



# **Reforming the framework for the economic regulation of UK airports**

## **The Civil Aviation Authority's response to the Department for Transport's consultation**

**May 2009**

*(page left intentionally blank)*

# Contents

Summary.....	iii
1. Introduction .....	1
2. Statutory duties and related proposals.....	3
3. New regulatory powers .....	27
4. Ensuring accountability .....	37
5. Passenger representation .....	45
Annex A. Detailed responses to the consultation questions.....	49

*(page left intentionally blank)*

## Summary

1. The CAA welcomes the opportunity to contribute to the Government's review of the economic regulation of UK airports. The review provides a timely opportunity to reflect upon how the UK airports market has changed in the twenty years since the current regulatory framework was established and to ensure that regulation serves passengers and other airport customers well for the next twenty years.
2. This can best be achieved by seizing the once in a generation opportunity provided by the Competition Commission's (CC) decision to break up BAA, through supporting the development of greater airport competition in the South East and Scotland, and building on the gains that competition has brought to passengers across the regional airports market. As opportunities for fundamental regulatory reform rightly arise infrequently, the new regulatory regime will need to be robust to the changes that might be expected over the coming decades and be able to cope with a broad range of circumstances.
3. The CAA strongly supports the Government's proposal to put the interests of passengers at the heart of economic regulation, whilst recognising that regulation will work best for passengers when it takes proper account of the views of airlines, airports, and other stakeholders, as well as of passengers. The clear, unambiguous focus of economic regulation on the protection of passengers has been recommended by a range of parties, including the CAA, the CC, the Transport Select Committee and a number of industry stakeholders, and would bring the CAA's regulation into line with the primary objective of economic regulation in other sectors. In this context, the CAA also supports the Government's proposals to enhance and strengthen passenger representation, and to bring together the two complementary functions of complaints handling and consumer advocacy into a single statutory body.
4. The CAA also welcomes the proposals to introduce a licence-based framework, which will be key to ensuring that regulation can be appropriately tailored to the different, and changing, circumstances facing the UK's airports in an increasingly competitive environment.
5. Overall, therefore, there is much to welcome in the Government's proposals and they would go a long way to delivering a regulatory framework that has the potential to maximise the benefits to passengers. However, there are areas where the proposals could be modified to ensure that the regulatory framework is robust to the challenges facing the UK airports market, namely:
  - to ensure that regulation helps to secure the potential benefits that increased competition can bring, following the expected break-up of BAA;

- to provide a stable platform for timely and efficient investment in service quality and capacity over the long term; and
  - to ensure that passengers do not pay for airport operators' decisions to adopt risky financial structures.
6. The CAA supports the Government's policy that UK aviation should meet its full environmental costs and that the UK meets the environmental challenges of emissions, noise and local air quality. The CAA notes the Government's view that Government is likely to be better placed to address environmental externalities. The CAA considers that environmental externalities are likely to be best addressed through broadly-based market, fiscal or administrative mechanisms that are not confined to airports with substantial market power, nor even to the UK airports sector. Within this approach the CAA could, however, take clearly defined roles where it has particular expertise, as will be the case for its envisaged role in relation to ensuring compliance with environmental limits at an expanded Heathrow. It is, however, vital to ensure that the right environmental policies and tools are deployed, using economy-wide, market-based measures or targeted local measures where appropriate. It is also important that a clear distinction is drawn between environmental regulation and the economic regulation of airport market power.

#### **Seize the opportunity presented by the break-up of BAA**

7. The implementation of the CC's remedies requiring BAA to sell Gatwick, Stansted and one of Edinburgh or Glasgow airports represents a fundamental change in the UK airports market, with the potential to bring significant benefits to passengers and to provide sharper incentives to airports to innovate and to invest in improved service quality and capacity. The CAA shares the CC's view that *"the sale of these airports will ... kick-start a process of competitive rivalry from a standing start where today there is no competition at all [between BAA's airports]"* and that *"the benefits will build over time, driven by the momentum of the development of competition, and will be significant, as has proved to be the case at other airports in the UK where there is already competition."*<sup>1</sup>
8. The impact of the changes in the South East is likely to be substantial. There will be a move from one company servicing around 90 per cent of traffic and controlling virtually all of the current opportunities for major investment in capacity to at least four independent airport operators around London, competing for passengers, airline business and expansion opportunities, both with each other and with other airports serving the South East. Evidence from the UK regional airports market shows the scale of potential benefits to consumers that competition can bring, through extra choice and improved service quality.

---

<sup>1</sup> CC News Release on BAA Market Inquiry, 19 March 2009, available at [http://www.competition-commission.org.uk/press\\_rel/2009/mar/pdf/11-09.pdf](http://www.competition-commission.org.uk/press_rel/2009/mar/pdf/11-09.pdf).

9. It is important that this transition is supported by proportionate economic regulation, allowing competition to replace detailed economic regulation, whilst also ensuring that economic regulation protects passengers' interests where competition alone does not provide adequate protection. An unduly restrictive regime, unable to adapt flexibly to changing circumstances, could undermine the realisation of some of the benefits of the expected development of competition.
10. The Airports Act 1986 currently provides the CAA with some ability to adapt economic regulation, and allows Government to extend or withdraw the obligation on the CAA to apply a price cap to individual airports. It also provides a broad power to the CC to identify issues that act against the public interest, albeit only at the time of the periodic price control reviews. However, the current regulatory framework was not designed to support a transition towards a more competitive market and, in particular, affords the CAA with less flexibility than typically allowed other regulators to support the development of competition and to ensure that consumers enjoy its benefits.
11. A reformed framework of economic regulation should support the transition to a more dynamic, competitive market in a number of ways.
12. First, the regulatory framework should better cater for the increasing diversity within the UK airports market and the likely pace of change. The Government's proposals for flexible licensing, with detailed economic regulation restricted only to those airports with very high degrees of market power, should help to meet this objective.
13. Second, the regulator should be able to reflect changes to the degree of competition faced by each airport over time and deploy a range of tools so as to ensure that regulation remains proportionate. As such, the CAA supports the proposals to extend the CAA's competition powers to cover airports, which will allow it to choose between the application of detailed sector-specific regulation – such as price controls – and the use of general competition legislation, reflecting the likely reduction in the market power enjoyed by some airports. By the same token, the CAA should have the flexibility to apply the full range of remedies to those airports falling within the Tier 1 licence category.
14. Third, as recognised by the CC's report into BAA, there is a need to ensure that the break-up of BAA is supported – as appropriate – by a removal of price controls (at least at Gatwick and Stansted) as competition develops. The framework of economic regulation needs to provide confidence that this regulatory withdrawal will, if warranted, take place. Failure to do so risks stifling the development of competition and discouraging airports and airlines from entering into more normal commercial arrangements, relying instead on regulation. With this in mind, the CAA welcomes the Government's support for the principles of Better Regulation, the use of measures to ensure that regulation remains proportionate – such as sunset clauses in licence conditions – and the proposals to give the CAA the power to determine which

airports should be subject to detailed economic regulation. These reforms are consistent with the CAA's own plans, announced in March 2009, to develop its approach to assessing airport competition and to identifying regulatory approaches that support the development of competition.

15. Finally, the CAA's and Government's interventions in the UK airports market will need explicitly to recognise the potential for greater competition and the gains that can accrue to passengers from interventions that support this. The CAA will, therefore, ensure that its regulatory decisions take full account of their impact upon competition. It will also be important that Government decision-making provides explicit support for competition, notably in respect of the freedom afforded to competitive airport operators to bring forward expansion plans. The development of a National Policy Statement for airport planning decisions provides an opportunity to give this support for competition as the best way to secure the investment that passengers need.
16. In summary, since competition between airports can reasonably be expected to be the central means by which consumers are protected from market abuse in future, it is important that the Government does not include anything in its proposals that would prejudice its effective development

#### **Provide a stable platform for timely and efficient investment**

17. As well as ensuring that the statutory framework affords the CAA sufficient flexibility to tailor the intensity of regulation to match the risk of abuse of market power, it is also important that there is enduring clarity – or stability – associated with the regime to minimise regulatory risk and uncertainty for airport operators and their investors.
18. The Government has rightly identified the need to improve the experience of passengers and recognises the link with encouraging appropriate levels of investment in service quality and additional capacity. In common with other capital-intensive businesses, airport investment often involves significant upfront costs with benefits that accrue over the longer term. This puts a considerable premium on removing unnecessary uncertainty and on providing a clear and stable regulatory framework that supports investment and attracts private finance at a price reflecting the risks intrinsic to airport development rather than more general regulatory risk. The fact that much of the UK airport market is competitive – and the South East segment of this market prospectively so – serves to emphasise the importance of providing a clear and stable framework. If competing airport operators are to take a greater role in defining how their airports operate and invest, they will need as much certainty as possible about the long-term future regulatory framework.
19. This has a number of implications for the Government's reforms, three of which are discussed below.

*Clarifying the Government's role in relation to airport investment*

20. Clearly defined roles and responsibilities are a necessary part of any effective regulatory regime. In general, this can best be achieved by giving the regulatory authority a clear focus to apply economic regulation that addresses the risk of abuse of market power, with an unambiguous focus on the protection of consumers' interests.
21. In this context, it will be important to ensure that the role of the Secretary of State in giving guidance to the CAA is circumscribed by reference to pre-defined areas of policy where it is necessary for some political discretion to be retained.
22. Government policy also clearly plays an important role in guiding the planning process, ensuring that non-market costs and benefits are properly accounted for and that airport operators have a degree of certainty about the Government support for individual development projects. Current Government policy is set out in the 2003 Air Transport White Paper, and as updated in subsequent statements. Following reforms to the planning process, the Government will establish a National Policy Statement (NPS) for airports in the near future. The purpose of the NPS is to guide the Infrastructure Planning Committee's decisions on planning applications for nationally significant infrastructure.
23. In principle, it is possible for the planning process and Government policy to support airport competition by providing useful information as to which projects are likely to attract planning consent, supported by the introduction of an independent decision-making body for major planning decisions. For example, Government – through the NPS – could identify the likely national and regional need for additional airport capacity and identify a range of sites where expansion would and would not be likely to deliver overall benefits to society. Such an approach would establish a clear policy framework within which airport operators could compete to invest, and thereby maximise the potential for gains to be realised from the break-up of BAA. In addition, it would build upon the CAA's current approach to regulating investment at the designated airports, which seeks to encourage economic, efficient and timely investment to meet anticipated consumer demand at all UK airports.
24. An alternative approach would be for Government to take an active role in determining investment outcomes. This approach would limit the discretion afforded to competing airport owners to bring forward their own investment plans. Furthermore, to the extent that the projects identified by Government were not commercially viable, it would be necessary to identify a source of funding in order to attract the necessary private finance. However, this alternative approach would risk undermining the benefits that can flow from airport competition, and could reduce the incentives faced by airport owners to innovate and bring forward investment plans that best meet the needs of passengers and airlines.

