



**The Competition Commission's  
Market Investigation of BAA Limited**

**The Civil Aviation Authority's response to the  
Provisional Decision on Remedies**

**January 2009**

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## Summary

1. The CAA welcomes this opportunity to comment on the Competition Commission's provisional decision on remedies in respect of the Market Investigation into BAA.

### **Requiring BAA to sell airports in the South East and Scotland**

2. The CAA supports structural reform of the UK airports market. BAA's ownership of three of the London airports and two of the airports in the central belt of Scotland significantly reduces the potential for competition to deliver appropriate price, service quality and investment to both passengers and airlines. Overall, therefore, the CAA strongly supports structural remedies requiring BAA to dispose of Gatwick and Stansted airports and one of Edinburgh or Glasgow airports.
3. Economic regulation is an imperfect substitute for competition and the CAA welcomes the Commission's clear statements that airport divestments should enable competition to replace some of this regulation, including that there is an expectation that competition should replace regulation at Gatwick and Stansted. The CAA also welcomes the Commission's acknowledgement that there is a need for a credible signal that regulation will not 'crowd-out' competition and that competing airports should be allowed to earn commercial returns on their investments in service quality, capacity expansion and other forms of innovation.
4. However, the CAA urges the Commission to take further steps to ensure that the overall package of remedies, and its analysis of inter-airport substitutability, competition and market power that underpins those measures, provides an unambiguous signal to airport operators that competition will be allowed to work. The CAA recommends that this should include a clear statement that in well-functioning airport markets there will be periods when some elements of airport capacity (e.g. runway capacity at certain airports, at certain times) are highly utilised, but that this is a normal feature of such markets and is neither sufficient to establish that an airport enjoys substantial market power nor an indication that regulation should be imposed on an airport.
5. Without such a clear statement there is a risk that competing airport operators will be discouraged from making commercial investments, for fear that regulation will intervene in any period when these investments are close to being fully employed and can therefore earn higher returns than at times when they are less fully employed. As capital-intensive markets typically exhibit fluctuations in capacity utilisation over time, and tend to realise the greatest contributions to remuneration of capital in periods when capacity utilisation is high, this could be expected to distort investment incentives, undermine the benefits of competition and, ultimately, reduce the gains to consumers from the structural remedies.

## **Reconciling additional regulation with greater competition**

6. The CAA continues to have a related concern that the overall package of remedies could serve to undermine some of the significant benefits realised from the divestment of airports in the South East and in Scotland. In general terms, the CAA sees problems with a package that seeks to introduce additional competition whilst simultaneously increasing the degree of regulation applied to these divested airports – beyond that currently applied under the Airports Act by the CAA and Commission – before there is evidence that increased competition has failed to deliver competitive pricing and/or improvements in service quality. Put simply, such intrusive regulation could deter Gatwick and Stansted from innovating in price structures and levels, service quality and investment, putting at risk the main gains from competition: better pricing, service quality, investment and innovation.
7. The Commission raises the prospect of additional regulatory measures for Heathrow and, potentially, Gatwick and Stansted. However, it does not set out what form all of these potential additional measures might take. The CAA has a number of concerns about this. First, the Commission needs to explain how such measures would operate, how they would interact with the existing regulation of these airports and, indeed, why there is now a case for additional measures so soon after the Commission reviewed whether the airport's conduct had been against the public interest in its September 2007 decision under the Airports Act.
8. Second, the CAA is concerned that, in general terms, the prospect of such additional measures serves to undermine the credibility of the overall remedies package, as it raises questions as to whether the new airport owners will, in fact, be allowed sufficient freedom to operate commercially, which risks dulling their ability and incentive to compete and innovate.
9. In this respect, the existing regulatory framework – although not ideal – provides a number of mechanisms by which the conduct of the new airport operators can be monitored. Without the need for any regulatory reform, the Airports Act provides the CAA and the Commission with powers to consider the pricing and conduct of Heathrow, Gatwick and Stansted. It also provides the CAA with powers of general oversight, referred to as 'section 41 powers', that mirror those of general competition law. A proportionate package of remedies should place some reliance on these powers – together with the role of more general competition law – so as to minimise unnecessary and costly duplication of regulations in line with Better Regulation principles. More generally, the CAA considers that the Commission should seek to avoid duplication through the simultaneous use of Enterprise Act powers and roles already granted by Parliament to the Secretary of State and/or other regulatory bodies.
10. The CAA, therefore, considers that the Commission has not made the case that there is a need for additional regulatory measures to be applied to

Heathrow beyond the package of service quality and other measures implemented following the recent price control review. Further, the CAA considers that applying additional measures to Gatwick and Stansted could undermine the benefits that separate airport ownership will bring.

### **Applying price controls to Aberdeen Airport**

11. The CAA does not consider that the evidence presented by the Commission is sufficient to justify the imposition of a price cap remedy at Aberdeen Airport. Price caps are one of the most intrusive forms of economic regulation and considerable care needs to be taken before they are imposed, including that the analysis undertaken is as robust and comprehensive as is reasonably possible. In this respect, the Commission's analysis of Aberdeen Airport falls short. Notably, the Commission places reliance on a set of indicators that may be misleading and does not undertake the analysis in accordance with its own guidelines.
12. On this basis, the CAA does not consider that there is sufficient evidence to justify the application of a price cap. Indeed, the form of price cap proposed appears likely to introduce a number of perverse incentives, including encouraging the airport operator to over-specify investment and undertake investment that is not efficient, as this would increase prices to airlines (and helicopter operators). Similarly, airlines would face perverse incentives to oppose investment – even if it were efficient and valued by passengers – and frustrate the consultation process in order to prevent the airport from earning the right to raise prices. This arrangement risks mirroring and, in all likelihood, magnifying the very form of regulation that has distorted conduct at Stansted Airport.
13. Furthermore, even if a remedy were needed, there is a range of more proportionate remedies that are more likely to improve outcomes and avoid the distorting effects associated with the form of price cap regulation proposed by the Commission. First, the Commission could place some reliance on existing regulatory processes. This could involve providing its analysis to the CAA and/or OFT so that these bodies could consider taking action under the Airports Act and/or Competition Act, or it could recommend to the Secretary of State to review the non-designated status of the airport, in accordance with the criteria recently established (following consultation) and using the powers granted to the Secretary of State by Parliament.
14. Second, the Commission could take action to increase the information available about Aberdeen's conduct, obliging it to publish financial performance data to allow the CAA, OFT and third parties to assess more easily whether its performance is unreasonable.
15. Third, the Commission could place additional obligations on the airport to operate in a "fair, reasonable and non-discriminatory" manner – mirroring

approaches adopted in other sectors – perhaps supplemented by monitoring and/or reporting obligations.

16. But, for the avoidance of doubt, the CAA does not consider that the evidence presented to date is sufficient to conclude that there is an Adverse Effect on Competition in respect of Aberdeen or that there is need to add a remedy to the existing body of regulation to which the airport is subject.

### **Criticism of the CAA's role in regulating airports**

17. The CAA firmly rejects the Commission's allegation that the CAA has wrongly interpreted its duties. The evidence tabled to support this allegation is slight to non-existent. Further, the Commission's allegation that this has had an adverse effect on competition, due to inadequate investment and poor service quality, is not supported by any analysis of this supposed claim of causality.
18. The CAA remains concerned by these assertions, not least because the Commission has not yet completed its evaluation of the extensive material provided to it by the CAA, nor sought to engage the CAA on it. As such, the CAA remains in the regrettable position of being unable to consider the Commission's arguments or to provide any further evidence or arguments.
19. The Commission also continues to ignore its own central role in the regulation of designated airports. The Commission is empowered under the Airports Act to make public interest findings in respect of price-controlled airports and to make recommendations to the CAA in respect of the price caps that should be applied.
20. In this respect, the CAA has pretty clearly followed the Commission's recommendations on service quality and investment, and has, of course, implemented remedies in respect of its public interest findings. The CAA's major points of departure have been in precisely those areas where following the Commission's recommendations would have had adverse effects on competition: in rejecting the Commission's support in 2002 for anti-competitive cross-subsidies between Heathrow, Gatwick and Stansted; and for price caps at Manchester in 2003 that would have inhibited the development of competition which has subsequently enabled the recent de-designation of, and removal of price caps from, the airport.

## **1. Introduction**

### **Purpose**

1.1 The CAA welcomes the opportunity to respond to the Competition Commission's provisional decision on remedies in its market investigation into BAA Ltd (BAA).

### **Background**

1.2 This response should be read in conjunction with other written and oral evidence that the CAA has provided to the market investigation to date, including:

- the CAA's response to the Commission's initial consultation (May 2007);
- the CAA's initial oral evidence (June 2007);
- the CAA's response to the Commission's Statement of Issues (September 2007);
- the CAA's submission to the Commission on economic regulation of UK airports (February 2008);
- the CAA's response to the Commission's Emerging Thinking (May 2008);
- the CAA's supplementary oral evidence (March and July 2008); and
- the CAA's response to the Commission's Provisional Findings and Remedies Notification (September 2008).

### **Structure of the document**

1.3 The structure of the CAA's response follows that of the Commission's report:

- chapter 2 considers the proposed structural remedies;
- chapter 3 considers the proposed behavioural remedies;
- chapter 4 considers the proposed remedies relating to economic regulation; and
- chapter 5 considers the proposed recommendations to Government.

1.4 This document is supported by four annexes:

- Annex A sets out additional material on Aberdeen Airport;

- Annex B contains a note prepared by George Yarrow, adviser to the CAA, on the links between scarcity of capacity, competition and market power;
- Annex C sets out the CAA's response to the working paper on Traffic Distribution Rules; and
- Annex D sets out the CAA's views on the distorting effect of RAB-based regulation of designated airports on non-designated airports, in response to the material published by the Commission as Appendix 8 of the provisional decision on remedies.

### **Contact details**

- 1.5 If there are any questions on any of the material contained in this response, please contact Chris Hemsley (on 020 7453 6237 or [chris.hemsley@caa.co.uk](mailto:chris.hemsley@caa.co.uk)) or Isabell Kohten (020 7453 6234 or [isabell.kohten@caa.co.uk](mailto:isabell.kohten@caa.co.uk)) in the first instance.

## **2. Structural remedies**

### **Introduction**

- 2.1 This chapter sets out the CAA's views on the structural remedies proposed by the Commission, together with the proposed obligations placed on BAA and/or potential purchasers relating to the proposed airport divestments.
- 2.2 The chapter is structured in two sections, dealing first with BAA's South East airports and then with Edinburgh and Glasgow airports.

### **Divestment of Gatwick and Stansted**

- 2.3 The CAA agrees with the Commission that BAA's ownership of Heathrow, Gatwick and Stansted has adverse effects on competition and that structural separation of these three airports is an appropriate and proportionate remedy.
- 2.4 The CAA considers that requiring BAA to divest Stansted is likely to have a number of significant benefits, in addition to those secured through the sale of Gatwick, both in the short and long-term.
- 2.5 The CAA agrees with, and welcomes, the Commission's statements that:
- there is a significant prospect that competition can substitute for regulation at Gatwick and Stansted and eventually perhaps at Heathrow;
  - separate ownership would improve the investment incentives faced by each airport;
  - it is better to rely on the process of competition to bring forward new capacity; and
  - a regulatory system will always be an imperfect and therefore an ineffective mimic of the market.
- 2.6 The CAA also agrees with the Commission's assessment that joint ownership of Stansted and Heathrow can be expected to adversely affect BAA's incentives to expand capacity at either airport, reduces the diversity of management approaches at the airports and reduces the information available to both the regulator(s) and Government about the efficient operation and expansion of these airports.
- 2.7 However, the CAA takes a different view from the Commission on the relative magnitude of the gains that are likely to be achieved from regulatory benchmarking (which the CAA thinks likely to be smaller) and from inter-airport competition (which the CAA thinks likely to be greater). These differences appear to go to the underlying rationale for divestment, with the

CAA, rather than calling into question the validity of the remedies proposed, suggesting that the proposed divestments will likely be more effective in promoting competition and consequential consumer benefits than the Commission currently argues. In addition, the CAA considers that the Commission could take additional steps to help to create a clear and stable regulatory framework that avoids the risk that regulation dampens the incentives faced by airport operators to compete, invest and innovate.

#### *Gains from improved benchmarking of performance*

- 2.8 The CAA has previously sought to use benchmarking techniques as part of determining the price controls at BAA's price controlled airports. In general terms, benchmarking has proved to be a useful technique – and, indeed, one that was used during the most recent price control review – when applied on a process level, comparing BAA's airports to a range of UK and international comparators (i.e. process benchmarking).
- 2.9 However, the CAA's experience is that the form of benchmarking typically employed by regulators setting price caps for natural monopoly network businesses (i.e. 'top down' benchmarking) suffers from some significant limitations, and is certainly less effective for airports than for network utility businesses. Airports tend to be heterogeneous businesses which in practice limits the degree to which statistical benchmarking techniques can be usefully deployed at the airport level.
- 2.10 The CAA agrees with the Commission that the process of competition, and the tendency for competing suppliers to innovate, adopt different approaches and express a diversity of views would have some beneficial impact upon the information available to support regulatory decision-making.
- 2.11 Overall, however, the CAA expects the gains resulting from the addition of one or two further comparators to the existing set of airports used for process benchmarking – albeit comparators located in the South East of the UK – to be somewhat limited and certainly less than the gains that arise directly from competition. In addition, the CAA does not expect the gains from 'top down' benchmarking to be significant. One implication of this is that it is more important to ensure that competition can develop, as economic regulation is likely to be a poorer substitute for competition than implied by the Commission's approach to benchmarking.

#### *Gains from increased competition*

- 2.12 The CAA considers that the gains from competition in the short-term are likely to be more significant than the Commission indicates in its report. In particular, the CAA considers that the gains from such competition for passengers and airline business are likely to be greater than "marginal"<sup>1</sup>.

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<sup>1</sup> The Commission refers in a number of places to the strength of potential competition between Gatwick and Heathrow and between Heathrow and Stansted as being 'marginal'. The CAA understands this to

- 2.13 Whilst the CAA agrees with the Commission that it is difficult to quantify and identify the gains from competition, there is likely to be a general tendency to place insufficient weight on these gains, by virtue of their being difficult to identify and quantify.
- 2.14 Further, the CAA considers that there would be a significant degree of competition in the near term, particularly when it is recognised that the airport with the greatest level of market power, Heathrow, is likely to continue to be subject to detailed regulation of price, service quality and investment (at least for the foreseeable future). Furthermore, the Commission's current assessment of the potential for these airports to expand is, for unavoidable reasons, based upon current expectations about the airports' capabilities. However, competition would be likely to prompt innovation and improved ways of working, unlocking much greater potential for rivalry than such an assessment would suggest.
- 2.15 Following divestment, the five main airport operators in the South East will face much sharper incentives to innovate and find ways of attracting additional passengers and more airline services, as well as to provide additional value-adding services. However, there is a risk that the gains from this competition are stifled by the regulation of price, service quality and investment decisions. Indeed, it appears that the Commission is contemplating an increase in regulation for three independently owned airports to a level beyond that it recently recommended as being appropriate under the Airports Act; a recommendation made under the assumption of continued common ownership by BAA. For this reason, the CAA does not support an increase in the degree of regulatory intervention at Stansted or at Gatwick, as to do so would directly reduce the magnitude of the benefits arising from the structural remedies.
- 2.16 Indeed, the Commission appears to attach significant weight to the need for extensive regulation in the near term. It seems to the CAA that this view results from the following arguments:
- there is a current and prospective shortage of runway capacity in the South East;
  - that this scarcity would confer short-term market power on Stansted and/or Gatwick following divestment; and
  - that the regulation of Stansted and/or Gatwick is an appropriate response to this scarcity and/or short-term market power.

The CAA considers each of these propositions in turn.

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be a reference to the magnitude of the benefit, rather than being a reference to the nature of the constraint, in the economic sense, implied by competition operating 'at the margin'.

## The current availability of capacity

- 2.17 As the CAA noted in its response to the Provisional Findings report, the Commission does not distinguish clearly between a shortage of runway capacity and an *artificial* shortage of capacity. In particular, the CAA argued that:

“While the CC correctly recognises that there is a shortage of runway capacity in the SE of England, the CC has not clearly demonstrated that any such shortage is an *artificial* shortage. In other words, the CC has not shown that current capacity constraints are anything other than temporary capacity constraints that could be expected naturally to feature from time to time in any capital intensive industry, and which far from inhibiting competition provide, as part of the competitive process, a stimulus to invest. This distinction is important because of its implications for policy and regulation going forward. To the extent that capacity constraints currently – and, importantly, in future – derive more from the natural investment cycle in a capital-intensive industry than artificially from operator behaviour or policy and institutional constraints, the more competition can be relied upon to resolve them relative to regulation.”

- 2.18 Evidence subsequently published by the Commission serves to illustrate that it cannot be assumed that there is a current *artificial* shortage of capacity. The Commission sought advice from the consultants ASA as to the timing of the proposed second runway at Stansted. Based on this advice, and its own analysis, the Commission concluded that:

“Following our analysis of passenger forecasts ... we did not expect that passenger numbers at Stansted will reach levels which would require construction work to begin on SG2 in Q5, which lasts until the end of 2013/14. ... [O]ur forecasts suggested that the need for significant investment in SG2 was delayed until Q6. Given the growth of demand for airport services in the London area, we did not doubt that substantial further capacity will be required, but we did not see a need for substantial investment in SG2 yet.”<sup>2</sup>

- 2.19 Similarly, the principal constraints on the expansion of runway capacity at Heathrow relate to environmental issues, notably the ability of the airport to expand whilst ensuring that NOx levels remain within acceptable limits. Again, this highlights that it is not reasonable to assume that there is a current *artificial* shortage of runway capacity at Heathrow. Rather, there are genuine environmental issues that need to be resolved before additional runway capacity can be contemplated. Such environmental constraints are to be expected in well-functioning airport markets and serve to illustrate that it cannot be assumed that there are current *artificial* runway constraints.

