in future regulatory periods.
33. The second is for the CAA to develop a set of principles that would allow it to set out a Default Price Cap. We note that any such price cap would need to be based on an objective justification. While we have not developed any firm proposals here, we would suggest that such a justification could be developed around the economic cost of delivering the airport services (rather than a notional cost under RAB) or possibly an adjusted benchmark – if the difficulties with this approach can be resolved.

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

34. We believe that the CAA should focus on improving incentives around:
 - Service delivery
 - The timing of capital projects
 - The timing of returns
 - Operating cost efficiency
 - Commercial revenue efficiency
35. We addressed service incentives above, so the remainder of this section focusses on remaining issues.

Capital projects

36. It is clear that the current fixed five year time scale for capital projects is not effective. At Gatwick the final Q5 capital plan bears no relation to the initial Q5 plan that was set out during the Q5 regulatory process. This is only natural, as it is inevitable that plans for capital investment will vary during a five year regulatory period.
37. We believe that the only viable solution is to move to shorter timescales for licenced capital expenditure plans. We suggest that capex should be put on to a two year time frame, with new capital projects being licenced by the CAA every two years, This would involve regular consultation between the airport and airlines, but on a much smaller capex plan than the 'traditional' five year capex plan, as it would only cover two years.

38. This would have three main benefits. The **first** is that the capital expenditure that goes into the licence would be based on timely consultation. The **second** is that capital expenditure would not be amended through a regulatory period without the CAA having oversight of this process. We believe it is inconsistent with the logic of the new Bill for capex to go into a RAB without the CAA having licenced it before it is implemented. The **third** is that it limits the risk of regulatory gaming over capital projects. Without CAA oversight of final capital expenditure decisions there is a real risk that an airport can push through capital projects at inefficient levels of cost or inappropriate service levels. This arises when airlines have to sign up to a project as they and their passengers need its benefits, but they have no real ability to influence the project in the absence of regulatory involvement in the final decision.

The timing of returns

39. In competitive airport markets it is clear that returns on investment are spread over long periods. In particular returns on capital are backloaded, i.e. are profiled to occur when traffic has built up over time. However, under RAB as it is currently applied at airports, returns are contained within a regulatory period. This leads to perverse price profiles, with prices rising as investments are made and then falling as demand increases; the opposite of the price profile seen in capital intensive sectors in competitive markets.
40. We note that Gatwick has put in place 15 and 30 year financing arrangements at relatively low rates of interest. There is clearly room therefore to profile returns over similar time periods.
41. We believe that Q6 regulation needs to put in place a regime that better reflects competitive markets by profiling returns over time. This would also help address any risks around gold plating the RAB.

Operating cost efficiency

42. We recognise that the current regulatory approach may limit the realisation of operating cost improvements, as the airport faces reducing incentives to make efficiency gains as the regulatory period progresses.
43. Therefore, we believe the CAA should focus on options that would allow the airport to retain some of its efficiency savings, in return for it making greater efficiency savings overall. However, we would expect such incentives to lead to greater efficiency savings than would otherwise be the case under current regulation.
44. One option may be to offer the airport a matrix of efficiency targets and savings retention proportions. This would allow the airport to keep a greater proportion of the savings, the more efficiency it is willing to offer upfront.
45. We also believe the CAA should consider separating the operating cost regulatory period from the price cap period. In other words operating costs could be put on a long term path (e.g. 8 years), while the price cap and capex could be reset more frequently

Commercial revenue efficiency

46. As with operating cost incentives we believe the CAA should focus on options that would deliver greater levels of commercial revenue than would otherwise be the case under current regulation.

How should the CAA interpret its new financing duty?

47. It is important that the financing duty does not create an opportunity for airports to justify higher charges (or lower service) based on their financing structure. In other words if airports choose financing arrangements that lead to financial weakness, they should not be rewarded for these decisions.

easyJet

July 2012