25. For this reason, the CAA favours an approach in which the Government uses the NPS as the means by which to guide the Infrastructure Planning Commission, and not as a tool with which to alter the central function of economic regulation, namely, the protection of consumers from the risk of abuse of market power.
26. The introduction of an NPS provides the Government with an opportunity to clarify the roles and responsibilities of the various participants in the airports sector and how these roles interact when proposed airport investments are brought forward. The CAA would therefore encourage the Government to develop a regulatory framework that makes clear the degree to which airport investment decisions flow from the commercial decisions of private investors, supplemented by regulation seeking to replicate the commercial pressure of a well-functioning airport market.

#### *A more stable licence regime*

27. The CAA welcomes the Government's proposal to introduce a tiered licence system that ensures that only airports holding very substantial market power will be subject to economic regulation and guards against the risk of building up unnecessary regulatory burdens for other airports subject to effective competition. However, the proposed system could benefit from further simplification. The CAA suggests that it would be better to have two licence tiers: a Tier 1 licence for airports enjoying a high degree of market power; and a Tier 2 licence for all other airports subject to relevant EC regulations. This second tier would reflect the current EC Airport Charges Directive but could also extend to cover other EC regulations, such as the regulation on passengers with reduced mobility. The Secretary of State could also be granted a power to modify Tier 2 as necessary to reflect future EC directives or regulations. This approach might result in additional airports falling within 'Tier 2' compared with the DfT's proposal, but would remove the need for Tier 3 and provide UK airports with a single set of legal obligations relating to economic regulation.

#### *Designing an appropriate appeals mechanism*

28. Regulatory decisions need to be both well understood and reliable. The Government's proposal for a clear, primary duty to passengers supports this aim, as do the proposals for a secondary duty relating to the principles of Better Regulation. A well-designed appeals process can also contribute to the stability of the regulatory framework, by exposing regulatory decisions to additional scrutiny, and reducing regulatory risk. Against this background, the CAA supports the proposals to allow affected parties – airports, airlines and consumer groups – to appeal the CAA's decisions to remove or extend its powers to subject an airport to detailed economic oversight (i.e. to move an airport into or out of the top licence tier).
29. The CAA also considers that while the current system – whereby price controls are automatically referred to the CC – provides considerable scrutiny

of the CAA's proposals, aiding overall accountability, there are limited rights of appeal provided to affected parties to challenge the CAA's price cap decisions or the public interest findings made by the CC. More generally, the current split of responsibilities for airport regulation between the CAA and the CC reduces the overall flexibility and accountability of the regime, whilst also resulting in a convoluted and time-consuming price control process.

30. The CAA therefore supports reform of the current system of appeals, but considers that these reforms need to avoid replacing the current system with one that has the practical effect of subjecting the CAA's regulatory decisions to a near-automatic reassessment by the CC. Such encouragement of appeals by stakeholders that serve their own commercial interests – including merely to delay the development of competition, stifle efficient investment and postpone regulatory reform – would be unlikely to serve the interests of passengers. As such, the CAA encourages the Government to bring forward a balanced and proportionate system of appeals and recommends that the Government avoid combining a broad right of appeal to all affected stakeholders with a form of appeal that involves a reassessment of the CAA's original decision from first principles. Such approaches would in effect reproduce the shortcomings of the current system.

### **Protecting passengers from the financing structures adopted by airports**

31. The CAA shares the Government's objective to ensure that there is an appropriate allocation of risks between passengers and airport owners and that where airport owners choose to adopt risky financial structures the consequences of doing so are not borne by passengers. In general, competition between airports should provide sufficient protection to consumers that airports do not divert resources from the provision of appropriate service and investment to serve unduly risky financial structures.
32. The CAA's current regulatory approach has sought to insulate passengers and airlines from any additional costs or risks arising from financial structures by focusing on the regulation of outcomes – rather than by trying to control financial inputs – and by ensuring that the airports face appropriate incentives to improve service quality and undertake investment. As a result, airport owners face the costs associated with the financial structure that they to adopt recently, demonstrated by the injection of additional equity into BAA's business since the CAA set price caps for Heathrow and Gatwick in 2008.
33. The Government's consultation document proposes a range of measures that would change the way that financial risks are regulated: namely, introducing special administration arrangements, placing a duty on the CAA to ensure that licensed airports are able to finance their activities and recommending that all Tier 1 airports are subject to a number of licence conditions that directly control their financial structure. This package of measures has been applied by a number of other regulators to natural monopoly network businesses.

34. The fact that airports are neither natural monopolies nor network businesses highlights the need to avoid “importing” this approach from other sectors without very careful analysis, including of why these measures are not applied by all economic regulators or in all parts of each regulated sector.
35. There is also a real risk that the application of the proposed package of “utility-style” measures could have the perverse effect of reducing the ability of the CAA to protect passengers from the consequences of the current and prospective financial structures adopted by airport owners. In particular, it is unclear how the price controlled airports – and Heathrow in particular – could make the transition from their current financial structures to a structure that would fulfil the requirements of the financial resilience provisions proposed by Government without passengers and airlines ultimately paying to repair the airports’ balance sheets. This would undermine the extent to which the CAA has sought to insulate passengers and airlines from these costs and set an unhelpful precedent about the extent to which airport owners should face the consequences of their own financing decisions.
36. The CAA agrees with the Government’s objective that a major airport should not close by virtue of its financial structure. However, the cash-generative nature of airport businesses – which results from their very high degree of capital intensity – means that the airport owners, creditors and any administrator would not choose voluntarily to close the airport. Such a course of action would sacrifice millions of pounds on a daily basis and would, therefore, not be a rational, or indeed credible, course of action. The experience of Eurotunnel, over a number of years, demonstrates how financial restructuring can be expected to take place alongside continuous operation.
37. The CAA therefore recommends that the Government build upon the current approach to regulating financial structures. Such a focus on incremental improvement would avoid the risks associated with designing a new approach and avoid the potential for the airport owners to use reform as an opportunity to pass risks that they currently face onto passengers and airlines. Some of this incremental improvement would flow directly from the introduction of a flexible licence-based framework that would enable the CAA, where appropriate, to ensure through incentives that airports deliver appropriate service quality to passengers and airlines.

# 1. Introduction

## Purpose

- 1.1 The CAA welcomes the opportunity to respond to the Government's consultation on its proposals for reforming the framework of economic regulation of UK airports.
- 1.2 The CAA supports the need for reform of the current regulatory regime, which has remained largely unchanged since its inception in 1986. The Competition Commission's (CC) recent confirmation that it will proceed with the break-up of BAA into a number of competing airports provides a clear focus for these reforms, so as to ensure that the potential benefits from increased competition flow through to passengers.

## Background

- 1.3 This response should be read in conjunction with other written evidence that the CAA has provided to Government and the Competition Commission's market investigation into BAA, in particular:
  - the CAA's submission to the CC on economic regulation of UK airports (February 2008);
  - the CAA's response to the CC's Emerging Thinking (May 2008);
  - the CAA's response to Government's call for evidence (July 2008);
  - the CAA's response to the CC's provisional Findings and Remedies Notification (September 2008);
  - the CAA's response to Government's request for views (October 2008); and
  - the CAA's response to the CC's Provisional Decision on Remedies (January 2009).

## Structure of the document

- 1.4 The CAA's response is in two main parts. The main document discusses the key issues raised by the consultation document. The responses to the specific questions raised in the consultation document are included in a separate Annex.
- 1.5 The main document follows broadly the same structure as the consultation document:
  - Chapter 2 discusses the statutory duties and any related proposals:
    - primary duty towards consumers;

- proposals aimed at improving financial resilience of airports;
  - proposed duty to follow Secretary of State guidance and to assist in the delivery of investment consistent with the National Policy Statement (NPS);
  - duty towards the environment and environmental reporting; and
  - provisions for the CAA to comply with relevant better regulation principles and legislation.
- Chapter 3 discusses the range of new regulatory powers:
    - the tiered licensing regime;
    - concurrent competition powers; and
    - compliance and enforcement powers.
  - Chapter 4 discusses mechanisms to ensure accountability of the regulator:
    - appeals mechanism; and
    - use of sunset clauses.
  - Chapter 5 discusses proposals regarding enhancing the role of the passenger representation body.

1.6 This document is supported by an Annex that contains detailed answers to the questions set out in the consultation document. In addition, the CAA has published two supporting papers that serve to clarify elements of the evidence base relevant to the Government's proposed reforms:

- Supporting Paper I provides detail about the CAA's processes guiding Constructive Engagement during the recent Q5 price control reviews; and
- Supporting Paper II discusses the CC's findings on economic regulation of airports that were part of the CC's final report on the market investigation of BAA<sup>2</sup>.

---

<sup>2</sup> CC, BAA airports market investigation – A report on the supply of airport services by BAA in the UK, March 2009, available at [http://www.competition-commission.org.uk/rep\\_pub/reports/2009/545baa.htm](http://www.competition-commission.org.uk/rep_pub/reports/2009/545baa.htm).

## 2. Statutory duties and related proposals

- 2.1 This chapter considers the main proposals for reforming the CAA's statutory duties.
- 2.2 It is structured in five main sections. The first considers the proposals for a primary duty to protect passengers. The second section considers issues relating to the regulation of airport financial structures, including the proposed financing duty and related proposals for special administration processes for some airports and for a package of licence conditions designed to control the financial structure of 'Tier 1' airports. The third section considers the duties relating to the airports National Planning Statement (NPS). The fourth section considers the proposed duty relating to the environment. The final section discusses the proposed approach to ensuring better regulation.