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<sup>2</sup> Paragraph 8.47, ‘Stansted Airport Limited, Q5 price control review’, October 2008, Competition Commission

- 2.20 There may, of course, be certain shortages of capacity at the London airports, in terms of either runways (for example, peak capacity) or terminals. However, it is important to recognise that “shortages” can be a natural feature of competitive markets, particularly in capital-intensive industries. Indeed, without instances where there is some degree of scarcity prices fall to zero and – put simply – markets do not operate and are not needed.
- 2.21 This position was recognised by the Transport Select Committee, in its report on the future of BAA, when it argued that:
- “There are more limitations on supply than there are on demand in the aviation sector, and there are no signs that this will change. To assume that spare capacity is necessary for competition is to deny the possibility of competition altogether.”<sup>3</sup>
- 2.22 In summary, the CAA considers that the balance of the available evidence can support a conclusion that a more competitive market could have led to a different investment outcome than that which has occurred. However, the evidence does not appear to suggest that the current investment position is outside the bounds of what might be expected to be observed, at times, in a well-functioning airport market: demand is growing, increasing the degree of capacity scarcity, which will, at some point, provide a commercial business case for airport expansion. Indeed, this is one way in which the sale by BAA of Gatwick and Stansted would deliver benefits: namely, by improving the incentives faced by the owners of all of the London airports to respond appropriately to the growth in demand and to bring forward appropriate investment plans to meet that demand in an efficient manner.

#### The link between capacity availability and market power

- 2.23 The Commission argues in a number of places that in the short term Gatwick and Stansted will retain their positions of substantial market power but that over the long-term market power will reduce, as investment provides spare capacity.
- 2.24 However, the Commission does not appear to have analysed the short-term market power that Stansted and Gatwick could be expected to enjoy following the implementation of the divestment remedies, still less that it has analysed this taking into account the distinction between short-term pricing power that arises from natural capacity constraints (which is not abuse) and the exercise of power over and above this. The CAA, therefore, questions the basis on which the Commission asserts that Gatwick and Stansted have and will retain a position of substantial market power.
- 2.25 In addition, the CAA considers that any analysis of airport conduct – relating to the short-term or long-term – needs take full account of both the capital-intensive nature of airports and the relationship between short-term conduct

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<sup>3</sup> Paragraph 81 of House of Commons Transport Select Committee, Fourth Report, 2007/08 session.

and long-term investment. In this respect, the Commission rightly recognises that it is difficult to distinguish between the short and long-term, arguing that:

“It should be noted that the conceptual distinction between the ‘short term’ and the ‘long term’ is likely to be less than clear-cut in practice. Decisions regarding the form and amount of significant additional capacity come into effect in the ‘long term’. However, the decisions themselves may take place in the ‘short term’ and would be influenced by the pressures of rivalry following divestiture. Thus the benefits of dynamic competition on the form and amount of capacity expansion are likely to begin to accrue in the ‘short term’ as decisions begin to reflect competitive pressures.”<sup>4</sup>

- 2.26 However, tension remains in the Commission’s arguments. The Commission argues that competition between airports can be an appropriate stimulus for investment (and that this is a significant source of benefits from break-up) but appears unwilling to rely on the competitive process to drive decisions on the next wave of investment in capacity.
- 2.27 The CAA accepts that Heathrow can be expected to enjoy a sustained period of substantial market power – by virtue of its location, surface access infrastructure and hub status – that is likely to warrant detailed economic regulation for the foreseeable future. However, if Gatwick and Stansted are to compete for investment over time – and compete with a regulated Heathrow – it is unclear how it can be *assumed* that these two, independently owned, airports will have substantial market power.
- 2.28 The Commission appears to reconcile these positions by linking the existence of spare capacity and substantial market power. However, as noted above, scarcity is a normal feature of markets and, whilst scarcity can affect the market power held by an undertaking, its existence is not sufficient to conclude that an undertaking has substantial market power. Indeed, the CAA considers that there is some ambiguity in the Commission’s approach to assessing market power, which is discussed in more detail in paragraphs 2.35 to 2.39.

The appropriate response to current scarcity

- 2.29 Even if the Commission were to establish that there is a current situation of artificial capacity scarcity this is not, in itself, justification for economic regulation or economic regulation in the form of a price cap.
- 2.30 Such artificial scarcity could result in prices that are higher than would otherwise be observed. However, the important question is how best to resolve any current artificial scarcity. It is possible to attempt to regulate the current consequences of any artificial scarcity – by applying price caps below market-clearing levels – but the cost of doing so will be to dull the incentives faced by airport operators to resolve that scarcity through investment.

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<sup>4</sup> Paragraph 46, ‘Provisional Decision on Remedies’, Competition Commission, December 2008

- 2.31 Indeed, there appears to be a choice between seeking to remedy the short-term price consequences of any artificial scarcity or putting in place the conditions that will encourage competing airport operators to make commercial investments and thus remedy the artificial scarcity in the longer-term.
- 2.32 However, care needs to be taken that any short-term regulatory intervention is properly justified. Merely regulating because there is, or might be, a capacity shortage – and doing so in a way that holds prices below competitive levels or by implementing remedies that determine particular investment and/or service quality outcomes – will significantly ‘crowd out’ the very competition that will provide a long-term, sustainable, solution. In other words, without full and rigorous justification that there is a short-term abuse that needs to be addressed, regulation in the short-term may mean that the market never achieves the long-term competitive outcome that the Commission supports.
- 2.33 The CAA therefore encourages the Commission to place greater weight on the need to stimulate competition and ensure that the new airport operators are given substantial latitude to vary their price, service and investment plans. This could be supported by greater emphasis of the role of general competition law, and existing sectoral regulation under the Airports Act, in providing a proportionate response to the risk of abuse of any market power.
- 2.34 This implies that the remedies package should avoid unduly constraining the ability of airport operators to vary their price, service quality and investment decisions and that it is important to establish a clear, credible framework that provides airport operators with confidence that competition will be allowed to work. Significantly tightening the regulation of Stansted and Gatwick (as the Commission contemplates including within its package of behavioural remedies) at a time when divestments are increasing rivalry risks undermining this credibility.

*Need to establish a credible long-term framework to support competition*

- 2.35 The CAA welcomes the Commission’s statements recognising that there is a risk that the regulator could be too reluctant to relax regulation and that this could undermine incentives to invest and to innovate and, ultimately, undermine the development of competition. The CAA also welcomes the Commission’s agreement that there is a need to ensure that there is a credible advance signal that economic regulation will respond appropriately to increased airport competition.
- 2.36 The Commission also considers the CAA’s argument that there is a risk that airport operators might perceive there to be a risk that economic regulation would seek to hold prices below the competitive level in periods of relative scarcity, undermining future commercial returns to investment and stifling the development of competition in the near term.

- 2.37 However, the Commission argues that a substantial market power (SMP) test "... if properly applied on a forward looking basis..." would address the concerns that the CAA raises. However, it appears to the CAA that there is some ambiguity in what the Commission considers constitutes such a test. For example, the Commission rightly distinguishes between increases in prices that reflect underlying scarcity and those caused by the exercise of substantial market power<sup>5</sup>. However, the Commission also describes a process by which changing scarcity corresponds to the "ebbing and flowing" of market power, and the increased ability to exercise this market power. This variation in market power is used to explain how short-term (or 'spot') prices would vary over time.<sup>6</sup>
- 2.38 However, it is not scarcity that determines market power. It follows that changing scarcity does not necessarily lead to changing market power. Short-term market power, e.g. prices sustained above the competitive level in the short-term, can occur, in principle, whether capacity is scarce or abundant. As such, a properly applied SMP test would not draw an artificial distinction between conduct in the short-term and the longer-term response of competitors. The CAA's adviser, George Yarrow, has set out his views in more detail in Annex B.
- 2.39 One way to mitigate the risk that airport operators hold inappropriate expectations about the application of an SMP test would be for the CAA to prepare, with appropriate consultation, sectoral guidance on the assessment of airport market power. This would usefully complement the extension of concurrent competition powers to the CAA in respect of airports.

*Obligations placed on purchasers and/or BAA pre-divestment*

- 2.40 Reflecting the above, the CAA recommends that the Commission should generally seek to minimise the constraints placed on the new owners of Gatwick and Stansted, so as to maximise the discretion afforded to the airport operators – increasing the degree to which they can vary their price, service quality and investment plans – and thereby maximise the gains from competition.
- 2.41 This general recommendation has a number of specific applications. First, as noted above, the CAA does not consider that, following divestment, there should be a need for additional regulation of Gatwick or Stansted airports. But in any case, the Airports Act already provides the CAA (and the Commission, in its public interest role) with a tool that enables regulation to be tailored to the circumstances of each airport, albeit with some limitations on the degree of flexibility and the tools provided to the CAA (and Commission). The Government's review of economic regulation is, of course, considering this issue in more detail and looks likely to extend the CAA's flexibility and powers.

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<sup>5</sup> Paragraph 248, Provisional Decision on Remedies.

<sup>6</sup> Paragraph 77 of Appendix 1, Provisional Decision on Remedies.

- 2.42 Second, the Commission raises the prospect of requiring either BAA (prior to divestment) and/or a new owner to pursue the current planning application for a second runway at Stansted. There may be a case for measures to ensure that BAA does not act to undermine the current planning application or to remove from the airport business information required for expansion at the airport. However, these measures should be narrowly focused to the objective of keeping the current option open for subsequent owners, rather than seeking to use the remedies package to influence the investment programme of the new owner. In addition, the CAA considers that the remedies package should take account of the incentives faced by BAA (and bidders) to ensure that valuable planning options are kept open, as to otherwise would undermine the value of the Stansted business to both BAA (as vendor) and to prospective purchasers.
- 2.43 In contrast, the CAA does not consider it appropriate to place any obligations on the new owners of Stansted to pursue the current planning application or to take forward the current development. Such an approach would seem to be more consistent with reasoning elsewhere in the Commission's decision. The Commission suggests that BAA's current plan for runway expansion are "unlikely to reflect a competitive outcome" and that "a new runway at Gatwick may be preferable to a new runway at Stansted in competition terms."<sup>7</sup> In addition, the Commission notes that a different airport operator might have adopted a different plan for Stansted expansion.
- 2.44 It seems to the CAA that one of the most significant gains from the sale of Stansted and Gatwick will be to bring greater competition and commercial discipline to the delivery of the next wave of runway capacity. The adoption of remedies that seek to either constrain that investment to BAA's current plans or to determine expansion through regulatory decision-making would undermine a very substantial element of the benefits that are likely to flow from the structural remedies. As noted in chapter 5, the likelihood that these potential benefits are secured would be increased if the structural remedies were accompanied by a clear statement that the timing, nature and order of capacity expansion should be left to airport operators to make in a commercial manner.

### **Divestment of Edinburgh or Glasgow airports**

- 2.45 The CAA agrees with the Commission that BAA's ownership of Glasgow and Edinburgh has adverse effects on competition and that structural separation of these two airports is an appropriate and proportionate remedy.
- 2.46 The Commission invited views on whether the remedies should specify which of the two airports should be divested by BAA. The CAA's view is that there is insufficient evidence to warrant a restriction of BAA's choice on this matter.

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<sup>7</sup> See paragraph 3, Appendix 5, 'Provisional decision on remedies', December 2008, Competition Commission.

- 2.47 The CAA agrees with the Commission that the available evidence suggests that the long-term competitive outcome of either divestment is the same as both result in three neighbouring airports owned by three independent owners.
- 2.48 The Commission proposes two reasons why requiring the divestment of Edinburgh might be appropriate: that ownership change would deliver additional benefits at Edinburgh and that the divestment of Edinburgh provides a greater prospect that a suitable buyer is found. The CAA considers these arguments in turn.
- 2.49 First, whilst the CAA agrees in principle that a change in management might prompt a more rapid change in the airport's operation, in practice the magnitude of any gains will be affected by the disruption caused by that change in ownership. In addition, it is not clear that, following divestment, the incentives faced by either airport are significantly different and, therefore, might be expected to prompt both the BAA and non-BAA management teams to pursue competitive outcomes (whichever airport they are operating). More generally, the CAA considers that the magnitude of any benefits arising from specifying Edinburgh are likely to be very small.
- 2.50 Second, in respect of the risk that a suitable buyer can be found, it seems possible for the remedies to be structured in a way that both provides BAA with the flexibility to choose between the two airports whilst also mitigating the risk that a suitable buyer cannot be found. In general terms such a remedy could be structured in the following manner:
- (1) BAA would be required to find a suitable buyer for either airport that meets all of the criteria established by the Commission; and
  - (2) In the event that (1) is not possible, BAA would be required to sell Edinburgh to a buyer that best meets the criteria established by the Commission.
- 2.51 Such an approach would have a number of additional benefits. First, it reduces the burden of the remedies package without undermining its effectiveness, thereby providing a more proportionate remedy. Second, it might increase the pool of potential buyers, as there could be potential purchasers that are interested in acquiring Glasgow but not Edinburgh. In current circumstances, the significantly constrained debt markets – which are likely to make airport sales (both in Scotland and the South East) more difficult than hitherto – will increase the costs associated with constraining BAA's freedom more than is required to achieve the Commission's longer-term objectives.
- 2.52 Finally, there is a risk that implementing a remedy that requires BAA to dispose of the more valuable airport – without a compelling reason to do so –

would risk increasing the degree of perceived regulatory risk associated with airport ownership.

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### **3. Behavioural remedies**

#### **Introduction**

3.1 This chapter considers the behavioural remedies proposed by the Commission. In particular, it assesses the case for the application of a price cap to Aberdeen Airport and a range of behavioural remedies on consultation, discrimination and service quality that are proposed for Heathrow and contemplated for Gatwick and/or Stansted.

#### **Aberdeen price cap**

3.2 This section provides an outline of the CAA's views on both the AEC finding at Aberdeen and on the remedies proposed by the Commission. More detail, including additional evidence, is provided in Annex A.

3.3 In summary, the CAA:

- is not convinced that the Commission has established that there are features relating to Aberdeen Airport that are having an Adverse Effect on Competition<sup>8</sup>;
- is not convinced that there is a need for a remedy; and
- considers that, even if there was a need for a remedy, the one identified by the Commission is neither proportionate nor, indeed, likely to be effective.

#### *AEC finding*

3.4 The CAA previously argued that the Commission had not established that there is an AEC at Aberdeen. Whilst it has published some additional analysis in its Provisional Decision on Remedies, this falls short of the level of analysis that is typically undertaken before an undertaking is made subject to price caps. Price caps are a particularly intrusive form of economic regulation and regulatory authorities typically take extreme care before imposing such measures. Indeed, the Secretary of State developed, following consultation, a set of criteria against which an airport should be assessed before a price cap is imposed.

3.5 In addition, the analysis presented by the Commission does not appear to be sufficient to justify either its view that the airport has enjoyed unreasonably high levels of profitability or that there has been a "significant lack of development" at the airport. These two issues are discussed below.

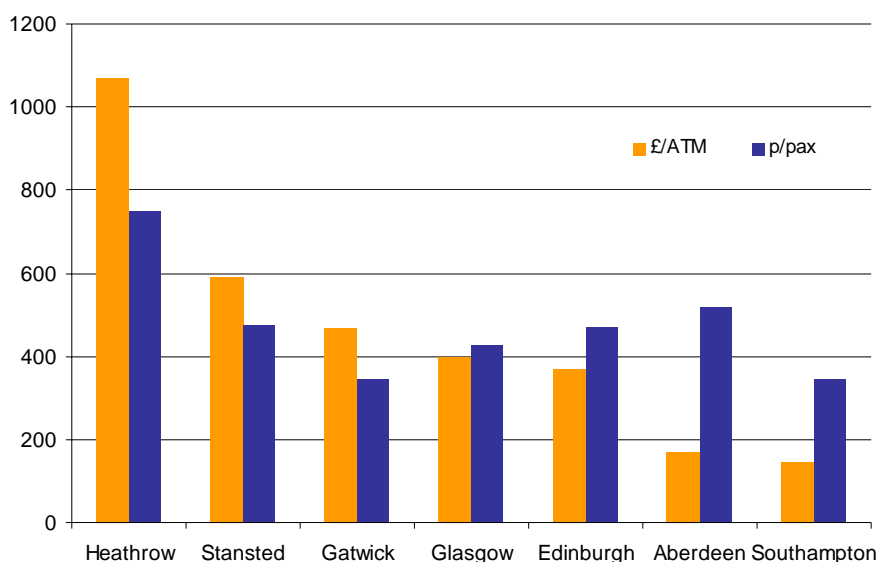
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<sup>8</sup> 'Response to the Competition Commission's Provisional Findings and Remedies Notification', CAA, September 2008

## Profitability

- 3.6 The Commission argues that “*all* indicators point to high levels of profitability ...”<sup>9</sup> of Aberdeen, presenting a comparison of the per passenger profitability of Aberdeen to other BAA airports and citing the return on accounting costs that the airport has generated in 2007/08. This raises a number of issues.
- 3.7 First, it is not correct that all indicators point to high profitability of Aberdeen Airport. Aberdeen is unlike the other BAA airports in that it has a very substantial business relating to serving helicopters and, in part related to this, a very low number of passengers per air transport movement. The consequence of this is that analysis prepared on a per passenger basis is likely to present a biased assessment of Aberdeen’s performance.
- 3.8 To illustrate this, the CAA has reproduced the Commission’s analysis of Aberdeen’s per passenger profitability, supplementing it with relative profitability assessed on a per movement basis. Figure 3-1 summarises this data and shows that on a per movement basis Aberdeen has one of the lowest levels of profitability across BAA’s airports (being slightly above that of Southampton). The CAA is not suggesting that this analysis is sufficient to conclude that Aberdeen’s profitability is appropriate<sup>10</sup> but it does serve to highlight that significantly more analysis is needed before it can reasonably be determined that Aberdeen’s profitability is excessive.