### Primary duty towards passengers

- 2.3 The CAA welcomes the Government's proposals to place passengers (and other end users or consumers, such as cargo shippers) at the heart of the framework for the economic regulation of airports, including the Secretary of State's endorsement of the importance of consumers' interests in his speech to Passenger Focus in April 2009<sup>3</sup>.
- 2.4 The Government's proposals reflect a strong and growing consensus between a range of parties – including the CAA, the CC, the Transport Select Committee and a number of industry stakeholders – that the purpose of economic regulation should be to protect the interests of consumers.
- 2.5 For the CAA to carry out its regulatory functions effectively and efficiently, it is important to have an unambiguous remit with clear duties and a clear hierarchy. The House of Lords Select Committee on regulators recommended in its report on UK economic regulators in 2007 that regulators' remits should ideally consist of a limited set of clear duties, and that the statute should give a clear steer on how these duties should be prioritised.<sup>4</sup>
- 2.6 The CAA, therefore, strongly supports the Government's proposals to give the CAA a single primary duty towards consumers, supplemented by a limited number of additional 'secondary' duties, within a tiered set of duties.
- 2.7 The CAA also welcomes the Government's proposal to reflect in the primary duty the principle that competition is the best mechanism through which to secure that consumers' interests are met, and that regulation should therefore aim to promote competition where possible. This would bring this important statement of the purpose of the economic regulation of airports into

<sup>3</sup> Secretary of State keynote speech – Passenger Focus Conference 22 April 2009:

<http://www.dft.gov.uk/press/speechesstatements/speeches/passengerfocusconf22april09>.

<sup>4</sup> House of Lords Select Committee on Regulators, Report on UK Economic Regulators, November 2007, paragraph 1.1, <http://www.publications.parliament.uk/pa/ld200607/ldselect/ldrgltrs/189/189i.pdf>.

line with the formulation used in the other major sectors subject to independent economic regulation.

- 2.8 However, it is important to distinguish clearly between the objective of economic regulation and how the CAA regulates to meet this objective. Recognising that the service received by consumers results from the actions of a range of other parties – notably of airlines – it will continue to be important to recognise that regulation will work best for passengers when it takes proper account of the views of airlines, airports and other stakeholders, supplemented by appropriate research into consumers' interests.
- 2.9 The consultation document proposes a number of other measures that should strengthen the focus of economic regulation on the protection of consumers, notably the proposals to place the passenger representation body onto a statutory footing. These are discussed in Chapter 5.

### **Financial resilience provisions**

- 2.10 The CAA shares the Government's objective to ensure that there is an appropriate allocation of risks between passengers, airlines, airport owners and investors and that where airport owners choose to adopt risky financial structures the consequences of doing so are not borne by passengers and airlines.<sup>5</sup>
- 2.11 In practice, this means putting in place a regulatory approach which aims to ensure that airport operators do not, simply by virtue of the financial structures that they have chosen to adopt, fail to provide continuity of supply, permit service quality to deteriorate or under-invest. In this way, economic regulation can replicate the disciplines that a well-functioning, competitive market brings to bear on airports, by insulating passengers from financial distress and/or failure of an airport owner.
- 2.12 The consultation document proposes to achieve this objective through a package of measures:
- placing a secondary duty on the CAA to “ensure that licence holders are able to finance the activities which are subject to the relevant licence obligations” (the proposed “financing duty”);
  - including within the Tier 1 licence a number of obligations to control the financial structure of the Tier 1 airports, such as an obligation to maintain an investment grade credit rating and provisions to place a financial ring-fence around the regulated assets; and

---

<sup>5</sup> In practice, the consequences of any financial distress or failure could affect airlines and/or passengers. The incidence of the cost will depend upon a range of factors, including the degree to which any increase in costs to airlines are passed on to passengers through increases to airfares.

- introducing a special administration regime for some airports, designed to reduce the likelihood that an airport would interrupt its operations by virtue of the financial structure it chose to adopt.
- 2.13 This package of measures would represent a significant departure from the current approach to regulating the financial structure of designated airports. Indeed, it would “import” the type of regulation applied by some UK regulators to natural monopoly network businesses. However, not all regulators deploy this package of measures<sup>6</sup> and regulators have not all chosen to deploy these measures across all parts of the sectors they regulate.<sup>7</sup>
- 2.14 In addition, it is clear that airports are neither natural monopolies nor network businesses. In contrast to energy and water networks, there is no physical interdependence between individual airports. Furthermore, following the break-up of BAA, any links that currently exist due to common ownership of several London airports will be severed, further reducing the parallels that could be drawn between the regulated airports and network utilities.
- 2.15 There can, therefore, be no presumption that what serves as “best practice” for the regulation of energy or water networks would represent an appropriate model for the regulation of airports. Rather, it is important to assess carefully the costs and benefits of the proposed approach – and any alternatives – to regulating the financial structure of airports, in order to understand better which is most likely to achieve the Government’s and CAA’s shared objective of safeguarding passengers’ interests.
- 2.16 This assessment of the relative costs and benefits of different approaches needs to consider how financial distress can lead to harm to passengers. This harm can arise in a number of different ways:
- the likelihood that an airport will be in financial distress or experience financial failure and the impact that each of these is likely to have on passengers and airlines (i.e. the expected cost of actual distress and/or failures);
  - the effect of the approach to financial regulation on the costs faced by passengers and airlines over time (i.e. the expected cost of regulation with or without any actual distress and/or failures); and
  - the transitional and ongoing costs associated with moving from the current approach to regulating financial structures to any alternative approach.

---

<sup>6</sup> For example, Ofcom is not subject to a financing duty and the telecommunications sector is not subject to special administration provisions.

<sup>7</sup> For example, electricity generation is not subject to financial ring-fencing provisions.

- 2.17 In general, the overall cost to passengers and airlines can be lowered by reduction in:
- the likelihood of financial distress or failure;
  - the consequences of financial distress or failure; and
  - the impact that the regulatory approach has on the costs faced by passengers and airlines over time,

whilst also considering the relevant costs associated with transiting from the current approach.

- 2.18 This helps to illustrate one of the key differences between the Government's proposed approach and that currently applied by the CAA. The CAA's approach focuses on minimising the extent to which any financial distress or financial failure results in an increased cost to passengers or airlines, or to a reduction in service quality or investment. In doing so, this exposes airport owners to the consequences of their own financial structure and thereby sharpens their incentives to avoid financial distress. The success of this approach depends upon the extent to which the regulator can effectively insulate passengers and airlines from adverse consequences by maintaining appropriate incentives to maintain service quality and investment outcomes. In other words, the CAA's current approach involves regulating the outputs (price, service and investment in capacity) rather than the inputs (financial structure).

- 2.19 In contrast, the Government's proposed approach seeks to control the financial structure adopted by the airport operator and in this way reduce the likelihood that the airport operator will experience financial distress or failure. However, an unintended consequence of this approach is a blurring of the responsibility for the airport's financial structure between the regulator and the airport owner. This could have the potential adverse consequence of reducing the extent to which the airport's owners believe that they will face the costs of any financial distress and/or failure that does result, dulling their incentives to avoid inappropriate financial structures. The success of this approach also depends upon the extent to which the regulator can effectively control the financial structure of the airport so as to prevent incidents of financial distress and failure.

- 2.20 The following sections consider the costs and benefits associated with each of these approaches in more detail. However, it is useful first to consider how likely it is that an airport such as Heathrow would cease operating by virtue of a period of financial distress and the costs that might result from it doing so, as this affects the choice between the two approaches that are identified.

- 2.21 In respect of the first, it is important to distinguish the accounting profitability of a business from its cash generation. Accounting profitability is based on

the accruals concept and, as such, includes non-cash items - such as depreciation and, depending upon the definition of profits used, may include interest payable and taxation – which in the case of an airport such as Heathrow are very substantial<sup>8</sup>. However, in the short run, accounting profitability is not a good measure of whether an airport will continue to operate. Rather, in order to consider the likelihood that Heathrow would continue to operate, it is necessary to consider the ability of the business to generate sufficient cash in current and future periods to cover the cash costs of continuing to operate over the same period (i.e. ignoring the current level of interest and depreciation).

- 2.22 In the case of Heathrow, using 2008 accounting information, the underlying business generates approximately £3 million per day in revenues, substantially greater than the cash costs associated with running the airport on a day-to-day basis. This provides important information about the likelihood that the owners and creditors of Heathrow (or an appointed administrator) would choose to close the airport, even for a short period. In particular, it suggests that such a course of action would only be profitable if (with costs unchanged) revenues fell by approximately 30 per cent<sup>9</sup> – from, say, a similar reduction in passenger numbers – or if the day-to-day costs of operating the airport increased by approximately 50 per cent. Indeed, the experience of Eurotunnel illustrates that the owners and creditors of a heavily indebted, capital-intensive business will maintain service continuity despite significant financial distress, even if this prompts a very substantial refinancing of the business.
- 2.23 It has also been argued that, given the significance of Heathrow to the UK economy, the owners and creditors might threaten closure as a means of extracting support for the airport from either the Government or the regulator. However, given that it is simply not credible that the owners or creditors would ever choose to close the airport, it is unclear to the CAA how any such bargaining position could be sustained with any degree of credibility. In short, it is a bluff that the Government and regulator can readily call.
- 2.24 An alternative strategy would be for the airport operator to use investment plans as a tool to secure a more generous treatment of the existing business. However, if there is a significant risk that an airport operator would choose to pursue such an “investment strike” strategy in an attempt to pressure the regulator or Government, then the updated regulatory framework should provide the regulator with appropriate sanctions and sufficient flexibility to address this risk directly. For example, the regulator could be provided with sufficient powers to ensure that if the incumbent airport operator chooses not

---

<sup>8</sup> For example, in 2008, Heathrow Airport Ltd recorded earnings before interest, tax, depreciation and amortisation (EBITDA) of £521 million, which was approximately 33 per cent of the airport's turnover. Other cost lines included depreciation of £346 million and interest costs of £548 million, which led to an overall pre-tax loss of £373 million.

<sup>9</sup> In practice, a fall in passenger numbers would also reduce operating costs, suggesting that the airport would have to experience an even greater fall in passenger numbers for it to choose to stop operating.

to undertake profitable investment, the regulator can invite alternative, competing operators to tender for commercial opportunities.

- 2.25 Overall, therefore, it is reasonable to conclude that the economics of airports generally – and Heathrow in particular<sup>10</sup> – are such that the owners and creditors (or appointed administrators) would choose to keep the airport open, as to do otherwise would sacrifice operating profits and reduce the value of their claims against the business. It follows that the probability that the airport would cease to operate for financial reasons is, in our opinion, very low.
- 2.26 Turning to the consequences of any service interruption at Heathrow, the CAA agrees with the Government that the costs of a long period of service discontinuity would be very significant, particularly for the individuals and businesses affected. However, as well as the likelihood of such an extended interruption appearing to be very low, once BAA divests Gatwick and Stansted the risk that problems at Heathrow will also spread to affect the operation of these airports will reduce.
- 2.27 Finally, when designing the approach to regulating finance for airports it should be noted that there are significant differences between the magnitude of the adverse effects that arise from a service interruption at an airport compared to that likely to be experienced for an energy or water network. Even a short-term interruption to national energy and water supply would be likely to have very adverse and widespread consequences for both the economy and for public safety. Short-term interruptions to service at airports occur from time to time, typically due to extreme weather events, and whilst the consequences are severe for those affected, the consequences for general public safety and the wider economy are significantly less than that expected for an interruption to energy or water supplies. It is also important to avoid conflating the overall economic importance of key – especially hub – airports to the UK economy with the costs associated with short-term disruptions to supply, the consequences of which will be very much less severe.
- 2.28 One implication of this is that the Government should avoid ‘importing’ measures from energy and water network regulation without careful analysis of the costs and benefits. The lower expected cost of any service interruption might suggest that a different approach is warranted. The CAA would advise the Government to establish some clear principles for whether measures such as special administration should be applied. These principles would aid clarity and reduce regulatory risk in the airports sector and would help to establish a consistent approach to regulating for finance across the regulated sectors.

---

<sup>10</sup> In light of the strong aeronautical and commercial revenues at the airport.

*Building on the CAA's current approach to regulating financial structures*

- 2.29 As noted above, the CAA's current approach is to focus on regulating outcomes, rather than the financial inputs applied by an airport operator to provide these outcomes. In practice this means that the CAA seeks to minimise the extent to which any financial distress or financial failure results in an increase in costs faced by passengers or airlines, or a reduction in service quality or investment.
- 2.30 Such an approach relies upon a range of measures to protect passengers and airlines. First, the price control includes a service quality scheme that provides the airport operator with specific financial incentives to maintain service quality standards. Second, the price control includes a range of incentives linked to the provision of certain capital projects, ensuring that any unjustified reduction in investment results in an automatic reduction in the airport's ability to recover revenue from airport users. This is supplemented by a third measure – a commitment to an *ex post* review of investment performance – that provides a clear signal to the airport operator that any gains achieved through an unjustified reduction in investment will be clawed back by the regulator. This package of measures is designed to insulate airport users from the consequences of any financial distress, by sharpening the incentives faced by the airport operator, reducing the likelihood that it would be in the airport operator's, creditors' or an administrator's interests to fail to continue to deliver service quality and to invest.
- 2.31 A fourth element of the current approach is the commitment given by the CAA not to adjust the price control to take account of the actual financial structure adopted by the airport operator. Instead, the CAA identifies a 'notional' financial structure and sets the price cap in a way that allows this 'notional' business to finance its activities (so long as the business operates efficiently). The CAA has made clear that if the airport operator departs from this notional financial structure then it will bear the additional risks associated with doing so and that any consequences will not be borne by passengers and airlines. In practice, this means that the current price cap – and future price cap settlements – will not be adjusted to pass the consequences of financial distress or financial failure to airport users.
- 2.32 In this respect, the CAA notes that there is some evidence to suggest that its approach has sufficient credibility to insulate airport users from the financial position into which BAA has entered. In particular, the CAA notes that in order to secure the transition from its 'acquisition' financing to the 'permanent' financing, the owners of BAA injected additional equity into the business.
- 2.33 One of the benefits of the current approach is that it maintains a clear line of accountability from the airport owners' financing decisions to the costs arising from these decisions. In particular, the CAA has not sanctioned – explicitly or implicitly – the financial structure adopted by the airport. As a result, the CAA

and the Government benefit from a significant degree of credibility that they will not pass the costs of financial distress or failure to airport users.

- 2.34 The success of this strategy also depends upon the ability to ensure that the airport has significant incentives to maintain the level of service quality and investment at appropriate levels. In this respect, the CAA considers that the introduction of a licence-based framework would improve the clarity and credibility of these measures and also provide the CAA with the ability to sharpen the incentives on the airport operator, where appropriate by broadening and/or deepening their scope. These reforms would also enable the CAA to place more general obligations on the airport operator to operate the airport in an efficient and economic manner which – if backed up by the proposed sanctions regime and powers to fine the airport operator for licence breaches – would provide the CAA with a powerful general tool to ensure that any gaps in the package of price control incentives do not result in costs and risks passing through to airport users.
- 2.35 A further reform that would act to reduce the risks faced by airport users would be to ensure that, in the event of financial distress, any prospective administrators of the airport were appropriately informed about the underlying profitability and cash generation of the airports business, the protections introduced by the regulatory regime and the impact that these incentives and licence obligations have on the profitability and cash generation of any course of action that reduced the level of service provided to airport users. This objective could be met by including provisions to allow the regulator to share information with prospective administrators, backed by appropriate information gathering powers.
- 2.36 Overall, this updated approach to regulating the financial structure of price-controlled airports would act to reduce the likelihood that any financial distress or failure would result in costs being passed from the airport's owners to airport users. Furthermore, establishing this clear line of accountability for the consequences of the airport's financial structure, this provides the airport's owners and prospective investors with a clear incentive to avoid periods of financial distress and/or failure, thereby reducing the likelihood that they occur.
- 2.37 Finally, as this approach represents an incremental improvement to the current regulatory approach – which was established prior to the acquisition of BAA by its current owners – the costs of any transition to this updated approach would appear to be very low. In particular, the incremental nature of the reforms would reduce the risk that during any transition costs or risks would be inadvertently be moved from the airport owners to airport users.

*The Government's proposed reforms to the approach to regulating financial structures*

- 2.38 The Government's proposals take a different approach to regulating financial structures, by focusing on the financial 'inputs' used by the airport owner,

through controlling the financial structure it adopts. This approach attempts directly to reduce the likelihood that the airport operator will experience financial distress or failure, and thereby reduce the expected costs to consumers and customers.

- 2.39 The Government proposes a package of measures to regulate the financial structure of Tier 1 airports: special administration provisions; a financing duty on the CAA; and a series of licence conditions aimed at improving the financial resilience of Tier 1 airports. This package of measures would affect the regulation of financial structures in a number of different ways.
- 2.40 First, the proposal to apply special administration to (at least one) price-controlled airport is designed to mitigate the risk that an airport owner, creditors or administrator would choose to cease operations. However, as noted above, the underlying financial structure of an airport such as Heathrow means that the introduction of this measure does not, in practice, have a significant impact on the probability that an airport would experience service interruption, as the underlying cash-generative nature of the major airports would, in any event, secure this outcome.
- 2.41 However, special administration comes at a cost to airport users, in two main forms. It reduces the rights enjoyed by airport owners and creditors, replacing the creditors' ability to trigger administration with one that is controlled by Government. Inevitably, this exposes airport owners and creditors to additional risk, the cost of which they must either bear or which must be borne by airport users. As special administration is designed to deliver benefits to airport users, it would appear logical for them to bear the increase in the efficient costs of airport operation that result.<sup>11</sup>
- 2.42 The introduction of special administration changes the seniority of creditors and customers, which is likely to increase the risk faced by creditors including the providers of debt. This increased risk could result in either an increase in the cost of debt or a reduction in gearing; both of which is likely to increase the cost of capital and therefore prices, albeit in future price reviews. Whilst, in principle, the Government could seek to ensure that only an appropriate increase in cost is passed on to airport users, BAA's owners and creditors would have strong incentives to seek to reduce the costs that they face.<sup>12</sup> In short, introducing special administration could have the perverse impact that airport users are exposed to higher costs – reflecting the higher cost of financing efficient airport operations – and are also exposed to transitional costs by meeting some of the costs arising from the financial structure that BAA's owners chose to adopt.

---

<sup>11</sup> Consistent with the CAA's current policy, airport users should only face the efficient costs that would be incurred by an airport operator that adopted the notional financial structure against which the price controls were set.

<sup>12</sup> The likelihood that the airport's owners and creditors are successful is increased by the inherent difficulty in reaching an objective measure of the appropriate compensation for the owners and creditors of BAA's price controlled airports. As a result, there is a risk that any attempt to pass the costs of introducing special administration to airport users could result in airport users facing an increase in cost that exceeds the value of any reduction in their risk exposure.

- 2.43 Second, the Government proposes introducing a statutory duty “to ensure that licence holders are able to finance the activities which are subject to the relevant licence obligations”. The consultation document explains that this duty is designed to give comfort to airport owners and creditors that the regulator will not expose them to unreasonable risk and, put somewhat crudely, seize value from the airport owners and pass it to airport consumers. The consultation document rightly acknowledges that such a course of action would significantly raise regulatory risk, undermine investment incentives and, therefore, act against the interests of passengers. As such, it can be argued that a financing duty is unnecessary, an argument acknowledged in the consultation document.
- 2.44 The CAA considers that there are significant risks associated with the financing duty, both in terms of the proposed form for any duty and more generally. In respect of the first of these, the current formulation suffers from a number of weaknesses, including that:
- it does not make clear that there is an obligation on the airport operator to operate efficiently;
  - it fails to recognise that the regulator cannot ‘ensure’ that any airport generates an appropriate return, given that the airports market is characterised by degrees of competition and traffic uncertainty rather than natural monopoly; and
  - it refers to an obligation to finance ‘activities’, rather than focusing only on an obligation to finance additional ‘obligations’ placed on the airport by the regulator.
- 2.45 More generally, the duty is vulnerable to misinterpretation by stakeholders and risks blurring the responsibility for establishing and maintaining an appropriate financial structure for the airport, providing the owners and creditors of the airport with an avenue through which to seek to pass financing risks to airport users. In principle, a clearly defined duty could mitigate these risks. However, in practice – and despite the best efforts of other regulators with financing duties – stakeholders in these sectors do not appear to share a common understanding of the implications of the financing duty for the allocation of risks between owners, creditors and customers.<sup>13</sup>
- 2.46 Whilst this does not mean that customers in other regulated sectors will, in the event of financial distress, end up facing additional costs, it does serve to highlight that these elements of ‘utility style’ economic regulation should not

---

<sup>13</sup> For example, industry participants have challenged the regulators interpretation of its obligations under the financing duties in a number of public forums. For example, at a cost of capital seminar at Exeter University in 2007 a representative of a water company challenged Ofwat’s interpretation of its financing duty. A similar incident occurred at the airport regulation stakeholder event on 16 July 2008 when a representative of investors in utility infrastructure questioned Ofgem’s interpretation. Dieter Helm presented on these issues at a CC lecture in May 2009 (“Utility Regulation, the Regulatory Asset Base and the Cost of Capital”, available at [http://www.competition-commission.org.uk/our\\_role/cc\\_lectures/cc\\_spring\\_lecture09.htm](http://www.competition-commission.org.uk/our_role/cc_lectures/cc_spring_lecture09.htm)).

be imported into the more competitive airports sector without clear analysis and consideration of whether a financing duty will reallocate risks from airport owners and creditors to airport users. Indeed, one interpretation of BAA's and some airport investors' support for the proposal is that these parties consider its introduction will pass risks that they currently bear onto airport customers.