**Figure 3-1 Operating profit of BAA's airports on a per passenger and per ATM basis, 2007/08**



Source: CC Table 1, Appendix 6, Provisional Decision on Remedies, plus CAA airport statistics

- 3.9 Second, the Commission’s analysis of profitability also relies on accounting measures of asset values and of costs. The CAA argued at its oral hearing with the Commission on 16 October 2008, that it was important to undertake

<sup>9</sup> Paragraph 2, Appendix 6, ‘Provisional decision on remedies’, December 2008, Competition Commission. Emphasis added.

<sup>10</sup> Indeed, this comparison will tend to under-state Aberdeen’s profitability.

such analysis on a depreciated replacement cost basis. Such analysis has the benefit of abstracting from the potentially misleading impacts of historical depreciation policies. In addition, this analysis would be consistent with the Commission's own guidelines, which state:

"The Commission will normally consider returns on the depreciated replacement cost of assets, unless there are specific reasons why this is inappropriate. Such profits could be significantly different from profits reported in statutory accounts which are usually on a historic cost (or modified historic cost) basis."<sup>11</sup>

## Investment

- 3.10 The Commission also argues that "all indicators point to ... relatively low levels of investment". However, the principal indicator used is one that compares EBITDA to the accounting value of assets and uses this to draw comparisons across a range of BAA's airports. As noted above, such analysis would normally include analysis based on the depreciated replacement cost of assets.
- 3.11 It seems to the CAA that there is a risk that the Commission's analysis fails to appreciate the context of Aberdeen and its market. Indeed, the Commission uses historical accounting profitability to reach a view on the failure of the airport to invest. However, the need for substantial new investment should be assessed against a forward-looking assessment of the likely future demand at the airport. To do otherwise risks implicitly assuming that an airport should always reinvest its accounting profits in capital projects, even if there is no commercial case for these projects.
- 3.12 It seems to the CAA that this risk is particularly relevant for Aberdeen. The airport serves *inter alia* a niche sector (i.e. the North Sea oil and gas industry) which is expected to decline in the medium to long-term. It seems reasonable, therefore, to treat Aberdeen as a mature, capital-intensive undertaking. Such undertakings might not be expected to be committing significant amounts of capital investment, certainly when compared to historical levels (which determine current depreciation).
- 3.13 In summary, the CAA does not consider that there is a strong evidential basis upon which to base the Commission's AEC finding. Further reasons for this view are given in Annex A.

## Remedies

- 3.14 In addition to its concerns with the AEC finding, the CAA considers that the remedy proposed by the Commission is neither appropriate nor proportionate and that, were the Commission to persist in its AEC finding, alternative remedies exist.

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<sup>11</sup> Footnote 22, 'Market Investigation References: Competition Commission Guidelines', June 2003.

### The price cap remedy proposed by the Commission

- 3.15 The Commission proposes a price cap that introduces both a one-off cut in prices and a system whereby prices will rise if capital investment is undertaken, so long as the airport meets certain consultation conditions.
- 3.16 This raises a number of issues. First, the approach would explicitly introduce a distortion to the incentives faced by the airport operator. Capital investment results in it being permitted to increase charges, introducing the familiar incentive to gold-plate, rather than deliver efficient capital investment. Put simply, the airport would have an incentive to push for any capital investment.
- 3.17 Under a normal price control framework the risks associated with this incentive are mitigated by a series of regulatory controls that ensure that there is no guarantee that capital investment will result in higher prices. The system proposed by the Commission does not have this control.
- 3.18 Rather, the remedy would involve an obligation to consult which, if not discharged appropriately, would prevent prices from rising. This element of the proposal also introduces a series of perverse incentives, encouraging incumbent airlines to frustrate consultation in order to keep prices low. It is also possible that incumbent airlines will oppose investment, even where it is efficient, in order to prevent prices from rising given the incentives that they would face.
- 3.19 Overall, therefore, the proposed price cap remedy suffers from the familiar distortions associated with RAB-based price caps – indeed, in magnified form – without the corresponding measures that seek to minimise the adverse consequences that would otherwise result.

### Alternative remedies

- 3.20 The CAA also considers that there are a range of alternative remedies that represent a more proportionate and more effective way to remedy any AEC that might exist.
- 3.21 First, the Commission could use its powers of recommendation to enable appropriate use of the existing legislative framework. Indeed, this would be consistent with principles of proportionality and better regulation since it would avoid duplicating what already exists. This could include:
- recommending to the Secretary of State that he review the designation status of Aberdeen Airport, using the existing powers granted to him by Parliament, avoiding the need to create a separate regulatory process for the airport; or
  - providing the detail of the Commission's supporting analysis to the CAA and to the OFT, so that they could then consider whether the airport's

conduct warrants further investigation under either of their respective powers (i.e. section 41 of the Airports Act and the Competition Act).

3.22 Second, the Commission could consider alternative behavioural remedies, including:

- obliging Aberdeen Airport to act in a 'fair, reasonable and non-discriminatory manner', perhaps supplemented by an obligation to report on its compliance with this requirement to the CAA and/or OFT; or
- obliging Aberdeen Airport to prepare and publish depreciated replacement cost accounts for the current and future years, and for a reasonable historical period to allow comparisons, so that the EC, OFT, CAA and affected third parties are better placed to assess the airport's conduct and consider taking enforcement action<sup>12</sup>.

3.23 As a minimum, the Commission should recognise the limitations and likely distortions caused by the proposed remedy and seek to limit the adverse consequences by applying a sunset clause, perhaps linked to the implementation of legislative reform by Government.

3.24 Should the Commission, notwithstanding the CAA's evidence and analysis, reach a firm conclusion that there is an AEC, the CAA urges the Commission to consider all of these possible alternative remedies, so as to ensure that any eventual remedy is proportionate both to the magnitude of any AEC and the balance of the evidence available on its existence.

3.25 These issues are discussed in more detail in Annex A.

### **Airline consultation, non-discrimination and quality of service**

3.26 The CAA does not accept that the Commission has made the case that the way the CAA has applied the current system of regulation has adversely affected competition between airlines, an issue considered in more detail in chapter 4. The CAA, however, acknowledges a number of shortcomings of the current regulatory regime and sees its reform as an important part of the overall package of remedies. The CAA continues to believe that regulatory and policy resources would be better directed towards designing a clearer, more flexible and ultimately more effective statutory framework for economic regulation of airports, than to the various interim behavioural remedies which the Commission has now proposed for Heathrow, and possibly other airports.

3.27 Considering the three proposed remedies designed to improve consultation with airlines, to reduce discrimination against certain airlines, and to enhance service quality, it is not clear to the CAA what AEC(s) these are designed to address. The CAA disputes that its application of its current statutory duties

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<sup>12</sup> Or, in the case of affected third parties, seek injunctive relief and/or damages through the courts.

has contributed to an AEC. If, on the other hand, some of these remedies are designed to address the AEC arising from Heathrow's position as the only UK hub airport, then they would clearly not be at all relevant to Gatwick or Stansted. In either case, the CAA does not consider that the Commission has put forward an evidenced argument that the proposed remedies would be a proportionate response to any identified AEC.

#### *Undertakings on consultation*

- 3.28 The CAA agrees that consultation between each of Heathrow, Gatwick and Stansted airports and their respective airline users should be improved, and has taken steps to put in place regulatory measures to achieve this outcome.
- 3.29 In the case of Heathrow and Gatwick, the CAA has embodied a broader and more stringent consultation protocol in its price control decisions for Q5, performance against which would be assessed during any mid-Q5 review and at the next price control review. Failure by the airport operator to meet the consultation standards could result in capital expenditure not being allowed into the regulatory asset base for subsequent remuneration. The CAA considers that this is a reasonable framework for incentivising better consultation performance. A balanced reading of the evidence would indicate that BAA's consultation performance had improved in recent years, and was improving further in 2008/09 under the new more stringent requirements.
- 3.30 The Commission comments that "in [its] view, the revised agreement in Annex G was, in effect, therefore tailored to what BAA was willing or able to provide"<sup>13</sup>. This conclusion ignores two factors. First, the CAA proposed and secured BAA's ultimate agreement to enhancements to Annex G (in line with revisions proposed by airlines) beyond what BAA had originally been willing to accept. In doing so, the CAA achieved what it considered was a reasonable specification of the consultation terms for each airport, and did not need to press for more. In finalising Annex G, the CAA weighed up carefully the various points on which BAA and the airlines differed and reached a balanced regulatory judgment (which BAA accepted) on a strengthened consultation protocol.
- 3.31 Second, the CAA did not anyway have power to impose any more stringent set of consultation requirements. This was because the Commission did not make an adverse public interest finding as to the airports' consultation performance in the Q4 price control period. The CAA finds it surprising that the Commission now considers that a consultation undertaking going beyond Annex G is necessary, when it had the opportunity to make an adverse public interest finding in this regard (and thereby give the CAA the regulatory locus and direction to enforce tighter standards) in its price control report to CAA only some 15 months earlier. The CAA does not consider that the Commission has adduced any additional or compelling evidence that was not

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<sup>13</sup> Paragraph 177

available to both the CAA and Commission during the course of the Q5 price control review in support of its proposed consultation remedy.

3.32 In particular, the CAA considers that the Commission has not made the case for additional regulation in the aspects of consultation which the Commission specifies. For example:

- **Timeliness:** Annex G already contains reasonable provisions for this, which recognize that the timeliness (and depth and breadth) of consultation will inevitably vary by project and so cannot be specified precisely in advance. At G.23: "Consultation should encompass the exchange of information and subsequent discussion between BAA and airlines with the objective of achieving agreement within an appropriate timescale to enable the successful delivery of the plan. A project plan will be developed by BAA which will show reasonable timescales for consultation commensurate with project complexity. The plan will show the timing of key decisions needed to maintain project programme in line with the CIP. All parties will endeavour to meet this timescale. However, it is recognized that agreement may not always be achieved in the time available to progress the investments. With this in mind it will be the responsibility of these bodies on a yearly basis to provide an agreed record of the agreements reached and those areas where there has been disagreement. This record of agreement/disagreement should also highlight the process undertaken to attempt to resolve any disputes."
- **Auditability of information:** it is not entirely clear what the Commission is proposing here. If this refers to how the airport explains to airlines how plans, costs and benefits may have changed over time, then Annex G already contains explicit provision for this (G.15 to G.18).
- **Strategic business plan:** Annex G already specifies that each airport provide airlines with a masterplan, a long-term land use plan, and an annual capital investment plan. The CIP will include information sufficient to consult users *inter alia* on "the principal business drivers behind the airport's development strategy" (G.9). The Commission has not articulated clearly the information deficit on "strategic business plans" from Annex G which its own proposed undertaking would fill, nor how this would remedy any AEC that may have been identified.
- **Detailed project information:** the CAA agrees that each airport should provide its users with relevant information on significant projects, which is why this requirement is specified in Annex G - at G.9 sub paragraph 6: "Cost estimates and efficiencies of individual projects: Providing airlines with information, to an appropriate level of detail, on total capital expenditure and the anticipated incremental impact upon the operating costs of both BAA and the airline community. The amount of cost detail will be related to the stage of the development process. For

those projects that have reached a high level of definition, specific cost estimates and indications of benefits will be expected" ... etc. At G.9 sub paragraph 7: "The outputs that are expected from individual projects: This should be both in terms of infrastructure that will be provided/replaced and the benefits that will be realized in terms of increased capacity, improved service levels, statutory compliance etc. The outputs should be quantified and provided on an incremental basis at a level of detail appropriate to the stage of the project. For any project, it should be clear how the benefits justify the costs: information should, therefore, be shared by the airport operator, as provider of the facility, and by those that operate the facility to enable users to assess the relative financial and operational benefits of the proposed development". Given the above, the CAA considers it strange that the Commission criticises the "absence of reference to a CBA" when Annex G includes specification of all the components of a cost benefit analysis on significant projects – in short, the CAA focussed on ensuring that the substance was provided to the airlines.

- Maintenance plan: although not explicitly part of Annex G, the CAA considers that, as part of its consultation on the CIP, each airport operator would be expected to discuss the choices between maintenance, refurbishment, replacement and extension of capital facilities when consulting airlines on specific projects.
- Appointment of a facilitator: the Commission adduces no argument or evidence in support of this regulatory innovation. Unlike at Stansted, the degree of engagement between airport operator and airlines at Heathrow and Gatwick appears to be both substantial and productive to date – there does not appear to be a communications impasse which would require regulatory intervention to solve. In future, it might be expected that the divestment of Gatwick and Stansted from Heathrow and the rest of BAA would encourage all three airports to work even harder at developing effective dialogue with users. The CAA therefore considers that the introduction of an independent facilitator would be otiose at Heathrow and Gatwick. It could also in practice undermine some of the progress that has and is being made through constructive engagement, distracting and detracting from the focused effort needed for effective exchange of views on airport development.

3.33 In sum, the CAA does not consider that there is a case for the consultation undertakings which the Commission has proposed, at either Heathrow or Gatwick.

3.34 In the case of Stansted, the CAA does have the regulatory locus (and, indeed, obligation) to regulate the airport's consultation performance more directly, as a direct result of the Commission's public interest finding during

its recent price control review. The CAA has proposed<sup>14</sup> to implement by way of a regulatory condition a consultation protocol and the appointment of a consultation facilitator, in order to implement the Commission's recommendations in this area. The CAA is currently consulting on its proposals until early February 2009, and anticipates making its final decision for the economic regulation of Stansted for the quinquennium starting April 2009 in the first half of March. Given that the CAA has followed the Commission's own recommendations closely, the CAA considers that there is no case for any additional Commission undertakings on Stansted.

#### *Undertakings on non-discrimination*

3.35 The Commission proposes a novel undertaking on Heathrow to seek comprehensive airline consent to any agreement with an individual airline on specific facilities and/or services. It appears to base its proposal on its assessment of:

- BAA's development of Terminal 5 for British Airways;
- the development of the Heathrow East Terminal; and
- the frequency with which other regulators have to date used relevant statutory powers to deal with any alleged undue discriminatory practices.

3.36 On the first and third points, the Commission considers that BAA's behaviour, *inter alia*, in allocating T5 to BA as "could be tantamount to discrimination in relation to a trade practice or a pricing policy and, in principle at least, the CAA may be able to intervene under section 41 of the Airports Act". The CAA notes that while it has received and investigated one complaint to date from an airline regarding discrimination by Heathrow in use of facilities<sup>15</sup>, it has received no such complaints from any airline in respect of BAA's allocation of T5 to BA.

3.37 The CAA agrees that it does have the powers under section 41 to intervene to prevent undue discrimination by Heathrow in the provision of facilities and/or services. But in the absence of any complaint brought to it in respect of T5, or evidence being provided by the Commission to it, the CAA has not investigated (under the auspices of its section 41 powers) the airport's behaviour in this area. It should also be noted that there is a reasonably substantial body of European competition law being applied to address discrimination issues at airports, including a number of cases where airports have been found to have breached EC competition law.

3.38 The CAA also notes that BAA's approach to the occupancy of the then proposed Terminal 5 has been well established since the mid 1990s. The

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<sup>14</sup> CAA proposals for the economic regulation of Stansted Airport, 2009-2014, December 2008

<sup>15</sup> The details of this complaint are currently confidential, but can be provided to the Commission on request.

implications of BA's sole occupancy of T5 and the potential regulatory reaction has been considered by the CAA and/or the Commission in at least two price control reviews. In 2002, the Commission discussed the process by which BAA had identified BA as the optimal occupant of T5 and then consulted airlines more generally on this proposal<sup>16</sup>. The Commission did not make any adverse comment about this process or its outcome; indeed, it concluded in favour of BAA's proposed sequencing of investment and the case for pressing on with T5 ahead of redevelopment of the central terminal area<sup>17</sup>.

- 3.39 In 2006-08, the CAA considered submissions from bmi which argued for differential (lower) charges for those airlines not benefiting from the enhanced facilities at T5. The CAA considered that there was not a strong case for mandating differentiation of airport charges for temporary differentials in terminal facilities<sup>18</sup>. The Commission concurred with this assessment<sup>19</sup> and concluded in respect of Heathrow and Gatwick that: "we do not believe there is sufficient ground to regard lack of differential charging between terminals (other than under the SQR scheme) at these airports to reflect different quality of service as currently against the public interest".
- 3.40 On the second point, the Commission does not appear to have addressed the CAA's evidence on and assessment of the development of the Heathrow East Terminal, which it presented in its responses to both the provisional findings and provisional remedies reports<sup>20</sup>. The Commission constructs an argument through the juxtaposition of unrelated facts (e.g. T5 opening day shambles versus complexity of building HET in midst of live operations in the central terminal area), which does not amount to a convincing description of unduly discriminatory behaviour by BAA.
- 3.41 Against this background, it is surprising that the Commission now considers (on the back of very little additional evidence than was available during the recent Heathrow price control review) that the putative and potential adverse effects of Heathrow discriminating against certain airlines is such as to warrant an additional layer of regulation. The CAA does not consider that a case has been made for such regulatory intervention.
- 3.42 With regard to the details of the Commission's proposed undertaking on non-discrimination, the CAA has the following comments:
- With regard to measures (a) (information to all on proposed agreement), (b) (options for mitigating any competitive disadvantage), and (c) (consultation on any airline concerns), the CAA would expect

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<sup>16</sup> CC 2002 BAA price control report, paragraph 9.58 et seq

<sup>17</sup> *ibid*, paragraph 2.85

<sup>18</sup> See, in particular, Annex C of 'Airport price control review – CAA recommendations to the Competition Commission for Heathrow and Gatwick Airports', CAA, March 2007

<sup>19</sup> CC 2007 BAA price control report, paragraph 6.58

<sup>20</sup> Notably Annex A of 'The Civil Aviation Authority's response to the Provisional Findings and Remedies Notification', CAA, September 2008

Heathrow to consult airlines across the board as a matter of course via its normal consultative process (under the terms of Annex G) on major projects such as those affecting terminal capacity, quality and airline relocations. There is evidence that BAA is currently doing so, and a regulatory incentive and oversight regime is already in place to encourage the airport to continue to do so throughout Q5. As such, it is not clear why these additional undertakings would be needed.

- There may, however, be other projects, notably the provision by BAA of premium class passenger lounges and passenger processing facilities, where airline competition on service offering could be stymied by the proposed mechanism, which could allow one airline effectively to hold back innovation and service improvements by others. This could lead to a “levelling down” of service and facilities, to the ultimate detriment of passengers.
- The introduction of an adjudicator (d) would introduce a fourth regulator (after the Commission, CAA and OFT) into the operation of the airport, with obvious direct and indirect costs (e.g. extra administration, regulatory risk affecting investment and innovation incentives adversely). While multiple regulators can clearly try to work together in a complementary and efficient manner, nevertheless this undertaking appears to the CAA to bring significant cost and risk for little identifiable benefit.

#### *Undertakings on service quality*

- 3.43 The Commission puts forward tentative and somewhat under-developed proposed remedies in respect of service quality. It is therefore difficult for the CAA (or any other party) to comment substantively on the evidence for and specification of any undertakings in this area.
- 3.44 The CAA would note that the two actions which the Commission has identified (audit and testing of SQ data, funding research led by the CAA into passenger preferences) have both already been put in train and/or in plan by the CAA. On the former, the CAA is currently consulting airlines on the scope and terms of reference of the CAA's first audit of service quality data measurement, which is due to commence February/March 2009. The costs of CAA resources and consultancy support for such a project would be charged back to the relevant designated airports, as part of the CAA's charge for airport regulation. Although the CAA has yet to conclude the Stansted price control review, the CAA would expect to commit to a number of service quality audits at Stansted during Q5, as it has done for Heathrow and Gatwick. The CAA has already proposed that BAA “maintain records of the actual quality of service and rebates made in such a form that performance could be independently audited against the standards defined by the CAA”<sup>21</sup>.

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<sup>21</sup> Paragraph 7.41, CAA Q5 Stansted proposals, December 2008

- 3.45 On the latter, the CAA is currently conducting research on passenger experience at the three BAA London airports (and Manchester) for the DfT. The CAA has also already committed publicly to undertake further research in this area to support its own ongoing airport regulation; in its March 2008 price control decision for Heathrow and Gatwick the CAA stated<sup>22</sup>: “In parallel with the 2008/09 audit, the CAA intends to investigate further, working with interested parties, how better to measure passengers’ preferences for the various elements of service quality and their willingness to pay for service improvements. This work should help inform future regulatory analysis of dimensions of service currently included within the service quality standards and rebates scheme and other aspects of service delivered at the airport”. Again, costs to the CAA of such a project would be recovered through charges on regulated airports, while leaving ultimate control of the research specification with the CAA.
- 3.46 In light of the above, the CAA can see no case for any additional undertaking on any of Heathrow, Gatwick or Stansted in respect of service quality.

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<sup>22</sup> Paragraph 12.68

## **4. Recommendations in respect of economic regulation**

### **Introduction**

- 4.1 In this chapter, the CAA responds to the Competition Commission's provisional decision on remedies in respect of economic regulation.
- 4.2 The CAA welcomes the Commission's support for reform to the framework of economic regulation, including to provide the CAA with greater flexibility in the way it applies economic regulation and an updated set of statutory duties. The CAA also welcomes the Commission's agreement that the CAA should have a primary duty towards passengers.
- 4.3 However, the CAA is concerned that the Commission's recommendations in respect of economic regulation are somewhat unbalanced. As noted in the previous chapter, there appears to be too much emphasis on the need for regulation to be strengthened (with greater accountability to airlines, and more comprehensive regulation of Heathrow in accordance with the 'full regulatory model'), and too little emphasis on the potential for competition between airports to drive the best available long term outcomes for consumers.
- 4.4 The need for regulation to be strengthened appears to be predicated, in part, on the Commission's provisional finding that the way that the CAA has applied regulation has had an adverse impact on competition between airlines, which the CAA strongly disputes. The basis on which the Commission's recommendations on regulation have been made is therefore highly questionable. This issue is discussed in the first section of this chapter.
- 4.5 The remaining sections of the chapter relate to the specific remedies that the Commission has proposed:
- the airport regulator's statutory duties;
  - rights of appeal;
  - aspects of the full regulatory model as applied to Heathrow; and
  - recommendations relating to the regulation of Gatwick and Stansted under separate ownership.

### **The absence of evidence to support the Commission's provisional view on the way the CAA has applied economic regulation**

- 4.6 In its August 2008 Provisional Findings, the Commission provisionally found that the current system of regulation of airports is a feature which distorts competition between airlines. This finding was based, in part, on a number of

criticisms of the way in which the CAA had operated the current regulatory regime.

- 4.7 In its September 2008 response, the CAA rejected these criticisms. In particular, the CAA rejected the finding that it did not give sufficient weight to the views of airline users and the findings that it attached undue emphasis on the fourth of its statutory duties. In doing so, the CAA submitted a detailed point-by-point rebuttal of the analysis that appeared to lie behind the provisional finding.
- 4.8 For example, the CAA questioned whether the Commission could substantiate the claim that BAA had under-invested, given the substantial contrary evidence contained in the Competition Commission's own 2002 report on BAA. The CAA also questioned whether any such investment had had an adverse impact on competition between airlines and that this adverse effect was allowed to occur owing to the inaction of the CAA.
- 4.9 In doing so, the CAA was conscious that:
- as part of the 2002 quinquennial price control review, the CAA argued that historically there was some evidence of under-investment which indicated the need for improved incentives<sup>23</sup>;
  - the Commission reviewed the historical evidence on investment incentives and concluded that "There is no evidence that the single till had led to any general under-investment in aeronautical assets at the three BAA London airports in the past, nor any expectation that it will do so over the next five years"<sup>24</sup>; and
  - during that five year period (i.e. the five years to 31 March 2008 or Q4) BAA went on to invest at Heathrow and Gatwick £874m more than was projected at the time of the Q4 review.
- 4.10 Moreover, in respect of its 2002 review of public interest issues under the Airports Act, the Commission concluded that in its view "... except for the delays in T5 that have largely been outside of [BAA's] control, BAA cannot be regarded as having systematically under-invested during Q3"<sup>25</sup> and that the Commission decided that it "...[did] not currently think an adverse finding either on BAA's conduct on investment or consultation would be justified"<sup>26</sup>;
- 4.11 The CAA also questioned why the Commission attributed shortcomings in the regulation of service quality performance to the CAA, given the limitations on the CAA's powers, and the fact that under the Airports Act 1986 the CAA cannot regulate service quality performance except to the extent that the

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<sup>23</sup> Paragraph 2.96, Competition Commission, *op cit*

<sup>24</sup> Paragraph 2.222(a), Competition Commission, *op cit*

<sup>25</sup> Paragraph 2.406, 'BAA plc: A report on the economic regulation of the London airports companies (Heathrow Airport Ltd, Gatwick Airport Ltd and Stansted Airport Ltd)', Competition Commission, 2002

<sup>26</sup> Paragraph 2.410, Competition Commission, *op cit*

Commission has previously identified poor service as an aspect of BAA's conduct that operates, or might operate, against the public interest. In this respect, it is notable that the Commission's Q4 public interest finding was made in respect of the extent to which prices reflected variations in service quality. The Commission did not make a finding that the average level of service quality was against the public interest.<sup>27</sup> Furthermore, insofar as the Commission did identify service quality issues, conditions to address these issues were properly implemented by the CAA.

- 4.12 In developing its December 2008 Provisional Decision on Remedies, the Commission has not taken into account the CAA's detailed comments in this area and has instead developed remedies to the disputed Provisional Findings. If anything, the Commission's position has now hardened such that the Commission now considers that there is a need for the CAA to change its "regulatory culture"<sup>28</sup> though it has not provided any further evidence to support this view.
- 4.13 The Commission has indicated that it is currently reviewing its Provisional Findings and updating them, where necessary, in the light of new evidence<sup>29</sup>. The Commission goes on to say if as a result of any such changes, or for any other reason, the Commission group undertaking this investigation materially revises its provisional decision on remedies, it will reconsult. But the CAA would be concerned if the Commission did not revise both its provisional findings and provisional remedies. If the CAA's understanding is correct – i.e. that the Commission would not expect to re-consult if its position remains unchanged – this would effectively deprive the CAA of a fair and reasonable opportunity to comment on the Commission's response to the CAA's detailed comments on its Provisional Findings. This would be highly unsatisfactory.
- 4.14 The CAA notes also that the Commission claims it has had discussions with a number of parties concerning the submissions in response to its Provisional Findings. At no point has the Commission invited the CAA to discuss its detailed comments on the Commission's analysis and/or findings in respect of economic regulation. Indeed, the issue was explicitly excluded from the agenda of the CAA's hearing on 16 October 2008 (which concentrated on remedies alone, at the insistence of the Commission), and from the subsequent CAA/Commission staff meeting on 24 October (which concentrated on the CAA's concerns about the Commission's competition analysis, again at the request of the Commission). The Commission has neither addressed the CAA's concerns nor responded with a justification for this aspect of its provisional findings – a serious shortcoming in view of the nature of the allegations that the Commission is making.

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<sup>27</sup> See paragraphs 2.444 and 2.445, Competition Commission, October 2002, *op cit*

<sup>28</sup> Paragraph 222, BAA Airports Market Investigation: Provisional Decision on Remedies, CC, December 2008.

<sup>29</sup> Paragraph 4, BAA Airports Market Investigation: Provisional Decision on Remedies, CC, December 2008.

- 4.15 For the avoidance of doubt, the fundamental problem is:
- the Commission alleges that the CAA has wrongly interpreted its duties, but the evidence it has tabled to support this allegation is slight to non-existent; and
  - the Commission alleges that the way the CAA has interpreted its statutory duties has had an adverse effect on competition due to inadequate investment and poor service quality, but the Commission has tabled nothing which supports this supposed claim of causality.
- 4.16 Indeed, in relation to both investment and service quality, the CAA has over the years pretty clearly followed the Commission's own recommendations. The CAA's major points of departure from the Commission have been in precisely those areas (potential for undercutting of competition at Manchester and cross-subsidy within the London system) where following the Commission's recommendations would have adversely affected competition between airports.
- 4.17 The CAA therefore reiterates its request for a clear account of the evidence and/or analysis on which the Commission bases its finding – including an explanation of how the Commission has taken into account the points it previously submitted – in good time to allow the CAA to respond before the Commission makes its final decision.

## **Statutory duties**

### *Primary duty to consumers*

- 4.18 The Commission will be aware that there has been extensive public debate on the question of how the CAA's statutory duties should be modified and – in particular – whether the CAA should continue to have a statutory duty to further the reasonable interests of users of airports generally, or rather have a statutory duty focused on the protection of consumers.
- 4.19 Although certain stakeholders have for understandable commercial reasons opposed change, a broad consensus has emerged over the past eighteen months that the primary objective of economic regulation of airports should be the protection, or furtherance, of the consumer interest rather than the protection of airport users generally:
- in July 2007, the House of Commons Transport Select Committee recommended that “when there is a conflict between the airline and the passenger interest in a particular area, there should be a general presumption that the CAA will come down on the side of the passenger”<sup>30</sup>;

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<sup>30</sup> Passengers' Experiences of Air Travel, 8th Report of Session 2007-08, House of Commons Transport Select Committee, July 2007, paragraph 69.

- in November 2007, the House of Lords Select Committee on Regulators recommended that: "... as the opportunity arises, further standardization of regulators' remits should be introduced with the aim of ensuring that they are statutorily required to follow best practice"<sup>31</sup>;
- in March 2008, the CAA published proposals that included "reframing the CAA's duties to place the interests of consumers first"<sup>32</sup>;
- in July 2008, Sir Joseph Pilling recommended that "the DfT review of the economic regulation of airports should consider whether the CAA's current duty towards users should be amended to give greater weight to passengers or consumers"<sup>33</sup>;
- in November 2008, the Secretary of State confirmed his view that the protection of passengers' interests should be the primary objective stating that "the focus on the passenger is ... why we are revisiting the current economic regulatory regime for airports", that "one of the key issues here is ensuring that passengers are a primary concern" and that "our ambition here is to put passengers first"<sup>34</sup>; and
- in December 2008, the DfT's Advisory Panel held a seminar at which it presented its current thinking that the CAA should be subject to a "Primary duty to protect the interests of (current and future) consumers ... wherever possible by promoting competition".<sup>35</sup>

4.20 Moreover, as the CAA noted in its September 2008 response to the Commission's Provisional Findings<sup>36</sup>, putting the consumer first would serve to align the CAA's duties in the Airports Act 1986 with its duties in the Civil Aviation Act 1982. It would also align airport regulation with best practice from other regulated sectors, where economic regulators generally have a primary duty to end consumers.

4.21 The view contained in the Commission's August 2008 Notice of Possible Remedies that it would be "appropriate to continue to include airlines, passengers and other users of airport services in the definition of users to whose interests the CAA must have regard"<sup>37</sup> (emphasis added) was clearly at odds with the emerging consensus described in paragraph 4.19 above. But the Commission's December 2008 statements represent a subtle, though

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<sup>31</sup> UK Economic Regulators, 1<sup>st</sup> Report of Session 2006-07, House of Lords Select Committee on Regulators, paragraph 3.28.

<sup>32</sup> CAA Submission To Competition Commission Recommends Reform Of UK Airport Regulation – Putting Consumers First, CAA, 17 March 2008

<sup>33</sup> Report of the Strategic Review of the CAA, Sir Joseph Pilling, July 2008 available on the DfT's website: [www.dft.gov.uk](http://www.dft.gov.uk)

<sup>34</sup> 'Speech to Airport Operators Association Conference', Secretary of State for Transport, 18 November 2007

<sup>35</sup> Slide 3, Duties and Governance, Chris Bolt, Member of the DfT's Advisory Panel, 18 December 2008

<sup>36</sup> The Competition Commission's Market Investigation of BAA Ltd: The CAA's response to the Provisional Findings and Remedies Notification, CAA, September 2008

<sup>37</sup> Paragraph 31, Notice of possible remedies under Rule 11 of the Competition Commission Rules of Procedure, Competition Commission, August 2008

significant, change of position. In its December 2008 Provisional Decision on Remedies, the Commission recommends a formulation along the following lines:

“The regulator’s principal objective is to further the interests of (present and future) consumers, where appropriate by promoting effective competition between airports. In assessing the interests of consumers, the regulator should have due regard to the views of airlines”<sup>38</sup> (emphasis added)

This formulation – by referring to ‘views’ rather than ‘interests’ – brings the Commission broadly into line with the consensus and regulatory best practice. It is, therefore, very much to be welcomed.

- 4.22 That said, the CAA questions whether the primary statutory duty should explicitly require the CAA to have due regard to the views of airlines given the Commission’s endorsement of the DfT’s Advisory Group’s proposal for a secondary statutory duty that would require the CAA to adhere to the principles of better regulation<sup>39</sup>. In complying with the principles of better regulation, the CAA will naturally have to have regard to the views of airlines, and all other interested parties, and show in clearly structured documentation how it has taken responses into account in arriving at its decisions. Indeed, all competition and regulatory authorities should meet such standards.
- 4.23 We recognise that the Commission’s rationale might lie in its assertion that the CAA has a “tendency ... to give insufficient weight to airline users of the airports and be non-responsive to airline concerns”<sup>40</sup>. However, as noted in the first section of this chapter, the Commission has so far failed to substantiate this allegation. Accordingly, the asserted concerns would not justify – or, as far as the CAA can see, be addressed by – an explicit requirement to have regard to the views of airlines.

#### *Need for a financing duty*

- 4.24 The CAA notes the Commission’s support for a secondary duty on the regulator to enable airport owners to finance their activities. However, the Commission does not articulate why it supports this approach, except to note that it is consistent with recommendations of the DfT’s Advisory Panel.
- 4.25 The CAA recognises that such a secondary duty is found in some – but not all – other regulatory regimes. However, the CAA would expect a proposed primary duty to consumers would effectively require the regulator to ensure that the regulated company is regulated in a way that permits it to finance necessary and desirable investment, rendering a financing duty otiose.

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<sup>38</sup> Paragraph 211, BAA Airports Market Investigation: Provisional Decision on Remedies, CC, December 2008.

<sup>39</sup> Paragraph 204(c)(ii), BAA Airports Market Investigation: Provisional Decision on Remedies, CC, December 2008.

<sup>40</sup> Paragraph 209, BAA Airports Market Investigation: Provisional Decision on Remedies, CC, December 2008.

Moreover, the CAA observes that introducing such a duty could jeopardise the ability of the regulatory regime to protect the best interests of consumers, by prejudicing its ability to regulate financial arrangements in the most effective way.