- 2.47 An alternative to the proposed approach would be to establish the clarity and stability required to attract investment through other elements of the regulatory regime. For example, a clear primary statutory duty, a secondary duty relating to Better Regulation and a well-designed appeals regime would all contribute to the overall stability of the framework, whilst avoiding the potential for a financing duty to reduce, rather than improve, clarity.
- 2.48 The third aspect of the proposed package – a series of Tier 1 licence conditions controlling the financial structure of the airport – is intended directly to constrain the financial structure of the airport. However, there is no clear analysis of the benefits of applying this standard 'utility' model to airports, including whether it is appropriate for a regulator to place such reliance on credit ratings established by third party agencies.
- 2.49 In addition, the act of introducing this package of measures appears likely to cloud the responsibility for bearing the consequences of financial distress and/or failure. The actual financial structure of the airport ceases to be the result of decisions taken by the owners and creditors and instead becomes the joint product of the regulator, airport owners and creditors. In such circumstances, in the event of financial distress, owners and creditors can be expected to argue that the regulator is at least partly responsible for, or at least associated with, the financial structure implicated in the distress, buttressing any case for the price control to be adjusted upwards to increase revenue recovery.
- 2.50 In part, the weaknesses of the proposed approach arise from the inability of the regulator to introduce a sufficiently effective scheme to regulate financial inputs. In benign conditions, the regulated company will face incentives to adopt innovative financial structures – albeit within the rules set out in the relevant licence conditions – in order to increase returns to shareholders. However, in less benign conditions, the regulated company will turn to the regulator to relax the price control. It is possible that the regulator will be able to resist this pressure, but the fact that the financial structure is partly the result of the regulator's decisions and policies opens up a route for challenge (exacerbated by any uncertainty that exists over the precise meaning of the financing duty).
- 2.51 It is, however, often argued that the introduction of the package of financing licence conditions reduces the cost of capital faced by the regulated business. The reasons for this are somewhat unclear. The licence conditions typically introduce a series of obligations that mirror those that providers of finance also choose to implement. Indeed, it seems that were

the introduction of a certain type of financial ring-fence or obligation to maintain a particular credit rating significantly to reduce financing costs, the airport's owners would already have a strong incentive to put these measures in place. It is therefore unclear to the CAA how such licence conditions can improve the management of the risk faced by an airport. Instead, it is possible that, rather than reducing overall costs, the introduction of these licence conditions merely passes risks from the airport owners and creditors to airport users, by virtue of the blurring of responsibility for financing risks that results.

- 2.52 Furthermore, the CAA is not aware of any analysis that clearly demonstrates that the package of financing licence conditions has had the effect of reducing costs to consumers of financing investment. Any such analysis would need to distinguish this potentially beneficial effect from the possibility that the cost of raising debt has been reduced by the perception that the regulator has, in effect, underwritten to some extent this debt by passing risks to consumers.
- 2.53 The CAA is also concerned that the proposals to introduce financing licence conditions to all Tier 1 airports will undermine the flexibility of the overall framework. In particular, it is unclear from the consultation document how the package of financing licence conditions would interact with: the tiered structure of airport licences, the ability for airports to move into and out of Tier 1, and the proposed freedom for the CAA to impose a broad range of regulatory oversight within Tier 1, ranging from detailed price control to price monitoring. For example, as proposed, it appears that should the CAA identify an airport that has acquired substantial market power and warrants Tier 1 regulation, this move would oblige the airport to refinance its activities in order that it can comply with the financing licence conditions. It is unclear how this process would work in practice, in particular as it would be undesirable for the act of detailed economic regulation – triggered by concerns about the degree of market power held by an airport – to prompt financing risks to be passed to passengers and airlines.
- 2.54 This would have the effect of increasing the costs associated with Tier 1 regulation, reducing flexibility, and limiting the CAA's ability to tailor regulation to the specific circumstances of each airport. In particular, the CAA would not be permitted to apply price-monitoring approaches without also regulating the airport's financial structure. In contrast, the alternative approach of permitting the CAA to choose which licence conditions to apply would avoid this step-change in regulation, and permit the CAA to regulate in a way that minimised the adverse impact on the normal commercial operation of airports.
- 2.55 Finally, and in common with the other elements of the proposed package, it appears to the CAA that the introduction of the licence conditions would expose airport users to risks associated with the transition from the current arrangements. For example, the introduction of an obligation to secure a

particular credit rating could, in current circumstances, require the airport to re-finance its activities and, in particular, necessitate an injection of equity into the airports business.

- 2.56 It is unclear from the Government's proposals whether the owners and creditors would be expected to meet this cost – and if so, how this would be justified or secured in practice - or whether it would fall to passengers and airlines who are, in principle, benefiting from the additional protections brought about by the new provisions. This places a premium on properly assessing the related costs and benefits of the proposed approach. The CAA also notes that the practical effect in current circumstances of passing these costs to airport users could be to pass the consequences of the airport operator's decision to adopt a risky financial structure. Such a step would set an unhelpful precedent, encouraging 'moral hazard' and could undermine the credibility that the Government and regulator could successfully resist future attempts to pass financial risks to airport users.

*Summary – regulating financial structures*

- 2.57 The CAA's current regulatory approach has sought to insulate passengers and airlines from any additional costs or risks arising from this structure. It has achieved this by focusing on the regulation of outcomes – rather than by trying to control inputs – and by ensuring that the airports face appropriate incentives to improve service quality and undertake investment, whilst also establishing a clear allocation of risk and reward between airport owners, creditors and airport users.
- 2.58 In contrast, the CAA considers that the application of the proposed package of "utility-style" measures could have the perverse effect of reducing the ability of the CAA to protect passengers from the consequences of the current and prospective financial structures adopted by airport owners. It is also unclear to the CAA how the price controlled airports – and Heathrow in particular – can make the transition from their current financial structures to that envisaged by the Government without passengers and airlines ultimately paying to repair the airports' balance sheets. This would undermine the extent to which the CAA has insulated passengers and airlines from these costs and set an unhelpful precedent about the extent to which airport owners should face the consequences of their own decisions.
- 2.59 The proposals would also appear to conflict with the proposals for a targeted and proportionate licence-based regulatory framework, reducing the flexibility afforded to the CAA and limit its ability to tailor regulation to the market circumstances of each airport.
- 2.60 Furthermore, the CAA does not consider that the consultation document identifies any significant benefits that would flow from this package of measures, due to the incentives to secure continuity implicit in the cash-generative nature of airport businesses.

- 2.61 The CAA, therefore, recommends that the Government focuses its reforms on incremental improvements to the current approach to regulating financial structures instead of introducing a financing duty and associated specific licence conditions. This focus on incremental improvement would avoid the risks associated with designing a new approach and avoid the potential for the airport owners to use reform as an opportunity to pass risks that they currently face onto passengers and airlines. Some of this incremental improvement would flow directly from the introduction of a flexible licence-based framework that would enable the CAA to sharpen the incentives faced by airports to deliver appropriate service quality to passengers and airlines.

### **Duty to assist in delivery of investment consistent with the National Policy Statement (NPS)**

- 2.62 Airports are highly capital-intensive businesses which means that the experience of passengers is significantly affected by the nature of investment in service quality and in additional airport capacity. The Government's reforms must, therefore, provide a regulatory framework that attracts efficient investment in airports.
- 2.63 The degree to which this is achieved will, however, depend upon whether Government planning policy interacts effectively with the regulatory framework.

#### *The Government's policy on airport development*

- 2.64 The planning process and, within the planning process, Government policy play an important role in controlling airport development, ensuring that non-market costs and benefits are properly accounted for and that airport operators have a degree of certainty about Government support for individual development projects.
- 2.65 The Government set out its policy on airport infrastructure in the 2003 Air Transport White Paper 2003 (ATWP)<sup>14</sup>, which included guidance on whether Government supported expansion in particular regions and at particular airports. However, Government also stated that the ATWP neither authorised nor precluded any particular airport development.
- 2.66 Following reforms to the planning process, the Government will establish a National Policy Statement (NPS) for airports in the near future.<sup>15</sup> The primary purpose of the NPS will be to guide the Infrastructure Planning Committee's decisions on planning applications for nationally significant infrastructure projects.

<sup>14</sup> As updated in December 2006, by the ATWP progress report.

<sup>15</sup> Under the new planning regime that was introduced in November 2008 through the Planning Act 2008, an independent Infrastructure Planning Commission (IPC) will take decisions on planning applications for nationally significant infrastructure projects. The Government will issue NPSs setting out the relevant Government policy for all relevant sectors, including airports, that will guide the IPC's decisions. The NPSs will be subject to extensive consultation and parliamentary scrutiny before coming into force.