- 4.26 For example, there is a real risk that the financing duty could carry a connotation that regulated companies could rely on the regulator to ensure in all future periods that it has sufficient capital resources to discharge its functions, weakening the incentive on the regulated company (and/or the providers of debt and equity finance) to finance itself prudently, perceiving that the regulator will be obliged to repair any weaknesses in its financing capability through more generous future price controls than would otherwise apply. Whilst other regulators have taken steps to clarify that this is not their interpretation, it is possible that regulated companies (and their investors) have invested on this basis in spite of the stated position of the regulators, and – as Professor Dieter Helm has previously observed – the meaning of the statutory duty has not been tested in the courts.
- 4.27 The Commission will also be aware that the CAA has clearly sought to protect users from the risks to price, service and investment that might flow from highly leveraged financial structures. In regulating Heathrow and Gatwick airports, the CAA has done so not by preventing highly geared financial structures from being adopted in the first place, but through the rigorous economic regulation of price, service and investment, designing a regime in which the regulated company (and its owners/investors) bear the risk of high leverage, not users. In practice, this means that if the financial arrangements adopted by the regulated airports lead to financial distress, it is the regulated airport and/or its owners/investors that must inject fresh capital, or else risk financial failure. This approach to regulating for financing relies on the regulator adopting a clear and credible position that the actual financial arrangements are not a matter for the regulator and that *in extremis* the regulator would be prepared to let a regulated company fail, which is the position the CAA has consistently and publicly made clear. The potential difficulty with the imposition of a financing duty is that it could serve to undermine the credibility of the preparedness of the regulator to allow failure (and associated losses to owners/investors, including bondholders), thereby undermining the efficacy of the policy, and thus the protection it affords users.
- 4.28 The CAA recognises that the Commission might not have the time or resource to consider what are inevitably complex issues thoroughly and rigorously prior to the deadline for its final report. In these circumstances, the CAA would encourage the Commission to leave open these questions, acknowledging that they need to be fully examined as part of the Government's review of the economic regulation of airports.

### *Better regulation*

4.29 The CAA fully supports the DfT's Advisory Panel's current view that the new airport regulatory regime conforms to principles of 'better regulation' and that having regard to such principles be included as a secondary duty. Indeed, the CAA considers that ensuring proportionate regulation by means of a statutory duty is likely to be more effective than requiring the CAA to undertake particular functions on a periodic basis.

### **Rights of appeal**

4.30 The Commission states that it follows from its provisional finding that the current system of airport regulation distorts competition between airlines, that the regulator should be more accountable to airlines<sup>41</sup>. The Commission also states that its proposed recommendations would 'significantly improve regulatory accountability; help to generate the change in regulatory culture that [the Commission] think is needed; and hence improve the quality of regulatory decision-making and provide greater customer focus'.<sup>42</sup>

4.31 As set out above, the CAA disputes the Commission's provisional view that the way in which the CAA has given effect to its statutory duties has adversely affected competition<sup>43</sup>, removing the main reason cited by the Commission in favour of extending (unspecified) rights of appeal to airline users.

4.32 In terms of the specific proposals, the CAA considers that there is a strong case for an improved appeals regime, allowing certain affected parties to appeal its decisions on the grounds of process (as now) and on merits (which is currently not possible), with the latter referred to the Commission. The CAA has also acknowledged that there may be merit in principle to extending this right of appeal to airports, airlines and consumer groups if a mechanism can be developed to balance the benefits of such appeals against the risk that this might result in near-automatic appeals, noting that this might be difficult to achieve in practice.

4.33 In its provisional decision on remedies, however, the Commission has failed to identify how the risk of near-automatic appeals could be avoided. In particular:

- while the Commission argues that every party with a sufficient interest in appealing faces some cost of doing so, it remains the case that an investigation (such as that typically carried out by the Commission in connection with a disputed licence modification) would place a

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<sup>41</sup> Paragraph 221, BAA Airports Market Investigation: Provisional Decision on Remedies, CC, December 2008.

<sup>42</sup> Paragraph 222, BAA Airports Market Investigation: Provisional Decision on Remedies, CC, December 2008.

<sup>43</sup> As summarised in paragraph 195(c), BAA Airports Market Investigation: Provisional Decision on Remedies, CC, December 2008.

substantially greater burden in terms of costs, risks and resources on the regulated company, than on any given intermediate or final consumer which might have initiated the appeal; and

- while the Commission argues that there would not always be a 'winner' or 'loser' to a price control decision, it is clear that at an airport – such as Heathrow – where the level of airport charges directly bears on the value of airline rights to use slots, and the large number of parties involved with different interests and commercial strategies, that one or other party would have a strong incentive to appeal.

4.34 Moreover, while the CAA recognises that clearly frivolous or vexatious appeals could be prevented, it is far from clear how a mechanism for awarding costs would work in the context of an investigation into a licence modification, which does not necessarily lead to a clear cut outcome (with a 'loser' bearing the costs of the appeal).

4.35 In sum, the CAA is far from convinced that the Commission's proposals would sufficiently diverge from the current situation. In other words, in practice, there would be a significant risk that pretty much all price control modifications – and probably other modifications too – would be referred to the Commission.

4.36 Such an outcome would be at odds with the general view that the CAA should not routinely refer price control proposals (or – prospectively – proposed licence modifications). In particular:

- in July 2007, the House of Commons Transport Select Committee recommended that “as of the next price control review, the Government implement its own 1998 proposals to make CAA airport review decisions subject to the standard regulatory model, in which the CAA reaches airport price control decisions based on its own review and the airports, as the regulated organisations, subsequently have the right of appeal to the Competition Commission”<sup>44</sup>;
- in November 2007, the House of Lords Select Committee on Regulators recommended that: “... as the opportunity arises, further standardization of regulators' remits should be introduced with the aim of ensuring that they are statutorily required to follow best practice”<sup>45</sup>;
- in July 2008, Sir Joseph Pilling recommended that “the Department propose amending the existing legislation to remove the automatic statutory reference to the Competition Commission in the setting of

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<sup>44</sup> Passengers' Experiences of Air Travel, 8th Report of Session 2007-08, House of Commons Transport Select Committee, July 2007, paragraph 34.

<sup>45</sup> UK Economic Regulators, 1<sup>st</sup> Report of Session 2006-07, House of Lords Select Committee on Regulators, paragraph 3.28.

airport price caps and establish this organisation as the appellate body”

<sup>46</sup>,  
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- in November 2008, the Secretary of State confirmed “that he accepted in broad principle Sir Joseph’s recommendations, as has the CAA board”<sup>47</sup>; and
- in December 2008, the DfT’s Advisory Panel presented its current thinking that, in modifying the licences of ‘top tier’ airports, the same processes should be adopted that apply in other regulated sectors, i.e. modification of licences by agreement with the regulated company, with references to the Commission only in the absence of agreement between the regulator and the regulated company. The Panel also confirmed that its current thinking was that the rights of appeal should be extended to airlines (and possibly other interested parties) only in relation to decisions taken as to the appropriate tier of licence that should apply to a licence, and not in respect of particular licence modifications.<sup>48</sup>

4.37 The CAA understands that the Commission believes there is wider problem of sector regulators being reluctant to make references to the Commission, not least the problems this reluctance creates in terms of ensuring the Commission maintains adequate regulatory expertise. However, it is not clear whether the reduction in the number of references to the Commission by sector regulators in recent years is a symptom of an ineffective appeals mechanism or – perhaps more likely – an inevitable consequence of the more contentious regulatory issues having already been addressed by the Commission in the first decade or so of the UK system of independent economic regulation. Either way, the CAA would encourage the Commission to make recommendations that will address the central issue that the CAA faces, namely, that routine references can serve unnecessarily to extend the length of price control reviews (or licence modification processes), bringing greater cost to consumers than they do benefit.

4.38 We would therefore encourage the Commission to reflect further on the appropriate approach to appeals, with due regard to the points raised by the CAA, and the latest thinking of the DfT’s Advisory Panel.

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<sup>46</sup> Report of the Strategic Review of the CAA, Sir Joseph Pilling, July 2008 available on the DfT’s website: [www.dft.gov.uk](http://www.dft.gov.uk)

<sup>47</sup> Statement to the House of Commons, 26 November 2008, Hansard

<sup>48</sup> The CAA notes that the CC also reports that “The Independent Panel envisages that, in cases where it is determined that an airport has SMP, the regulator would have powers to impose licence obligations *in addition* to price controls.” (paragraph 230(a) of its provisional decision on remedies, emphasis added). The CAA’s understanding is that the Panel uses the term ‘price controls’ to refer to a broad spectrum of price regulation ranging from intensive, cost-based price control regulation through to price surveillance, without price caps. In practice, this means that the Panel envisages that the decision as to whether or not price control regulation should apply (as well as the form of price control regulation) should reside with the CAA, subject to the conventional appeal processes that apply in other regulated sectors.

## Aspects of the full regulatory model applied to Heathrow

- 4.39 The CAA welcomes the decision of the Commission not to attempt to set out a new regulatory structure for Heathrow, nor to write its licence. Deciding upon the contents of the licence for a particular airport is properly a task that should be carried out with full regard to the market circumstances that apply to the airport, which are not currently known or understood with any great certainty.
- 4.40 Indeed, it is the case that over the course the next few years market circumstances are likely to change considerably, especially if the Commission's proposals to require the divestment of both Gatwick and Stansted airports come to fruition. The CAA has recently announced that it intends to initiate work periodically to assess the degree of competition between airports; this work too is likely to inform the drafting of any new licences.<sup>49</sup>
- 4.41 For these reasons, the CAA suggests that the Commission focuses its recommendations on supporting reforms that would give the CAA the flexibility to apply proportionate regulation in varied and changing market circumstances, and to resist the temptation to speculate – before the event and in the absence of the latest evidence on market circumstances – on the appropriate contents of a Heathrow licence.
- 4.42 As explained in chapter 2, the messages sent by the Commission in terms of the future balance between competition and regulation can be expected to have immediate implications for investment incentives. It is therefore important that such statements cohere with the underlying rationale for the proposals to require the divestment of two of the three SE airports, and the consequent development of competition. Ambiguity in this respect will simply contribute to uncertainty about the regulatory approach that will be adopted in future, creating risk and cost which will ultimately be borne by consumers. The CAA's concern is that such ambiguity in the Commission's position remains. To illustrate this more clearly, it is worth considering two contrasting statements in the Commission's report:
- in its assessment of which aspects of the 'full regulatory model' should apply to Heathrow in future, the Commission implies that Heathrow is a "utility"<sup>50</sup> and states that there are "some proposals [including price monitoring] that would be most unlikely to meet the needs of consumers at Heathrow"<sup>51</sup>; and

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<sup>49</sup> Airport Regulation: Price control review – CAA price control proposals for Stansted airport, CAA, December 2008

<sup>50</sup> Paragraph 234, BAA Airports Market Investigation: Provisional Decision on Remedies, CC, December 2008.

<sup>51</sup> Paragraph 237, BAA Airports Market Investigation: Provisional Decision on Remedies, CC, December 2008.

- on the other hand, in its assessment of dynamic competition, the Commission states that “In the long term, [the Commission] consider that there is a significant prospect that competition can substitute for regulation at Gatwick and Stansted and eventually perhaps at Heathrow”<sup>52</sup>.

4.43 These statements beg the question as to the circumstances in which the Commission would envisage that competition could substitute for regulation. This is the question that the Commission either needs to answer fully and consistently or, alternatively, leave to the CAA to determine in applying any future regulatory regime which flows out of the current DfT review of economic regulation.

4.44 On a related issue, the Commission claims that it has not seen clear evidence of distortions to investment at unregulated airports.<sup>53</sup> The CAA finds this assertion surprising in view of the submissions made by Bristol and Luton airports<sup>54</sup>.

4.45 Indeed, the CAA noted that the Commission reported Bristol’s position as being that:

“[Bristol] did not see how a combination of the combination of traditional cost-based RPI-X regulation (which tried to replicate competition) would work. **Setting an artificial price distorted the market.**”<sup>55</sup> *[emphasis added]*

4.46 The CAA considers the conceptual issues relating to these distortions in Annex D of this document.

### **Recommendations relating to the regulation of Gatwick and Stansted under separate ownership**

#### *Regulatory models for Gatwick and Stansted*

4.47 The CAA’s views on this aspect of the Commission’s provisional decision on remedies is broadly covered in chapter 2. In essence, the CAA welcomes the recognition by the Commission that there is a need for a credible advance signal about the circumstances in which price control regulation would or would not apply, and that “[the Commission] strongly support the reduction and removal of regulation as competition develops”<sup>56</sup>.

4.48 The CAA would note that the Commission’s description of the current position of the DfT’s Advisory Panel is not as reported in paragraph 249. The

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<sup>52</sup> Paragraph 70, Appendix 1, BAA Airports Market Investigation: Provisional Decision on Remedies, CC, December 2008.

<sup>53</sup> Paragraph 237, BAA Airports Market Investigation: Provisional Decision on Remedies, CC, December 2008.

<sup>54</sup> Appendix 2.2, Provisional Findings Report, Competition Commission, August 2008

<sup>55</sup> Paragraph 7, Appendix 2, Provisional Findings, Competition Commission.

<sup>56</sup> Paragraph 250, BAA Airports Market Investigation: Provisional Decision on Remedies, CC, December 2008.

Panel has not recommended “the use of an SMP test to determine whether to re-impose price caps”<sup>57</sup>. As the Panel clarified at the seminar on 18 December 2008, the Panel uses the term price control to refer to a broad spectrum of price regulation ranging from intensive, cost-based price control regulation through to price surveillance, without price caps.

- 4.49 The CAA believes that the actual position of the Panel – as opposed to that reported by the Commission – is appropriate.

*Potential distortions from interaction between price-capped and unregulated airports*

- 4.50 The CAA does not agree with the Commission’s view that the regulation of designated airports has no distorting impacts upon unregulated airports. The Commission considers the CAA’s arguments on this effect in its Appendix 8. However, the Commission misrepresents the CAA’s position and, as a result, incorrectly dismisses the CAA’s argument.

- 4.51 The CAA has set out more detail in Annex D of this paper but, put simply, the CAA’s point is that price controls tend to distort investment incentives, and where they are applied to a subset of substitutable supplies the distorting effects can be expected to occur more widely, including to non-price controlled suppliers.

- 4.52 This problem does not arise in natural monopoly network utilities – such as water and energy networks – but is one that can be expected to occur in the UK airports market where there is a range of competing suppliers with varying degrees of market power.

- 4.53 In addition, and as noted in paragraph 4.44, the CAA does not agree with the Commission’s assessment that there is no evidence of distortions to investment at unregulated airports caused by price-controlled airports.

*Introducing terminal competition*

- 4.54 The CAA shares the Commission’s view that terminal competition as a means of introducing competitive disciplines into the airports sector might suffer from the relatively long list of shortcomings identified by the Commission.<sup>58</sup> Nevertheless, the CAA would welcome modernisation of the regulatory regime to ensure that the statute does not artificially constrain competition. This means there could be advantage in designing the regime with sufficient flexibility to allow more innovative solutions such as greater competition between terminals, which may – in certain circumstances – be in consumers’ best interests.

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<sup>57</sup> Paragraph 249, BAA Airports Market Investigation: Provisional Decision on Remedies, CC, December 2008.

<sup>58</sup> Paragraph 33, BAA Airports Market Investigation: Provisional Decision on Remedies, CC, December 2008.

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## **5. Recommendations in respect of Government air transport policy**

### **Introduction**

- 5.1 This chapter focuses on two issues: the Commission's proposed statements about Government planning policy; and the Commission's recommendations in respect of the Traffic Distribution Rules.

### **Government policy on airport expansion**

- 5.2 The CAA welcomes the Commission's recommendations regarding the Government's approach to aviation and planning policy. As the CAA set out in its previous submission<sup>59</sup> the planning process plays a significant and important role in controlling airport development, ensuring that non-market costs and benefits are properly accounted for. However, this planning system should aim to avoid unduly constraining the market and competition between airports for investment.
- 5.3 The CAA welcomes the Commission's comments on the risk that the current position in respect of planning policy is unclear. In this respect, the CAA would urge the Commission to add to its proposed statements on planning policy and to set out its position on whether and to what extent there is a need for the order and timing of individual projects to be specified. More generally, the Commission could also refer to the benefits to competition, and ultimately consumers, that can be expected from not unduly constraining the set of airport expansion projects that could be pursued.
- 5.4 In this respect, the CAA notes that the Secretary of State's policy commitment on making the National Policy Statement for airports location specific would allow, as it does for nuclear power stations, Government to publish a list of a number of suitable airports in a given region and let these airports compete for the investment, rather than pre-determining the specific sites.

### **Traffic distribution rules**

- 5.5 The CAA welcomes the Commission's proposal to recommend to the Secretary of State that the current Traffic Distribution Rules (TDR) are reviewed. However, there appears to be no reason to limit such a review to cargo traffic at Gatwick.
- 5.6 The Commission notes that one airline has referred to the potential distorting effects that the TDRs might have on its current plans for Gatwick. However, the issues that the airline raises have more general application and could easily apply to Heathrow. More generally, Heathrow currently serves

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<sup>59</sup> Chapter 4, 'The Civil Aviation Authority's response to the Provisional Findings and Remedies Notification', CAA, September 2008

significantly more non-passenger aircraft, with 2,887 cargo-only flights in 2007, compared to 152 at Gatwick. This highlights that there is demand, and some capacity, for cargo-only operations, even with the current slot values at Heathrow. Further, expansion of either airport, or changes in demand, could increase the proportion of slots that would be used by non-passenger aircraft in a well-functioning airport market.

- 5.7 However, the CAA notes that the TDRs appear likely to have a different impact on the operation of the market than described by the Commission in its working paper. The TDRs do not prevent the operator of Heathrow or Gatwick from accepting additional cargo-only and/or general aviation (GA) flights. Rather, in general terms, the TDRs remove any obligation on the airport operator not to discriminate between passenger aircraft and cargo-only and/or GA flights.
- 5.8 In practice, therefore, even with the current TDRs, the airport operators of Heathrow and Gatwick would have the *ability* to accept additional non-passenger services. However, under the current TDRs, the protections afforded to airlines operating, or wishing to operate, cargo-only and GA aircraft at Heathrow and Gatwick are lower than at other airports. Annex C discusses these issues in more detail.

## **Annex A. The proposal to price cap Aberdeen Airport**

### **Introduction**

- A.1 This annex provides further material in respect of the proposal to apply a price cap remedy to Aberdeen Airport.
- A.2 As set out in chapter 3, the CAA is not convinced that the Commission has established that there is an Adverse Effect on Competition (AEC); or, to the extent that there is an AEC, that the Commission has correctly identified a proportionate remedy.
- A.3 Whilst the Provisional decision presents some additional material, the Commission appears only to have carried out limited further analysis and provides only a limited consideration of the points made by the CAA and others in response to the Commission's Provisional Findings.
- A.4 Price cap regulation – particularly in the form proposed by the Commission – is perhaps the most intrusive form of economic regulation. It is for this reason that considerable care must be taken to ensure that it is only applied where the benefits of doing so are likely to exceed the costs. Indeed, the Secretary of State consulted upon and established a set of criteria to determine when airports should be designated and be subject to price cap regulation. These criteria refer both to the need to consider the efficacy of competition law – as well as other sectoral powers – and to the importance of assessing the costs associated with such regulation.
- A.5 In contrast, the Commission's case is based on a limited competition assessment and a potentially misleading set of indicators of profitability. In addition, the Commission has not considered the range of costs – both direct and indirect – that are likely to arise from the application of a price cap and, in particular, the form of price cap it proposes.
- A.6 This Annex is structured in three main sections. The first considers the analysis put forward by the Commission to support its AEC finding. The second considers the remedy proposed by the Commission and the alternatives that exist that appear to provide a more proportionate approach to the remedying of any AEC that might exist. This is followed by a short conclusion.

## The Commission's AEC finding

A.7 In general terms, the analysis published by the Commission to date fails to present a sufficiently robust explanation of the basis of its conclusions in relation to Aberdeen. Based on the material published to date, and the CAA's understanding of the Commission's reasoning, it appears to the CAA that the difference between the CAA and the Commission arises as a result of:

- the Commission adopting a different model of airport competition which results in it underestimating the nature of the competitive constraints on an airport such as Aberdeen, even when such an airport is geographically remote; and
- weaknesses in the Commission's assessment of the available evidence on profitability and investment.

These are discussed in turn below.

### *The Commission model of airport competition*

A.8 The Commission's approach to assessing competition focuses on competition between neighbouring airports. This approach, whilst appropriate for the assessment of whether the joint ownership of neighbouring airports is an AEC, is not appropriate to the assessment of the market power enjoyed by an airport. In fact, such analysis will only capture one way in which airports compete – i.e. for passengers that find neighbouring airports reasonable substitutes.

A.9 However, as the CAA has previously argued, airport markets can be thought of as two-sided markets<sup>60</sup>. As explained in a paper by Starkie-Yarrow, one practical consequence of this approach to analysing airport competition is that airports can be thought of as competing for airline business, as well as competing for passengers. Importantly, the first of these forms of competition can take place across a wider market, extending beyond an airport's geographical neighbours.

A.10 Indeed, the CAA has referred the Commission to a broad range of evidence that supports the view that airport operators typically refer to the fact that they are competing with a range of airports to attract airline business. Indeed, there is a range of evidence, from airports and airlines, that pan-European competition is an important form of competitive constraint faced by airports.<sup>61</sup>

A.11 Further, the CAA has highlighted the importance of understanding the impact of the capital intensity of airport operations – and the existence of revenues from non-aeronautical activities – on the incentives that they face. The cost

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<sup>60</sup> Indeed, the presence of significant retail operations has led them to be described as "three-sided" markets.

<sup>61</sup> See, for example, paragraph 4.16 of 'CAA comments on Competition Commission's Stansted competition working paper', CAA, August 2008

and revenue structures of airports, particularly those with available capacity, are such that they are less likely to find it profitable to sustain prices above the competitive level (i.e. they are less likely to enjoy substantial market power for a given set of competing suppliers). This is a relevant consideration for Aberdeen Airport which, the CAA understands, is not in a position of facing significant capacity constraints. As a result, the airport will tend to face stronger incentives to make best use of the existing terminal and runway assets.

A.12 It also seems to the CAA that the Commission fails to analyse a number of important features of Aberdeen Airport, including the:

- relatively low level of passengers per air transport movement;
- very significant helicopter business operating from the airport; and
- fact that current expectations are that one of the core niche markets supporting Aberdeen Airport's operations – North Sea oil and gas exploration and production – will decline over the medium and long term.

This final point impacts particularly on any forward-looking assessment of the airport's investment plans.

A.13 In its Provisional Findings report, the Commission considers the helicopter business at Aberdeen, stating that it "... has seen no evidence that other airports are a good substitute for this part of Aberdeen's business."<sup>62</sup> However, the Commission does not present any evidence at all in respect of the substitutability of this demand between alternatives. As such, on the basis of the evidence presented, it could equally be concluded that there is no evidence that other airports are not a good substitute for the helicopter business. In light of the inherent mobility and flexibility of helicopters, the CAA does not believe that the Commission can simply *assume* that a sufficient segment of this business will not switch away from the airport.

A.14 The Commission's analysis also fails to take account of the impact of general competition and sector-specific legislation on the incentives faced by the airport to abuse any position of substantial market power that it might enjoy.

*The Commission's assessment of the available evidence*

A.15 The CAA also takes a different view on the available evidence about Aberdeen's conduct in terms of its current pricing and investment. The CAA has not sought to undertake a detailed analysis of the airport's conduct, as this has not been possible in the time available. Rather the CAA has sought to demonstrate that the analysis that the Commission has sought to rely upon

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<sup>62</sup> Paragraph 4.135, Provisional Findings report.

might provide a misleading impression of the airport's pricing and investment and that other analysis exists that might support an alternative view.

- A.16 The CAA considers the evidence presented on the airport's profitability and investment below.

#### Profitability

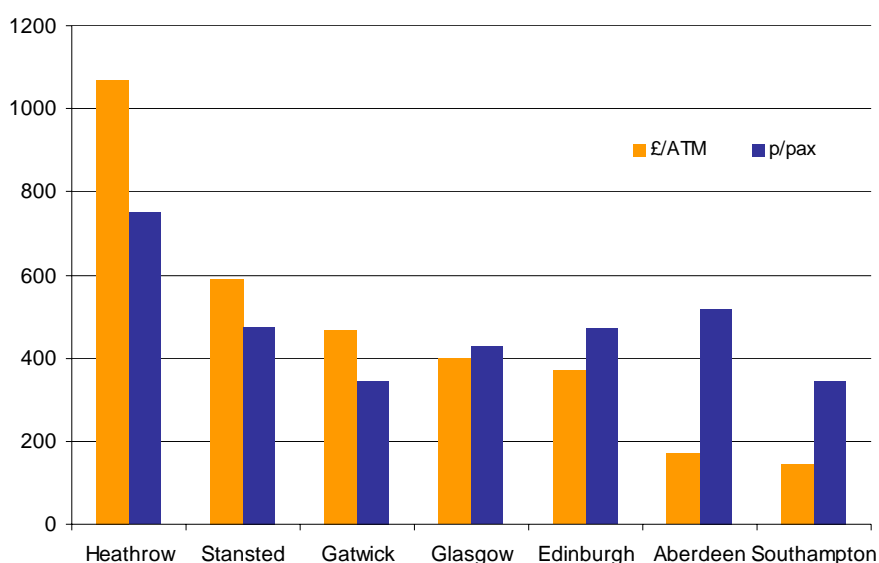
- A.17 The Commission argues that "*all* indicators point to high levels of profitability ..."<sup>63</sup> of Aberdeen, presenting a comparison of the per passenger profitability of Aberdeen to other BAA airports and citing the return on accounting costs that the airport has generated in 2007/08. This raises a number of issues.
- A.18 First, it is not correct that all indicators point to high profitability of Aberdeen Airport, as the Commission has relied upon analysis based on the earnings per passenger. As a result, the Commission's analysis of the level of charges at Aberdeen fails to take any account of the fact that Aberdeen is one of the busiest heliports in the world.
- A.19 Approximately half of all movements at Aberdeen are by helicopters, which generally have a much lower passenger carrying capacity than fixed wing aircraft. As a result, Aberdeen has relatively lower average passengers per air transport movement than other airports. For example, according to figures produced by the CRI, in 2006/07 average passenger loads at Aberdeen were around 33 which was less than at almost all other airports of any significant scale.
- A.20 This tends to increase the airport's income per passenger, the measure used by the Commission, since the landing and parking charges are spread over a smaller number of passengers. In contrast, analysis on a per Air Transport Movement (ATM) basis provides a very different picture of the airport's profitability.
- A.21 To illustrate this, the CAA has reproduced the Commission's analysis of Aberdeen's per passenger profitability, supplementing it with relative profitability assessed on a per movement basis. Figure A 1 summarises this data and shows that on a per movement basis Aberdeen has one of the lowest levels of profit across BAA's airports (being slightly above that of Southampton). The CAA is not suggesting that this analysis is sufficient to conclude that Aberdeen's profitability is appropriate<sup>64</sup> but it does serve to highlight that significantly more analysis is needed before it can reasonably be determined that Aberdeen's profitability is excessive.

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<sup>63</sup> Paragraph 2, Appendix 6, 'Provisional decision on remedies', December 2008, Competition Commission. Emphasis added.

<sup>64</sup> Indeed, this comparison will tend to under-state Aberdeen's profitability.

**Figure A 1 Operating profit of BAA's airports on a per passenger and per ATM basis, 2007/08**

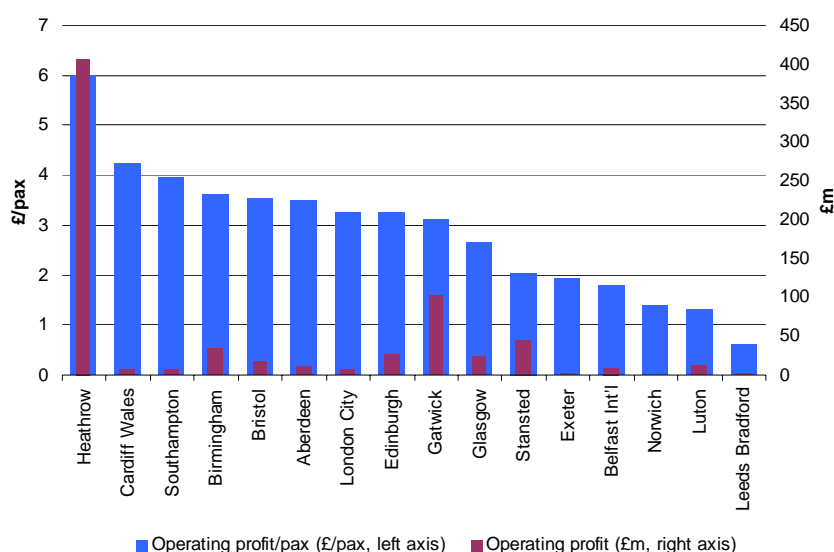


Source: CC Table 1, Appendix 6, Provisional Decision on Remedies, plus CAA airport statistics

- A.22 The Commission also appears to focus on comparisons across BAA's airports. In light of the fact that three of these are designated, and that all are at different stages of their development, it is also important to consider comparisons with non-BAA airports. In this respect, the available evidence presents a rather mixed picture, and does not support the Commission's view that all indicators point to high levels of prices and profitability.
- A.23 For example, the CAA presented a range of indicators of the relative profitability of UK airports, based on accounting data, in 2006.<sup>65</sup> Analysis of operating profit per passenger shows that Aberdeen Airport, whilst not the lowest amongst UK airports, is below that of a number of other UK airports, including Birmingham and Bristol (an airport considered by the Commission to be a competitive airport). This analysis is shown in Figure A 2 below. Of course, this analysis suffers from the weakness that it over-states Aberdeen's relative operating profit as it ignores the helicopter business and lower passengers per air transport movement at the airport.

<sup>65</sup> Supporting Paper II, 'Initial price control proposals for Heathrow, Gatwick and Stansted airports', December 2006.

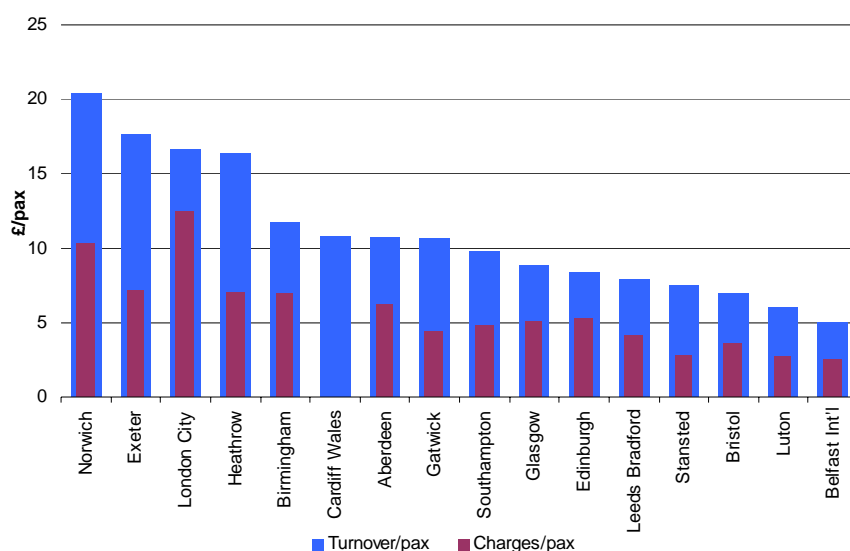
**Figure A 2 Operating profit: gross and per passenger (2004/5, selected airports) (originally published December 2006)**



Source: Airport statutory accounts and CAA airport statistics

5.9 Alternative measures could also be considered. To illustrate this, the CAA has reproduced some additional analysis that it originally published in 2006.<sup>66</sup> Figure A 3 presents a summary of the turnover and airport charges per passenger at a number of UK airports in 2004/05. Figure A 4 presents the same information for 2003/04, which shows a greater range of airports due to the greater availability of published financial accounts for this period. Both of these pieces of analysis show that Aberdeen is roughly mid-table in terms of its charges and turnover per passenger.

**Figure A 3 Turnover and airport charges per passenger, selected airports - 2004/05<sup>67</sup> (originally published December 2006)**

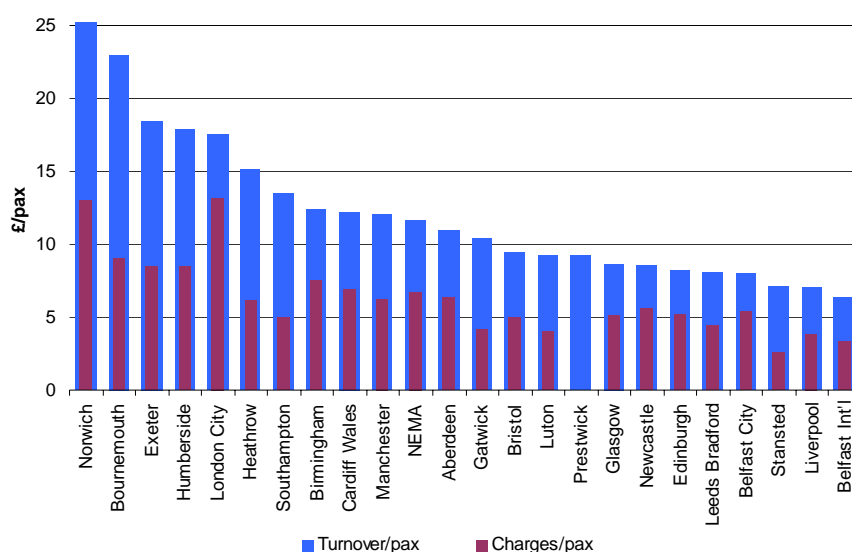


Source: Airport statutory accounts and CAA airport statistics

<sup>66</sup> Supporting Paper II, 'Initial price control proposals for Heathrow, Gatwick and Stansted airports', December 2006.

<sup>67</sup> The revenue data is collated from published accounts and may not correspond to the financial year 2004/05 in all cases. Passenger numbers are for the calendar year to 31 December 2005 and are taken from CAA data.

**Figure A 4 Turnover and airport charges per passenger, selected airports - 2003/04 (originally published December 2006)**



Source: Airport statutory accounts and CAA airport statistics

A.24 The CAA stresses that it is not arguing that the above analysis is sufficient or conclusive. Rather, it is seeking to demonstrate that the Commission's analysis is sufficient neither to make its AEC finding nor to apply a price cap to Aberdeen.

A.25 Second, the Commission's analysis of profitability – in common with much of the above analysis – also relies on accounting measures of asset values and of costs. The CAA argued at its oral hearing with the Commission on 16 October 2008, that it was important to undertake such analysis on a depreciated replacement cost basis. Such analysis has the benefit of abstracting from the potentially misleading impacts of historical depreciation policies. In addition, this analysis would be consistent with the Commission's own guidelines, which state:

“The Commission will normally consider returns on the depreciated replacement cost of assets, unless there are specific reasons why this is inappropriate. Such profits could be significantly different from profits reported in statutory accounts which are usually on a historic cost (or modified historic cost) basis.”<sup>68</sup>

#### Investment

A.26 The Commission also argues that “all indicators point to ... relatively low levels of investment”. However, the principal indicator used is one that compares EBITDA to the accounting value of assets and uses this to draw comparisons across a range of BAA's airports. As noted above, such analysis would normally include analysis based on the depreciated replacement cost of assets.

<sup>68</sup> Footnote 22, 'Market Investigation References: Competition Commission Guidelines', June 2003.