*Clarifying the Government's role in determining airport investment*

- 2.67 The introduction of an NPS and the reform of airport regulation provide the Government with an opportunity to clarify the roles and responsibilities of the various participants in the airports sector and how these roles interact when proposed airport investments are brought forward.
- 2.68 In particular, the Government should make a clear statement about the degree to which airport investment decisions should be determined by commercial decisions by private investors, supplemented where necessary by regulation which seeks to replicate the commercial pressure of a well-functioning airport market.
- 2.69 In this context, the CAA notes the CC's recommendations that the Government, when developing the NPS, should consider the implications of the divestiture of Gatwick and Stansted and the ambitions of the new owners of Gatwick Airport.
- 2.70 In principle, it is possible for the planning process and Government policy to support airport competition by providing useful information as to which projects are likely to attract planning consent, supported by the introduction of an independent decision-making body for major planning decisions. For example, Government – through the NPS – could identify the likely national and regional need for additional airport capacity and a range of sites<sup>16</sup> where expansion would (and would not) be likely to deliver overall benefits to society.
- 2.71 Such an approach would establish a clear policy framework within which airport operators could compete to invest, and thereby maximise the potential for gains to be realised from the break-up of BAA. In addition, it would build upon the CAA's current approach to regulating investment at the designated airports, which seeks to take full account of its impacts on other airports, thereby seeking to encourage economic, efficient and timely investment to meet anticipated demand at all UK airports.
- 2.72 An alternative approach would be for Government to take an active role in determining investment outcomes. This approach would limit the discretion afforded to competing airport owners to bring forward their own investment plans. Furthermore, to the extent that the projects identified by Government were not commercially viable, it would be necessary to identify a source of funding in order to attract the necessary private finance.
- 2.73 The CAA considers that a clear choice between these two models, and their implications, would assist in the development of a consistent and clear regulatory framework.

---

<sup>16</sup> This could be implemented either by including within the NPS a list of permitted sites or by setting out the framework for assessing the costs associated with development at individual sites.

*The proposed statutory duties in respect of the NPS*

- 2.74 The Government proposes a statutory duty for the CAA to “assist in the delivery of airport infrastructure consistent with the National Policy Statement on Airports unless there are compelling reasons not to do so”. This is proposed as a secondary duty, and therefore subordinate to the primary duty of promoting the interests of consumers.
- 2.75 However, the NPS will necessarily need to go beyond issues relating to consumers’ interests and take account of a number of wider public interest considerations, including in respect of the environment, impacts on local communities as well as wider social and economic impacts.
- 2.76 This calls into question the extent to which a regulator is in practice able “to assist” in the delivery of the NPS without being in breach of its primary duty towards consumers and competition. The extent to which there may be a conflict between these two objectives would depend upon the form that the Government adopts for the NPS. An NPS that provides a significant degree of commercial freedom for airport operators to bring forward commercial investment projects would appear to reduce the potential for such conflicts.
- 2.77 Indeed, the consultation document recognises this potential inconsistency between the proposed secondary and primary duties and states that “where delivery of the proposed [investment] project was not consistent with its [the regulator’s] primary duty to promote the interests of consumers, this would represent a compelling reason not to accommodate the project”.
- 2.78 However, it is not clear whether the Government envisages that the CAA should, in fact, interpret the proposed statutory duties in this way, by placing significant weight upon the above qualification, or whether the Government intends that its proposed secondary duty should have a different effect in practice.
- 2.79 The CAA’s current interpretation – placing a strong emphasis on the above qualification – would mean that it would only give effect to investment proposals consistent with the NPS if they were also in the best interests of consumers. Against a background of a commercial and increasingly competitive airports market, this would imply that the CAA would place weight on the need to avoid distorting competition between airports, in order to protect consumers’ interests in the long term.
- 2.80 Under this approach, the regulator’s decisions would not be significantly affected by the duty “to assist” with the delivery of the NPS, and the outcome would largely be in line with the CAA’s current approach to investment. This approach has a strong record in encouraging efficient investment at designated airports – whilst also ensuring that competition is not unduly distorted – as illustrated by the recent Heathrow price control, which included an allowance for expenditure to develop options for the expansion of

Heathrow amounting to c. £600m.<sup>17</sup> A further implication of this interpretation of the proposed statutory duties is that as competition between the London airports develops, the regulator could leave investment decisions increasingly to the competing market participants.

- 2.81 An alternative interpretation of the statutory duty relating to the NPS is that it significantly alters the assessment that the CAA should make of investment projects or alter its approach to regulation. For example, the duty could be interpreted as meaning that the CAA would be expected to take a more active role in promoting investment projects that are included in the prospective airports NPS. Indeed, the consultation document suggests that the regulator would have the ability to provide incentives for airport operators through, for example “indicating that the regulator would be sympathetic to allowing an appropriately scoped proposal to be accommodated within a price control”.
- 2.82 Although the consultation document argues that the airport operator would retain the commercial risk, in practice a duty on the regulator to assist in the delivery of specific investment projects – interpreted in this way – would be likely to have an effect on the commercial discipline to which the airport operator is subject. In particular, it could be interpreted as obliging the regulator to ensure that the airport operator finds it profitable to pursue investments specified in the NPS, even if these projects would not be expected to be brought forward in a well-functioning market and would not normally be regarded as “commercially justified”.
- 2.83 This could lead the CAA to develop regulatory approaches that distorted competition to favour particular airports and/or projects, for example through cross-subsidies between UK airports. An alternative, available where an airport enjoyed a position of substantial market power over a significant proportion of its customers, would be to permit the airport to set charges that might otherwise be regarded as excessive in order to meet the short fall associated with the funding of non-commercial investment.
- 2.84 These approaches would appear to conflict with the primary duty, expose investment at non-regulated airports to regulatory risk, involve the regulator in distorting competition between airports and thereby undermine the role envisaged for the CAA as a concurrent competition authority for airports. The CAA, therefore, recommends against the Government using economic regulation in this way. Instead, where Government identifies a need for a particular investment that a well-functioning, competitive market would not deliver, Government should provide a transparent funding mechanism to support its delivery, which is clearly distinguished from the regulation of market power.

---

<sup>17</sup> CAA, Economic Regulation of Heathrow and Gatwick airports, 2008-2013 – CAA Decision, March 2008, paragraph 2.61.

- 2.85 The CAA recognises, of course, that the NPS will be an important input into its decisions given that it will determine, to a certain extent, the bounds within which commercial and market forces can interact to deliver investment and consumer choice. However, the Government's proposed set of statutory duties would risk blurring the boundaries between the responsibilities of Government and the regulator, and also compromising the clarity and transparency of the regulator's remit. The CAA notes that the House of Lords Select Committee, in their report on UK economic regulators, emphasised the importance of a clear differentiation and definition of the duties and roles of the regulator vis-à-vis Government, whilst recognising that guidance can be a useful tool for the Government to communicate its policy objectives to the regulator in a transparent manner.
- 2.86 This suggests an alternative way of ensuring that the CAA incorporates the NPS into its decision-making processes; namely to modify the proposed duty to place an obligation on the CAA to have regard to the NPS, along the following lines:

*"To have regard to the National Policy Statement on Airports."*

## **Environment**

- 2.87 The CAA welcomes the Government's consideration of the role of environmental issues in the context of a reformed framework for economic regulation of airports. The CAA considers that the aviation industry should meet the full costs of its environmental impacts, and CAA supports the Government's objectives around sustainable development. This is reflected in an internal objective of the CAA to encourage civil aviation to reduce, control and mitigate the impact of the industry on the environment.
- 2.88 The CAA notes the Government's view that Government is likely to be better placed to address environmental externalities. However, it may be appropriate for the CAA to take clearly defined roles where it has particular expertise to implement government's policies, as will be the case for its envisaged role in relation to ensuring compliance with environmental limits at an expanded Heathrow. It is, however, vital to ensure that the right environmental policies and tools are deployed to effectively achieve the desired environmental outcomes, using economy-wide, market-based measures or targeted local measures where appropriate and that a clear distinction is drawn between environmental regulation and the economic regulation of airport market power.

### *The CAA and the environment*

- 2.89 The CAA already has a number of such specific environmental roles, including:
- providing expert advice on aircraft noise issues;

- taking account of environmental factors when considering airspace change proposals; and
  - providing advice to Government on issues around the use of economic instruments to tackle climate change.
- 2.90 These roles have also evolved over time; for example, the CAA has recently been appointed as the expert advisor to the Environment Agency (EA) as the EA carries out its functions as the EU Emissions Trading Scheme regulator for aircraft operators in England and Wales.
- 2.91 In the context of economic regulation, airport price controls at Heathrow and Gatwick<sup>18</sup> already allow environmental costs to be recovered where these are judged necessary for the economic and efficient operation and development of the airport. The CAA considers that this should continue to be the case.

#### *Addressing environmental externalities*

- 2.92 As recognised in the consultation document, there are a wide range of existing (and pending) statutory provisions that directly or indirectly address the environment impact of aviation. The CAA would agree with the conclusion in the consultation that where existing provisions are effective there is little *prima facie* case for applying additional regulation.
- 2.93 The CAA also considers that it is important that environmental considerations – where not already being addressed – are tackled in an appropriate context, and that the most effective and appropriate policy levers are deployed in order to meet the desired objectives. The CAA supports the consultation document's conclusion that economic regulation should be focused on issues arising from a lack of competition in the airports market and potential abuse of market power, while other aspects of market failure, including environmental issues, would best be addressed by other forms of Government intervention. In this light, the CAA encourages the Government to distinguish clearly the role of economic regulation of airports from economy-wide or local measures such as planning rules or carbon pricing (which might actually be more effective at meeting environmental aims), which will more appropriately deliver key environmental goals.
- 2.94 This question is particularly relevant as the Government is already planning to address the issue of the CAA's environmental roles more comprehensively in the context of responding to the recommendations of the Pilling review, which included a recommendation that the CAA should be given a general statutory duty on the environment, with an accompanying policy framework. Our understanding is that this recommendation – along with the conclusions from this review – will be taken forward as part of a future Civil Aviation Bill<sup>19</sup>. It is important that any new roles and responsibilities falling to the CAA in the

---

<sup>18</sup> This treatment does not apply at Stansted, which is not strictly a cost-based control.

<sup>19</sup> This would also include legislating where necessary for aspects of Heathrow environmental compliance, which the CAA will be leading on.

environmental arena should be considered holistically. The CAA will continue to work with Government on these issues.

*Considering environmental factors in economic regulation*

2.95 In considering further the possibility of including environmental issues in the statutory framework for the economic regulation of airports, the CAA recommends that:

- the proposals should contain a clear distinction between, and description of, the Government's, the regulator's and airport operators' roles and objectives, to avoid regulatory uncertainty and leaving decisions on complex trade-offs between conflicting policy goals to an unelected regulatory body;
- there would need to be absolute clarity about the primacy of the regulator's duty to promote the interests of consumers, where appropriate through the promotion of competition. A corollary of this condition would be that any secondary duty or regulatory functions regarding environmental issues should not have adverse impacts on competition between UK airports.