- A.27 To illustrate the potential impact of this approach, it is useful to consider the value of the “proxy” RAB adopted by the Commission and to compare this to other UK airports.
- A.28 The Commission’s analysis of statutory accounting data, results in a proxy “RAB” of between £50 million and £70 million. This compares to the aeronautical assets of Doncaster Sheffield airport, serving around one million passengers in 2007 (i.e. approximately a third of the number at Aberdeen), which are held on the accounts at a value of £100 million. The CAA is not claiming that this is definitive evidence that the Aberdeen proxy RAB is wrong, but it does suggest – to the CAA at least – that the RAB might be significantly under-valued and that there is a need for additional analysis.
- A.29 The Commission also presents analysis in Annex 1 (to Appendix 6) of the yield implied by applying a building block calculation formula to Aberdeen. This is used to calibrate the price cap remedy proposed by the Commission. However, this analysis is undertaken over a period of four years, whereas airport assets are remunerated over much longer periods. Analysis of any short-term period risks presenting an unrepresentative account of the airport’s performance, unless it is supplemented by opening and closing adjustments for the enterprise value at the start and end of the period.
- A.30 In addition, the CAA is not clear how the Commission has treated investment properties. The Commission states that the value of these assets are removed from the RAB but it is unclear whether the Commission has made corresponding adjustments to the revenue and operating cost lines.
- A.31 More generally, it seems to the CAA that there is a risk that the Commission’s analysis fails to appreciate the context of Aberdeen and its market. Indeed, the Commission use historical accounting profitability to reach a view on the failure of the airport to invest. However, the need for substantial new investment should be assessed against a forward-looking assessment of the likely future demand at the airport. To do otherwise risks implicitly assuming that an airport should always reinvest its accounting profits in capital projects, even if there is no commercial case for these projects.
- A.32 It seems to the CAA that this risk is particularly relevant for Aberdeen. The airport serves *inter alia* a niche sector (i.e. the North Sea oil and gas industry) which is expected to decline in the medium to long-term. It seems reasonable, therefore, to treat Aberdeen as a mature, capital-intensive undertaking. Such undertakings might not be expected to be committing significant amounts of capital investment, certainly when compared to historical levels (which determine current depreciation).
- A.33 The CAA also understands that the North Sea helicopter business at Aberdeen relocated there from Sumburgh Airport, in response to the level of charges at that airport. Care should be taken not to penalise the airport for this success.

A.34 Whilst the CAA makes these points primarily to highlight the apparent weakness in the Commission's conclusions on the AEC and therefore the arbitrary nature of the Commission's conclusion, the product of this analysis is equally important in determining the nature of the AEC and therefore the reasonableness of any proposed remedy. In the view of the CAA the Commission cannot properly discharge its statutory duty in relation to remedies without first testing its conclusions on the AEC against this analysis so as to assess the reasonableness and proportionality of any remedy.

### *Remedies*

A.35 Even if the Commission's conclusions on an AEC at Aberdeen are well founded, which the CAA doubts, the selection and design of an appropriate remedy is not straightforward. The Commission has not properly considered the full range of remedies open to it. Instead, it has jumped immediately to the idea that it should impose its own price cap. However, the price cap that it proposes is both incomplete and flawed in its design.

#### The price cap remedy proposed by the Commission

A.36 The Commission proposes a price cap that introduces both a one-off cut in prices and a system whereby prices will rise if capital investment is undertaken, so long as the airport meets certain consultation conditions. However, the proposal appears to be both flawed in its design; and lacking in considerable important details, which would be automatically available if the price cap were to be imposed using the existing regulatory regime.

A.37 This raises a number of issues. First, the approach would explicitly introduce a distortion to the incentives faced by the airport operator. Capital investment results in it being permitted to increase charges, introducing the familiar incentive to gold-plate, rather than deliver efficient capital investment. Put simply, the airport would have an incentive to push for any capital investment.

A.38 Under a normal price control framework the risks associated with this incentive are mitigated by a series of regulatory controls that ensure that there is no guarantee that capital investment will result in higher prices. The system proposed by the Commission does not have this control.

A.39 Rather, the remedy would involve an obligation to consult which, if not discharged appropriately, would prevent prices from rising. This element of the proposal also introduces a series of perverse incentives, encouraging incumbent airlines to frustrate consultation in order to keep prices low. It is also possible that incumbent airlines will oppose investment, even where it is efficient, in order to prevent prices from rising given the incentives that they would face.

A.40 Second, the lack of detail about the proposed remedy – such as terms, criteria for amendment, revenues captured – significantly increases the financial uncertainty and absence of flexibility faced by the airport. The

Commission has published only the briefest outline of the main points of the price control. However, it is essential both to get every detail of a price control correct and, when implementing novel price controls where neither the airport nor the regulator has previously had final responsibility for a price control, ensuring that there is sufficient flexibility in the regime to enable adjustment for unforeseen consequences.

- A.41 Further, in light of the time typically taken to implement complex behavioural remedies and the time taken to analyse and implement the case for de-designation of Manchester and Stansted, it is the CAA's view that the process of designation, reference and final decision by the CAA can be completed in a comparable period to that which might be associated with the Commission's development of, consultation on, and implementation of its proposed price control. Indeed the tried, tested and understood process is likely to be considerably easier to implement.
- A.42 Overall, therefore, the proposed price cap remedy suffers from the familiar distortions associated with RAB-based price caps – indeed, in magnified form – without the corresponding measures that seek to minimise the adverse consequences that would otherwise result.

#### Alternative remedies

- A.43 The CAA also considers that there are a range of alternative remedies that represent a more proportionate and more effective way to remedy any AEC that might exist.
- A.44 First, the Commission could use its powers of recommendation to enable appropriate use of the existing legislative framework. Indeed, this would be consistent with principles of proportionality and better regulation since it would avoid duplicating what already exists. This could include:
- recommending to the Secretary of State that he review the designation status of Aberdeen Airport, using the existing powers granted to him by Parliament, avoiding the need to create a separate regulatory process for the airport; or
  - providing the detail of the Commission's supporting analysis to the CAA and to the OFT, so that they could then consider whether the airport's conduct warrants further investigation under either of their respective powers (i.e. section 41 of the Airports Act and the Competition Act).
- A.45 In respect of the first, if the Commission considers that a price cap is necessary, then the appropriate course of action is to recommend to the Secretary of State that he should designate Aberdeen airport for economic regulation pursuant to section 40 Airports Act 1986. Designation would result in Aberdeen airport becoming price controlled on the same basis as other price controlled airports in Great Britain.

- A.46 Price control through designation would provide a much higher degree of certainty in relation to Aberdeen, reflecting that the designation criteria have been consulted upon and the processes have been applied in practice. In addition; the process for variation, review and termination of the price control are clearly understood; and the operation of the price control would then fall under the relevant sectoral legislation, avoiding unnecessary duplication of arrangements. These arrangements also provide for oversight by both the CAA and Commission, facilitating the implementation and update of appropriate performance level targets.
- A.47 It is not the CAA's position that the current regulatory regime for designated airports is perfect. The CAA has several times stated publicly its views about the shortcomings of the current regulatory regime. It is, however, the CAA's view that there are likely to be significant benefits from ensuring that all price capped airports are subject to the same price control regime. In particular, the CAA considers that even the current regime is significantly more appropriate than the imposition of an ad hoc price control, prepared on a different basis, on Aberdeen.
- A.48 Second, an alternative available to the Commission would be to consider alternative behavioural remedies, including:
- obliging Aberdeen Airport to act in a 'fair, reasonable and non-discriminatory manner', perhaps supplemented by an obligation to report on its compliance with this requirement to the CAA and/or OFT; or
  - obliging Aberdeen Airport to prepare and publish depreciated replacement cost accounts for the current and future years, and for a reasonable historical period to allow comparisons, so that the EC, OFT, CAA and affected third parties are better placed to assess the airport's conduct and consider taking enforcement action<sup>69</sup>.
- A.49 The second of these options appears to more directly address the issues raised by the Commission. It seems that the primary issue raised by the Commission in relation to Aberdeen is one of under investment and lack of transparency. Yet the Commission has not given consideration as to whether an increase in transparency would be sufficient to remedy the issues that it has identified.
- A.50 The CAA considers that an obligation on Aberdeen to prepare and publish accounts on a replacement cost basis would result in considerable information coming into the public domain and being available to airlines. This alone would be sufficient to bring pressure on the airport to pursue appropriate investment policies; but it would also facilitate and enable airlines critical of the airport's future investment policy to bring the issue to the CAA and other regulators. The CAA considers that such a remedy would quickly

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<sup>69</sup> Or, in the case of affected third parties, seek injunctive relief and/or damages through the courts.

generate advantages to consumers and customers, be proportionate and reasonable in the light of the strength of the AEC and impose a low regulatory burden on a relatively small business.

### *Summary – alternative remedies*

- A.51 Whilst the CAA does not agree with the Commission's findings on an AEC at Aberdeen, and so does not believe that there is a need for any remedy, it also considers that the above four alternative remedies – or variants upon them – which have not been considered by the Commission would be more reasonable and proportionate remedies, should the Commission persist with the AEC finding, than the remedy alighted on by the Commission.
- A.52 As a minimum, the Commission should recognise the limitations and likely distortions caused by the proposed remedy and seek to limit the adverse consequences by applying a sunset clause, perhaps linked to the implementation of legislative reform by Government.
- A.53 Should the Commission, notwithstanding the CAA's evidence, reach a firm conclusion that there is an AEC, the CAA urges the Commission to consider all of these possible alternative remedies, so as to ensure that any eventual remedy is proportionate both to the magnitude of any AEC and the balance of the evidence available on its existence.

### **Conclusion**

- A.54 The CAA has not sought to present a detailed assessment of Aberdeen's conduct and market position. However, it considers that the evidence and analysis presented in this Annex questions both the Commission's AEC finding and whether it has presented sufficient analysis to justify a price cap remedy.
- A.55 Furthermore, the CAA considers that the nature of the Commission's proposed price cap is such that it can be expected to have a range of unintended consequences. These consequences will, inevitably, reduce the benefits of this remedy and go to the appraisal of the overall costs and benefits of the remedies and to its proportionality.
- A.56 Finally, if after undertaking additional analysis the Commission remains of the view that an AEC arises, it should consider the alternatives that exist to a price cap remedy, including recommendations in respect of designation, reporting requirements or placing reliance on existing sectoral or general competition legislation.

## **Annex B. The links between capacity scarcity, competition and market power – a note prepared by George Yarrow, adviser to the CAA**

### *Introduction*

1. This note contains my general views on the implicit economic reasoning underpinning the CC's provision decision on remedies, particularly in so far as it applies to issues of inter-airport competition and, more specifically, of the influence of capacity constraints on such competition. It does not seek to repeat detailed points made in Starkie/Yarrow and Marshall/Robinson papers written in the context of the Stansted pricing review<sup>70</sup>, nor does it attempt to deepen the analysis in ways that would be appropriate for gaining a better and fuller understanding of inter-airport competition.
2. It should be clear from those earlier papers that, to understate matters a little, I have serious reservations about the CC panel's economic analysis; and it serves no purpose to paper over these differences, for example by pretending that they are to do with differences in philosophies or cultures. They are real differences of view about the appropriate analysis of a complex set of policy issues, and as to what constitutes economic reasoning that might reasonably be characterised as convincing and/or substantiated (see footnote 4 below, for example) – which is the standard that all public bodies are required to aim for and to achieve.

### *General overview*

3. In very general terms, my view is that the CC panel simultaneously underestimates the advantages of greater inter-airport competition, particularly in the short- to medium-term, and over-estimates the capacity of regulation (even within a reformed regime that would address some of the weaknesses of the current legislative framework) to achieve the kinds of developments in the airports sector that the panel seems to think are desirable. More specifically:
  - The CC panel's analysis significantly understates the likely benefits of the central feature of its own remedies proposals, namely the divestiture of Gatwick, Stansted, and one of Edinburgh and Glasgow, airports.
  - By over-stating what can realistically and effectively be achieved by more intrusive regulation, the CC panel includes within its package of remedies a

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<sup>70</sup> In that context, the CC referred to the authors collectively as the CAA's advisors, but it should be noted that this description is inaccurate and misleading in relation to David Starkie, Eileen Marshall and Colin Robinson.

number of measures that are not only disproportionate but also likely to be counter-productive (i.e. a classic 'unintended consequences' outcome, arising from a lack of realism when assessing the likely consequences produced by complex processes). Examples of such disproportionate measures are the suggested remedies relating to the future regulation of Aberdeen airport.

4. Both competitive market processes and regulatory processes can be expected to be imperfect, and often highly imperfect, but, generally speaking, economic history indicates that adaptation and adjustment to current imperfections tends to be handled in a much more flexible and timely way by market processes than by regulatory processes. The CC panel's economic analysis, being mainly static in nature, does not really capture this difference between competition and regulation in (dynamically) responding to existing market inefficiencies (although the CC panel's analysis is not entirely consistent in its views on statics and dynamics, and there are one or two points in the provisional decision where the significance of a more dynamic perspective is recognised – see further below).

### ***Capacity constraints***

5. The most obvious, and possibly the most important, example of divergence of views between the CC panel on the one hand and myself, my colleagues (Starkie, Marshall, Robinson) and the CAA on the other concerns the analysis of the implications of the existence of capacity constraints for competition. There is no difference of view as to the existence of *some* capacity constraints at *some* locations in the UK airports sector, particularly at Heathrow, although I think that it is also probably fair to say that the panel sees the constraints as being 'harder' than I do (Heathrow has continued to accommodate rising passenger numbers with two runways, and there are few signs of significant slot rents at other airports). Similarly, there appears to be no major difference of view as to the importance of taking account of the implications of such constraints when considering future investment programmes.
6. In my view, (a) inter-airport competition provides a means of *addressing the capacity/investment issues more effectively than has been done in the past*, and (b) experiences of combining attempted liberalisation with continued, intrusive regulation warrants a healthy scepticism toward any beliefs that such regulation will assist, rather than hinder, the relevant process. This view draws not only on the CAA's own considerable experience in airports regulation, but also on the track record of various combinations of competition and intrusive regulation that have occurred from time to time and place to place in other sectors such as energy and telecoms. The combination has, for example, proved toxic in the energy sector in the USA, and it is arguably

holding back investment in next generation access infrastructure in telecoms in some jurisdictions.

7. Seeking both to increase competition and, at the same time, intensifying outcome-oriented regulation may look like a 'belt and braces', super-safe approach to policy making, but in practice it generally turns out to be the opposite, largely because the regulation so frequently undermines the incentives of the competitive process.
8. As already stated, there are one or two points in the CC's provisional decision on remedies where the positive dynamics of competitive processes are fully recognised. For example, at paragraph 46 it is stated that:

*"Decisions regarding the form and amount of significant additional capacity come into effect in the 'long term'. However, the decisions themselves may take place in the 'short term' and would be influenced by the pressures of rivalry following divestiture. Thus the benefits of dynamic competition on the form and amount of capacity expansion are likely to begin to accrue in the 'short term' as decisions begin to reflect competitive pressures."*

9. I fully concur with that statement, and would simply add that it is very far from being the whole story, since, to make just two of the many points that could be made at this point:
  - Another, highly significant part of the benefit of competition, which can also be expected to accrue in the short- to medium term, is the effort and innovation directed at making best use of *scarce* capacity.
  - As just explained, over-intrusive regulation can 'crowd out' market adaptations and generally hinder the dynamic adjustment processes so clearly described in paragraph 46.<sup>71</sup>
10. For the most part, however, the provisional decision document appears to rest upon an alternative, more static, narrower, and less realistic 'theory of competition' - one that might perhaps be summarised in the proposition that *existing capacity constraints place severe limits on the benefits that can be expected from competition in the short- to medium term (and, as a corollary, that there is a "need" for continuing regulation)*. Thus, at paragraph 44 it is stated that:

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<sup>71</sup> It can also be noted that paragraph 46 appears also to be inconsistent with the CC panel's view, expressed elsewhere, that price regulation can not be expected to distort investment at airports other than the airport to which it is applied. Given, however, that no party disputes the potential distorting effects of price regulation on investment at the airport that is price regulated, it is difficult to see how the distortions can be locationally contained in a market environment where investment decisions at airports "...would be influenced by the pressures of rivalry following divestiture".

*“We therefore expect Heathrow and Stansted to compete under separate ownership. At first, we anticipate that they will be confined to competing for passengers with one another within the confines of economic regulation and existing runway constraints and that the impact of this competition may be marginal (my emphasis<sup>72</sup>). However, as capacity increases and regulation is relaxed we expect competition between Heathrow and Stansted to become more intense.”*

11. Earlier, at paragraph 40, the perceived linkage between capacity constraints and regulation is made explicit in a slightly different way:

*“In our Remedies Notice we considered that existing capacity constraints in BAA’s London airports might restrict the extent of competition in the short term following divestiture and that this implied regulation in some form might need to continue at Gatwick and Stansted until more capacity became available.”*

12. In my view, the CC’s ‘theory of competition’, which appears to place particular emphasis on capacity constraints as a very major determinant of the degree of competition among airports, is not only wrong in principle (competition as a process does not depend upon the existence of excess capacity to be effective – it would be pretty useless if it did) but also can be expected to be positively harmful if it is used to guide airports policy. The theory<sup>73</sup> carries a general implication that the balance between regulation and competition almost necessarily tilts toward the former when a resource (specifically airport capacity of one sort or another) becomes scarce, and hence that *investors can expect that there will be a significant risk of the imposition of price controls on an airport in those periods when capacity is scarce and when they (investors) would therefore naturally be expecting to see the largest contributions being made toward the remuneration of their (sunk) invested capital.*

13. That the adverse consequences for investment decisions of this type of expectation are more than just a theoretical issue can be seen, for example, by examining the recent history of attempted liberalisation in the US electricity

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<sup>72</sup> The word ‘marginal’ in this context appears to be being used in an ordinary language sense – roughly ‘of little significance’ – rather than in a technical economics sense of ‘competition at the margin’ (which can, of course, be intense).

<sup>73</sup> There is a ‘theory’ of sorts lying behind the arguments – there always is – although the fact that it is unarticulated and unexamined makes it difficult to pin down with any precision. Thus, one may envisage an implicit economic model that *assumes* homogeneous outputs, divisible capital, absence of inter-temporal demand effects, etc. which is capable (subject to further assumptions about parameter values) of exhibiting significant capacity constraint effects on the only mode of competition encompassed by the theory (short-run price competition). The problem is that such a model is, metaphorically speaking, a million miles away from commercial realities in the airports sector – none of the three assumptions is satisfied in airports, for example, or even remotely close to being satisfied.

sector. As Professor Paul Joskow points out in a very recent paper<sup>74</sup> (which on this point serves simply to repeat received wisdom among economists), the tendency of US regulators to impose administrative price caps on energy prices and on ancillary services when the demand/capacity balance becomes tight – caps that are rationalised in terms of a need to constrain market power *but which are nevertheless below the prices that would clear the market when capacity is fully utilised*<sup>75</sup> – is one of the major factors that have served to discourage the construction of new capacity in the electricity sector (with consequences that are becoming increasingly severe over time).

14. As it does in relation to the wider, dynamic aspects of competition, the CC panel's provisional decision on remedies recognises at least some of the relevant issues. Thus, for example, explicit attention is given to the problem of distorted investment incentives in the discussion starting at paragraph 244. The difficulties, however, are indicated by paragraph 249:

*“We accept the point made by the CAA that once competition has been established there may be periods of relative capacity shortage and rising prices when it would not be appropriate to re-impose price caps and also note that if airports expect price caps to be re-introduced whenever capacity starts to tighten they are unlikely to have adequate incentive to invest. Nonetheless, we support the use of an SMP test to determine whether to re-impose price caps which, if properly applied (sic) on a forward looking basis as envisaged by the Independent Panel, should not give rise to the problems raised by the CAA.”*

15. The final sentence says, in effect, that, if we *assume* there is a solution to the problem (a “properly applied” SMP test), then we can proceed as if the problem has been solved. The real question, however, is: what does a “properly applied” economic assessment of market power look like in the relevant circumstances, and there lies disagreement. In my view, the CC panel has grossly overstated the importance of capacity constraints as a determinant of the likely effectiveness of competitive processes in the airports sector. On this view, if this error (of economic analysis) is mapped into future assessments of market power, the regulatory approach promoted by the CC panel will give rise to the problems described in the discussion starting at paragraph 244, most particularly a bias toward underinvestment, to the detriment of consumers' interests in the longer term.

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<sup>74</sup> “Capacity payments in imperfect electricity markets: need and design”, *Utilities Policy*, 16, 2008.

<sup>75</sup> The below-cost nature of the regulated prices signals the existence of political influences on price determination. In the airports sector, there is a long track record of pricing below market clearing levels, which investors in airport capacity could hardly fail to notice.

16. Further, this is not a matter of dispute that can safely be left to be settled ‘on another day’ (i.e. when the application of SMP tests come to be made, whether properly or improperly). Investors looking at what the CC panel has said about the relationship between capacity constraints and competition – for example, the indication that, in the short- to medium term, capacity constraints will likely mean that competition between Heathrow and a divested Stansted would be “marginal” – could reasonably take the view that, if they invested in new capacity today and if, in some future period the demand/capacity balance became tight, re-application of the CC reasoning could easily lead to a conclusion that inter-airport competition had become “marginal”, that SMP had re-emerged, and that the airport should be regulated at below (short-run) market clearing levels. On that basis, the UK airports sector would likely not look like a good place to invest; and, as correctly indicated in paragraph 46, the effects would start to occur immediately, not at some ill defined future time.
17. Such a reading of the CC position is also strengthened by remarks concerning potential linkage of regulated prices to long run incremental costs. Thus, at paragraph 237 it is stated that:

*“In the context of Heathrow, linking prices to long-run incremental costs could significantly increase airport charges and hence, given some pass through to fares, would be to the detriment of consumers.”*

and, slightly later at paragraph 239, following a re-assertion of the point that capacity constraints in the South East of England imply a “need” for continuing regulation, footnote 38 explains by saying:

*“Because at a site-constrained airport, such as Heathrow, long run incremental cost based on the cost of new developments could be considerably above existing costs including a reasonable return on assets after depreciation.”*

18. Taken together, these statements imply a policy stance that is perfectly happy to contemplate the price capping of prices at below LRICs, and *a fortiori* at less than market clearing levels in capacity constrained situations when such clearing levels exceed LRICs, on the basis of an argument that raising prices would be to the detriment of consumers. This is, of course, a very short-termist view of the consumer interest – which ignores the potential for long-term damage to future air passengers resulting from consequential effects on investment – and it is precisely the manifestly harmful policy stance that is described by Joskow in the context of US electricity regulation.

19. Given such statements in the CC's provisional decision on remedies, I do not believe that a *Panglossian* approach to the future conduct of regulatory policy is warranted ("it will be all right on the night", or "trust future regulators to make the right competition assessments, notwithstanding the obvious differences of view on such assessments among policy makers today"), or that it will carry much credibility in capital markets; even when those markets have recovered from their currently fragile states. My own advice to the CC would therefore be, even at this late stage:

- explicitly to recognise that *there are important dimensions of competition that are not significantly hindered by the existing of capacity constraints*, and indeed that in some cases the existence of such constraints even encourages and strengthens a relevant mode of competing (e.g. competition to discover how best to improve capacity utilisation efficiency); and
- building upon the insights at paragraph 26, but not restricting rivalrous conduct to major investment decisions alone, explicitly to recognise that, even in the short- to medium term, the competition between Heathrow and divested Gatwick and Stansted airports could be expected to be much more than "marginal" in its intensity, significance and effectiveness.

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## **Annex C. The CAA's response to the working paper on Traffic Distribution Rules**

- C.1 In December 2008 the Competition Commission published a working paper on the London Air Traffic Distribution Rules (TDRs). This reviews the background and history of the TDRs, describes the complaint made by BA World Cargo and discusses whether the existing TDRs or the provision in the Airports Act 1986 for the Secretary of State to make TDRs amount to an AEC.
- C.2 So far as the background and history of the TDRs are concerned in paragraph 2 of the working paper the Commission describes the arrangements that were put in place through the Traffic Distribution Rules 1986<sup>76</sup> for Airports Serving the London Area following a review by the CAA and its advice to the Secretary of State under section 31 of the Airports Act. While the Commission accurately describes the import of the 1986 rules applying to international scheduled services, domestic scheduled services and charter flights it suggests that those rules introduced a ban on new all-cargo, business and general aviation flights at Heathrow and Gatwick. This is not the case. The effect of the relevant rule was that in periods of peak congestion at Heathrow and Gatwick, as defined by the CAA, such flights could operate but before doing so would need the express approval of the airport operator. This rule survived the subsequent review by the CAA that led to the Government's decision to withdraw the other TDRs in 1991. The same rule remains in place today at Heathrow and Gatwick as set out in Appendix 2 of the Commission's working paper.
- C.3 The nature of the rule affecting all-cargo (and business and general aviation) flights needs to be properly understood as it effectively allows the airport operator to make a commercial judgment whether in periods of heaviest demand for access to runway slots those slots should be used by passenger flights (which will as a by-product also carry belly-hold cargo) or flights that carry no passengers. Absent such a rule, it could be argued that both types of service have an equal claim to access to the airport and under slot allocation rules once a runway slot has been allocated to an aircraft operator it currently has a right to use that slot in perpetuity.
- C.4 Under the TDRs an airport can therefore have a major influence on the use of runway slots in peak periods by non-passenger flights:
- through its power to approve the operation of non-passenger flights during such periods; and
  - through the recommendations it makes to the CAA (along with ACL, the company that conducts the administrative allocation of slots at congested airports) as to the duration of the peak periods.

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<sup>76</sup> Rather than 1978, as cited by the Commission.

- C.5 In this way, even if the existing TDRs were to remain in place a new owner of Gatwick that wanted to compete more vigorously for cargo operators could, for example, give approval to new cargo operators to operate in peak periods, subject to their obtaining the necessary runway slots and/or could recommend to the CAA shorter periods of peak congestion or indeed no such periods.
- C.6 The CAA will generally accept the recommendations made to it for both Heathrow and Gatwick subject to ensuring that peak periods do not extend for any longer than is necessary. It does this by declining to agree to an hour being declared as peak where, in the busiest week of the relevant winter or summer season, there are more than two unallocated slots. The CAA does not therefore recognise the observation made by the Commission in paragraph 8 of its working paper that it has designated periods as “peak” when Gatwick is “much less congested”.
- C.7 Nevertheless, the CAA supports the recommendation made by the Commission that there should be a review of the current TDRs. They have been in place since 1991 and as the Commission discusses there have been several developments over recent years that bring into question the continuing need for such administrative rules. In the CAA’s opinion such a review, which at the request of the Secretary of State would be conducted by the CAA in consultation with airports and airlines, should bring within its scope the current rules at both Gatwick and Heathrow as they affect all-cargo and general and business aviation flights.

## **Annex D. The distorting effect of RAB-based regulation of designated airports on non-designated airports**

D.1 This Annex considers the arguments presented by the Commission in Appendix 8 ('Potential distortions from the interaction between price-capped and unregulated airports') of the provisional decision on remedies.

### **The CAA's views**

D.2 The CAA's general point is a simple one: price controls tend to distort investment incentives, and where they are applied to an airport which competes with other airports, the distortion can be expected to extend to those other airports.

D.3 Clearly the extent to which the distortions spread will depend on, among other things, the degree of substitutability. The contamination can be limited for a product from which it is very difficult to substitute away.

D.4 From there on, the precise nature of distortions will depend upon the particulars of the relevant context, including the specifics of the regulatory regime: each regulatory regime has its own drawbacks. A common theme, however, is that when prices are capped by reference to a Regulated Asset Base (RAB) (or other forms of rate of return regulation), regulated firms can have incentives to use investment decisions in part to influence allowed prices upwards. In these circumstances, the investment decisions made by a regulated firm are likely to be affected by the effect that investing would have on its ability to raise prices in future. By contrast, this effect is absent for an unregulated firm.

D.5 The overall impact of this effect depends upon a range of factors, including: the relationship between the allowed rate of return and the firm's actual cost of capital; the nature of other regulatory incentive measures; and the credibility attached to the RAB by the airport operator and those providing finance. Sometimes this can lead to over-investment, most familiarly when the allowed rate of return is higher than the actual cost of capital and the airport operator attaches a high level of credibility to the remuneration of investment. However, regulation can also lead to under-investment, particularly when regulatory credibility is low and/or the allowed rate of return is below the actual cost to the company of raising additional finance.. Overall, the methods employed by UK regulators (including the widespread adoption of the RAB or RAV) have typically been viewed as tending to encourage over-investment rather than under-investment, including in the airports market<sup>77</sup>.

D.6 Over-investment can manifest itself in a number of different ways, including premature construction of new capacity. It is also important to recognise that any bias towards over-investment can be expected to have dampening

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<sup>77</sup> See, for example, "Investment Incentives and airport regulation", David Starkie, May 2006.

effects on, investment at competing airports, by crowding it out. In such circumstances, more efficient projects at unregulated airports will tend to be displaced by less efficient projects at regulated airports. This is the prospective outcome that is most relevant in the UK context and that, given its sector wide duties, the CAA necessarily has had to consider in its own deliberations.

- D.7 The potential for these distortions to affect outcomes was particularly relevant in relation to the issue of investment at Stansted airport as compared with investment at other, substitutable airports.

### **Assessing the Commission's points**

- D.8 It is clearly the case that the distorting effect already exists – it was one of the motivations for the CAA's recommendations in relation to de-designation of Stansted airport and, subsequently, its proposals in relation to the form of the price cap. The CAA understands the difference between the Commission and the CAA is that the Commission believes that inter-airport substitutability (for example the impact of Stansted on Luton) is significantly lower than does the CAA. There is no disagreement in principle that, if substitutability is low, the magnitude of any distortion will also be low. The issue is one of interpreting evidence on substitution.

- D.9 There is also a tension in the Commission's position that does not exist in the CAA's position. If, in relation to new investment, inter-airport substitutability is so low that there is no evidence of a 'distortion' from price-capped to non-regulated airports then, almost definitionally, there can be no competition in new investment. But this is contrary to what the Commission says in the main body of its provisional remedies report at paragraph 46:

"Decisions regarding the form and amount of significant additional capacity come into effect in the 'long term'. However, the decisions themselves may take place in the 'short term' and would be influenced by the pressures of rivalry following divestiture. Thus the benefits of dynamic competition on the form and amount of capacity expansion are likely to begin to accrue in the 'short term' as decisions begin to reflect competitive pressures."

- D.10 The CAA continues to find it difficult to see how the two positions can be reconciled, unless the Commission is restricting its comments to the strength of available evidence – i.e. that the evidence is not sufficient to identify and/or measure a distortion – rather than an observation of what economic theory indicates about the likely effects of price-caps. However, the CAA believes there is evidence of distortion: two airport operators refer to the impact of price-capped airports on their operations, as set out in paragraph 4.44.

- D.11 To reaffirm its views, the CAA considers that paragraph 46 is the accurate reflection of the commercial realities.

## The Commissions assessment of the CAA's position

### *The Commission's summary of the CAA's position*

D.12 In paragraph 5 of Appendix 8, the Commission presents a confusing account of the CAA's argument on the relationship between slot values, price regulation and distortions to investment before presenting its rebuttal, despite the CAA having clarified its position in response to a Commission 'put-back' in which the CAA stated that:

"[The CC's draft paragraph] appears to confuse two factors. Expansion will increase supply and so will tend to reduce total airline slot rents – this could prompt incumbent airlines to oppose efficient expansion projects. However, slot rents will tend to be higher at price-regulated airports than at non-regulated airports, as the price cap will tend to prevent the regulated airport from capturing all of the "rent" generated by the incremental investment. This has two effects. It can lead to under-investment by the regulated airport operator and can lead to new entrant airlines preferring expansion at a regulated airport even if there is a more efficient project at a non-regulated airport."

D.13 Despite these observations, the Commission retained its incomplete summary of the CAA's position and its resulting misleading chain of argumentation. It is, therefore, not surprising that the Commission dismissed the CAA's argument.

### *The Commission's rebuttal*

D.14 In light of the above, there is limited value in considering the Commission's rebuttal. However, the CAA makes the following observations regarding the Commission's construction of the argument in the first part of paragraph 5:

- It appears that paragraph 5 sets out an argument drawing upon some form of underlying economic model or theory, which is unarticulated and non-transparent, and therefore difficult to assess.
- The efficient allocation of slots in the short term- which is where the paragraph starts - is a rather different issue from long run investment incentives<sup>78</sup>, and it is unclear what is meant by the statement that "*it is the combination of RAB-based prices and slot prices that provides the (sic) signal to the market*"; which raises the question: what is being signalled and to whom.
- Even if slot trading were highly efficient, it is expectations about the level of the RAB-based price cap that matters in relation to incentives for new investment in airports, as the 'slot rents' go to the airlines. Slots might (in the hypothetical circumstances) be efficiently allocated against

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<sup>78</sup> The risks of mixing up static and dynamic issues has separately been identified in George Yarrow's paper in Annex B.

given capacity in the short-term, but capacity development (the relevant issue) could be expected to be distorted as a result of price control.

- D.15 In the second part of paragraph 5, the CC makes three arguments in response to the CAA's position concerning airline preferences for the location of investment. In general terms, it seems to the CAA that the Commission's reasoning misses the point. It is true that *other things equal* capacity expansion at a capacity-constrained airport can be expected to reduce the *value of each slot*. Depending in large part upon the relevant demand elasticity (a matter of evidence), it might also be the case that the *total value of slots* accruing to airlines operating at the airport falls; although, even if that is the case, the increase in the number of slots will mitigate the effect on total value.
- D.16 The CAA's point was different, however, as the CC's *other things equal* assumption does not apply. The issue is: how does price control affect choices when the locational decision is 'either/or' (i.e. where there is at least some degree of mutual exclusivity between the projects – as, for example, when the construction of a new runway at time T at airport A displaces construction of a new runway at the same time by airport B).
- D.17 In these circumstances, it cannot be assumed – as the Commission implicitly does – that other things are equal. Indeed, as the CAA highlighted to the Commission, there will be a range of effects arising from capacity expansion. First, capacity expansion will tend to reduce the value of existing slots at both the investing airport and at substitutable airports. The precise impact of this on the incentives held by airport operators and airlines will be affected by whether a price cap applies at the airport. In simple terms, at a price controlled airport the reduction in slot values will principally have an adverse effect on airline rents, whereas at an unregulated airport it will principally have an adverse effect on airport rents (setting aside the impact of long-term contracts).
- D.18 Second, capacity expansion provides the investing airport operator with slots that can be supplied to airlines. Again, the position at price-controlled and unregulated airports differs. At the former, the airport operator can charge up to the lower of the price cap and the airlines' willingness to pay for this incremental capacity, whereas an unregulated airport operator can charge up to the airlines' willingness to pay. As the CAA has argued in the context of Stansted, the application of the RAB-based, building-block, price cap methodology can distort investment decisions by allowing the price controlled airport to raise prices to incumbent airlines to pay for investment (as the price cap remains below the airlines' willingness to pay). Unregulated airports, by contrast, typically see downward pressure on prices when they expand capacity, rather than an increase in their ability to raise prices.
- D.19 Whilst it is difficult to generalise, two observations seem reasonable:

- the incentives faced by airport operators to invest are affected by the application of price caps and are different at price-capped and unregulated airports; and
- the incentives faced by airlines – both incumbent and new entrant – to support airport expansion are affected by the application of price caps and are different at price-capped and unregulated airports.

D.20 Overall, therefore, where there is a degree of substitutability between price-capped and unregulated airports, the application of those price caps can be expected to affect the incentives faced by the airport operators and by their airline users. This is because – while the multiple effects of price control regulation on different commercial operators might operate in different directions (e.g. in some circumstances tending to promote under-investment and in others over-investment) – it is almost inconceivable that these effects will net off such that the overall impact of price control regulation on outcomes is immaterial.