2.96 Should the Government consider that there may be merit in modifying the framework of economic regulation to be more responsive to environmental goals, then there should be a clear cost-benefit assessment to identify whether there are gains from doing so, over and above those from addressing environmental issues through existing and possible alternative measures.

*Secondary environmental duty*

2.97 The CAA notes that in other sectors environmental issues have typically been included in the statutory duties of the regulator, but have not featured in the principal or primary objective. Typically economic regulators are required, as a secondary duty, to have regard to the environmental issues when discharging their primary duty, and it would therefore be reasonable to follow this model in regulating airports, as long as the requirements it places on the regulator and on airport operators as well as the interface with the wider legal and regulatory framework are clearly defined.

2.98 The consultation document notes that the addition of a secondary duty on the environment "is not intended to encourage the CAA to duplicate existing environmental provisions rather it is intended to ensure that the development of airports takes place within any set environmental limits. In pursuit of this end, we propose that large airports should be required to publish reports setting out how they plan to meet their environmental obligations and what steps they are taking to engage local communities on the issues that affect them." The CAA's current understanding of these proposals is that the secondary environmental duty serves as a reminder that existing

environmental obligations placed on airport operators can affect their commercial appraisals of investment of operational decisions, which needs to be taken account of by the regulator in its regulatory decisions, including price control decisions. The CAA further understands that the only additional function proposed in relation to the environmental duty is ensuring that airport operators within the two top licence tiers regularly publish environmental reports. This function is discussed further below.

- 2.99 In light of this understanding, and the stated aim of such a secondary duty in the consultation document – that “Government would want to be confident that the economic regulator takes account of the Government’s environmental objectives” – the CAA suggests that it would be better to reflect the roles of Government and the CAA by changing the current proposals to include a duty towards environmental issues within the secondary tiers of duties and for this duty to be framed as an obligation to have regard to guidance issued by the Secretary of State. This would imply a duty framed in the following manner, building on the text set out in paragraph 2.86):

*“to have regard to the National Policy Statement on Airports and to any guidance issued by the Secretary of State on the Government’s environmental policy framework”.*

*Environmental reporting licence condition by Tier 1 and Tier 2 airports.*

- 2.100 The consultation document proposes that Tier 1 and 2 licences should contain a condition requiring airport operators to publish annual reports on their environmental performance. The document does not discuss, however, the content of such reports, the costs and benefits of this additional requirement that goes beyond the current arrangements under existing environmental obligations and voluntary reporting already undertaken, according to the consultation document, by a number of airports, or the possibility of distorting competition should environmental obligations be placed on some airports and not others. The CAA recommends that Government explore these issues further in its impact assessment.
- 2.101 While the CAA considers that it could enforce this licence condition, the CAA understands that it would have no wider role having taken receipt of such reports (e.g. in any way to monitor compliance or enforce adherence to environmental obligations). Further, it is not clear why this requirement should be tied to economic regulation as opposed to a separate regime.<sup>20</sup>
- 2.102 The CAA notes that the consultation document also refers to reports being available “for the scrutiny of the CAA” and others. It is not clear on what basis the CAA would be scrutinising the reports, and what actions it would be expected to take should it have any findings. The expert panel’s report foresaw that this function could be accomplished without turning the CAA into

---

<sup>20</sup> See footnote 27.

a regulator requiring a large specialised environmental staff with all of its employment and cost implications – which suggests that there would not be a requirement for in-depth scrutiny by the CAA. However, the Department needs to clarify this.

- 2.103 The consultation document further refers to the possibility that the CAA could “seek to impose additional obligations by means of a change in licence conditions if it believed that such a change was necessary”. Such a wide power (to impose any licence conditions it believes are necessary), going beyond its role as economic regulator, could lead to the CAA having to make judgments that are more properly made by Government, including on trade-offs between different Government policy objectives, in particular between the objectives to deliver the best outcome for consumers and to protect the environment.
- 2.104 Furthermore, such environmental obligations on the regulator could distort competition between airports where they are not applied equally to all airports. Even the minimum requirement of publishing environmental reports – and the ensuing scrutiny – would only apply to Tier 1 and 2 airports. Yet, as the relevant tests for including airports within Tiers 1 and 2 are not based on environmental considerations, this raises questions about the suitability of economic regulation for securing environmental outcomes.

### **Duty to have regard to the principles of Better Regulation**

- 2.105 The CAA welcomes the Government’s proposal that the CAA should have a duty to have regard to the principles of Better Regulation. This would follow best practice adopted in other regulated sectors and would replace the CAA’s current duty “to impose the minimum restrictions necessary consistent with performance by the CAA of its functions”. The CAA considers that these two formulations should have broadly the same effect (targeted and proportionate regulation), but as the principles of Better Regulation have become a well established and understood guideline the CAA agrees that they should be incorporated in its statutory duties.
- 2.106 The consultation document further proposes to introduce a duty – through an amendment to the Regulatory Enforcement and Sanctions Act 2008 (RESA08) or through primary legislation<sup>21</sup> – on the CAA regularly to review the regulatory burdens it imposes (with regard to economic regulation), to reduce any that are unnecessary and to report on progress annually. The CAA recognises that regular reviews of regulatory burdens are best practice, and the CAA considers that it has to date adopted processes – notably in respect of the application of price controls to airports – that have ensured that the necessity of regulatory burdens has been regularly reviewed.

---

<sup>21</sup> The CAA notes that other economic regulators are subject to the relevant provisions of the RESA08. Therefore it would seem reasonable to apply the relevant provisions also to the CAA’s economic regulatory activities for airports. However, the CAA sees some attraction in seizing the opportunity that the reform of the regulatory framework offers to ensure that all duties are specified in one single place. Therefore, the CAA would regard provisions in primary legislation governing the CAA’s remit and function as the preferable mechanism to introduce such requirements.

- 2.107 However, it might be proportionate to reduce the frequency with which the CAA is obliged to undertake such reviews to ensure that the reviews are meaningful and can properly involve stakeholders. The rationale for ongoing economic regulation of airports depends largely on the degree of market power that they currently and prospectively hold. In order properly to assess whether the extent of economic regulation remains appropriate, the CAA would need to analyse the extent of competition faced by each airport, an exercise which is best undertaken less frequently than annually. Otherwise, this proposal, intended to keep regulatory burdens under review and control, could significantly add to them.
- 2.108 Such an approach would be consistent with the DfT's proposal to make use of sunset clauses (as discussed in chapter 4) that also require regular reviews of the regulatory burdens imposed on airports. This would provide an additional protection to ensure that regulation remains appropriate, reducing the need for reviews every year.

*(page left intentionally blank)*

### **3. New regulatory powers**

- 3.1 The CAA welcomes the Government's proposals to give the CAA a more flexible set of regulatory powers, including the introduction of a licence-based regime and concurrent competition powers, supported by strengthened compliance and enforcement powers.
- 3.2 These reforms would bring the CAA's regulatory powers more closely into line with those typically provided to other economic regulators and give the CAA the flexibility it needs to apply regulation in a targeted and proportionate manner.
- 3.3 The following sections provide comments on the detail of the Government's proposals, considering first the tiered licence-based framework before turning to issues relating to concurrent competition powers. The final section of this chapter considers the appropriate compliance and enforcement powers.

#### **Proposals for a tiered licence regime**

- 3.4 The consultation document proposes a three-tiered regime. Under this approach, Tier 1 would focus on the regulation of only those airports with (at least) substantial market power. Tier 2 airports would only be subject to licence conditions that are necessary to secure compliance with the requirements of the Airport Charges Directive (ACD). Tier 3 is then used to apply regulation to additional airports to capture a number of other requirements.
- 3.5 Within this framework, the CAA would have the power to change licence conditions that apply to airports within Tiers 1 and 3 and be able to move – subject to appeal – airports between Tiers 1 and 2. It is also proposed that the initial set of licences be determined by the Secretary of State, who would be informed by advice from the CAA under section 16 of the Civil Aviation Act 1982 and the results of a consultation.
- 3.6 The CAA supports the Government's objective of developing a framework that targets detailed economic regulation only to those airports that warrant such regulation. In addition, the Government needs to ensure that the framework implements current and prospective European legislation.
- 3.7 After considering the details of the Government's proposals, it appears to the CAA that these objectives could be met through a modified approach, whilst maintaining the principle that economic regulation should take the form of a series of 'tiers' so as to ensure that it remains proportionate.
- 3.8 In particular, the CAA considers that the three-tier system could be replaced by a 'two-tier' approach, which only distinguishes between:

- ‘Tier 1’ airports – those airports with a degree of market power that warrants detailed economic regulation through a flexible licence, as set out in the consultation document.; and
- ‘Tier 2’ airports – those airports that need to be subject to licence obligations by virtue of EC regulation.

3.9 This approach would allow the ACD to be implemented into UK law, but would also provide a flexible mechanism by which other EC regulation – both current and future – could be codified. As such, it would avoid designing the regulatory framework in a way that proves not to be robust to future changes in EC law. Indeed, by changing the nature of Tier 2 in this way, the licence framework could be used to cover other regulatory requirements, such as those relating to passengers with reduced mobility and ground handling.

#### *Government proposals for Tier 1 licences*

3.10 The CAA welcomes the Government’s proposal that the highest level of economic regulation should be applied in a targeted and proportionate manner, through a specific licence tier based on the market power enjoyed by an airport operator.

#### The criteria for applying Tier 1 regulation

3.11 The CAA welcomes the Government’s proposal to apply the criteria currently used to decide the designation of airports for the purpose of price control regulation under the Airports Act 1986 to decide whether an airport should be included within Tier 1.

3.12 The CAA also considers that the criteria for applying Tier 1 regulation should be specified in primary legislation, as this would provide certainty and transparency to airport operators about the basis for the more detailed form of economic regulation associated with a Tier 1 licence.

3.13 The three proposed criteria are:

- the airport operator, either alone or together with any other airport(s) in common ownership or control, has or is likely to acquire, substantial market power; and
- domestic and EC competition law may not be sufficient to address the risk that, absent regulation, the airport would increase and sustain prices profitably above the competitive level or restrict output or quality below the competitive level; and
- regulatory intervention within the Tier 1 licence will deliver additional benefits for airport consumers (i.e. over and above competition law) that exceed the costs and potential adverse effects of any regulatory intervention.

- 3.14 As the Government also proposes to extend the CAA's Competition Act powers to cover airports, the CAA supports the proposal to ensure that Tier 1 licences are only applied where this level of regulation brings additional benefits beyond the application of general competition law. However, the criteria – and the way that they would be applied – could be improved in a number of, relatively minor, ways.
- 3.15 The first criterion sets out that an airport must hold a position of substantial market power. This mirrors the threshold included in general UK competition law (i.e. 'dominance')<sup>22</sup>. However, many undertakings in the UK are likely to hold such a level of market power and are not subject to additional sector-specific economic regulation. This, in part, reflects the fact that competition law can – and does – deal with markets that have dominant players. There would, therefore, be merit in clarifying that sector-specific regulation would only be applied where the level of market power is somewhat above that which would confer a dominant position on an airport (or group of jointly controlled airports).
- 3.16 In particular, the Government could usefully clarify that the additional regulation associated with Tier 1 is only likely to be justified where (after taking account of the deterrent effect of competition legislation) there is a significant risk that an airport will undertake abuse and that such abuse is likely to have significant effects. The implication of this observation is that whilst a position of substantial market power is a necessary pre-condition for designation, it is not a sufficient condition and that the level of market power held by an airport is likely to be greater than this level for Tier 1 regulation to be justified.
- 3.17 In respect of the second criterion, the CAA considers that the proposed threshold, that competition law “may” not be sufficient to address the risk of an airport abusing its substantial market power, could be improved by instead referring to whether competition law “is *unlikely* to address the risk of an airport abusing its substantial market power”.
- 3.18 Finally, the CAA considers that it would be beneficial if the Government were to clarify that whilst the size of an airport (in terms of its traffic) is not a relevant test criterion, a smaller airport would be less likely to pass the criteria and be subject to Tier 1 regulation. In particular, the CAA notes that the criteria oblige it to avoid applying detailed economic regulation when the benefits from doing so do not exceed the costs of regulation. In this respect, the CAA notes the CC's recent decision not to apply a price control remedy to Aberdeen Airport and instead place reliance on remedies based on

---

<sup>22</sup> The CAA has taken the Government's proposed 'threshold' of substantial market power to be substantially equivalent to the 'threshold' of dominance as defined within the Chapter II prohibition of UK competition law. The CAA notes that 'dominance' carries a legal implication whereas 'substantial market power' is primarily an economic concept. However, the CAA notes that the OFT's guidance on competition law states that dominance is the same as, or above, substantial market power: "An undertaking will not be dominant unless it has substantial market power." (OFT Guideline 402 on abuse of a dominant position, December 2004).

improving consultation processes and on releasing information to market participants.<sup>23</sup>

## Licence conditions

- 3.19 Regarding the conditions to be contained in a Tier 1 licence, the CAA considers that, to ensure flexibility, the regulator should retain full discretion over the type of licence conditions to be included in the licences. Such an approach would mean that a Tier 1 licence could be identical to one applied to Tier 2 airports. This is because, in principle, the minimum distinguishing feature between Tier 1 and Tier 2 would be that the CAA had greater powers to impose additional regulation on the former to deal with the risk of an abuse of market power. This approach would also remove the need to define any minimum set of additional licence conditions to differentiate Tier 1 licences from other potential licence tiers. For the avoidance of doubt, in practice it seems likely that there would be a significant difference between the licences of Tier 1 and Tier 2 airports, and that the licence held by Heathrow Airport would contain a number of additional conditions, not least a price cap.
- 3.20 One of the weaknesses of the current regime is the high level of prescription regarding the form that regulation must take. In line with other regulated sectors, the CAA should not be confined to a pre-defined list of mandatory or discretionary licence conditions from which it can choose. Rather, the regulator should have full flexibility to apply the licence conditions it sees fit for each individual airport to enable it to target regulation precisely at the individual circumstances pertaining to each airport.
- 3.21 In particular, the CAA, in addition to its more general issues with the financial resilience provisions<sup>24</sup>, has concerns about making them mandatory for all Tier 1 licences. Such mandatory provisions would unduly restrict the flexibility of regulator to modify regulation to accommodate the development of a competitive market. For example, financial resilience provisions only have value where they are applied in combination with a RAB<sup>25</sup>-based price control as provisions such as ring-fencing or investment grade credit rating conditions typically refer to assets included in the Regulated Asset Base. Therefore, if the regulator varied its price control approach, financial resilience provisions would sit uncomfortably alongside any less intrusive price control approach.
- 3.22 Furthermore, mandatory financial resilience provisions are likely to increase the costs of imposing a Tier 1 licence. The CAA considers that there is a possibility that some airports for which economic regulation under a Tier 1 licence would have had net benefits in the absence of financing provisions, could fail the third criterion of the regulated status test as the costs of

<sup>23</sup> CC, BAA airports market investigation, final report, March 2009, paragraphs 10.198 *et seq.* For the avoidance of doubt, the CAA does not consider that the CC has presented conclusive evidence to establish a finding about Aberdeen holding substantial market power.

<sup>24</sup> As discussed in paragraph 2.10 *et seq.*

<sup>25</sup> Regulated Asset Base

introducing the financing provisions could significantly distort the cost-benefit analysis.

- 3.23 Accordingly, the CAA recommends that Government reconsider the costs and benefits of fixing specific licence conditions in primary legislation and cautions against adopting this approach.

#### *Tier 2 licence*

- 3.24 The CAA welcomes the intent of the Government's proposal to implement the Airport Charges Directive (ACD) through the licence regime and as many of the provisions as possible through licence conditions on airports. However as noted above, rather than determining both the conditions and scope of a Tier 2 licence through the ACD alone, the CAA believes there is an alternative approach to a licensing regime that will build a framework that is more robust to future changes in the EC regulation. In particular, it is not clear why Tier 2 licences should only focus on airport charging issues, as there are other elements of EC economic regulation that relate to airports, and the prospect of additional regulation in future. This raises questions around whether the Tier 2 licence should only be focussed on airport charging issues or whether it should incorporate other aspects of current and prospective economic regulation.

- 3.25 There are three related issues the CAA considers relevant; the license provisions themselves; the threshold for the Tier 2 licence and the benefits in maintaining a consistently applied framework for compliance and enforcement activities across all forms of economic regulation. These are discussed in more detail below.

#### Tier 2 licence provisions

- 3.26 The CAA supports the intent of Government to incorporate the requirements of the ACD into Tier 2 licence conditions. However, as noted above, there are additional conditions relating to the economic regulation of airports contained in EC regulations related to ground-handling and passengers with reduced mobility that have not been considered. These additional provisions are currently given force in secondary legislation and partly through the application of the Airports Act. Further, it is likely that other forms of economic regulation related to airports will be considered by the EC in the future either through new regulation or amending current regulation. The CAA believes that the most flexible approach to managing the range of current and future requirements relating to the economic regulation of airports in EC regulation is to incorporate them all into the Tier 2 licence regime.<sup>26</sup>

---

<sup>26</sup> This approach would change Tier 2 from being focused solely on economic regulation – i.e. correcting for issues relating to market power – but retain a clear purpose for the licences, namely to secure compliance with relevant EC regulation.

- 3.27 The CAA proposal would involve granting the Secretary of State powers to incorporate current and new forms of economic regulation from the EC into the Tier 2 licence (but not broader powers to modify these licences for other purposes).<sup>27</sup>
- 3.28 Additional requirements not related to EC regulation, such as proposed environmental reporting conditions, could be included as stand-alone obligations within primary legislation<sup>28</sup>.

### Thresholds

- 3.29 As noted by the CAA in its response of November 2008, the CAA considers that there are strong arguments against requiring all aerodromes to hold an economic licence, not least as this would increase the risk – whether actual or perceived – that the degree of regulation applied to these airports would increase, with associated compliance costs.
- 3.30 However, as noted above, there is already a range of regulatory obligations stemming from EC requirements that impose differing thresholds based on a range of metrics including annual turnover, a definition of commercial air movements and passenger movements. The CAA considers that adopting an approach that places a particular threshold into primary legislation might rapidly become obsolete and necessitate further primary legislation.
- 3.31 The CAA has developed its thinking in this area and believes the number of airports captured by a Tier 2 licence should not be of concern if the process for determining license condition thresholds is suitably constrained. For example, based on current EC thresholds that are already contained in related statutory instruments, Tier 2 licence conditions would apply as follows.
- licence conditions relating to the ACD, ground handling and passengers with reduced mobility would apply to 13 Airports in 2008.
  - licence conditions relating to the ground handling and passengers with reduced mobility would apply to 21 airports in 2008.
  - licence conditions only applying to aspects of the regulation on passengers with reduced mobility would apply to 34 airports in 2008.
- 3.32 Further, if this approach were adopted it would not have a significant impact on the number of airports already captured by the current ‘permission to levy charges’ regime contained in the Airports Act. As noted above, the impact

---

<sup>27</sup> The mechanism for transposing the EC requirements would be through the development of a statutory instrument by the DfT that would link EC requirements to the development of a tier 2 licence conditions by the CAA.

<sup>28</sup> Such an approach would also allow the Government to place any obligations to collect and/or review these environmental reports onto a range of public bodies, and thus allow consideration to be given to whether the CAA, or other body, should fulfil this role.

would be that Tier 2 licenses would apply to more airports, but only where there was already a regulatory obligation, through EC requirements.

### Compliance and Enforcement of the Licence Conditions

3.33 A further benefit, as explored in more detail below, is that this approach to Tier 2 would allow Government to codify a framework for compliance and enforcement that would apply to all forms of current and future economic regulation. This could simplify the overall framework for compliance and enforcement, reduce the risk of inconsistency and duplication, and reduce compliance costs for airport operators. For example, airport operators would have a larger number of their obligations codified within a single document, all of which fell under the same compliance and enforcement regime.

#### *Tier 3 licence*

3.34 The consultation document proposes the introduction of a third licence tier, to address individual concerns based on, for example, material complaints from passengers, freight users or airlines about poor performance at airports falling below the Tier 2 licence threshold of five million annual passengers. There is no specific test defined for assigning Tier 3 licences and appears to be wholly at the discretion of the regulator, subject to appeals by affected parties.

3.35 However, it is not clear what purpose Tier 3 would serve within the overall approach proposed in the consultation document, as it seems that the combination of Tiers 1 & 2, competition and consumer legislation and EC regulations would provide a package of appropriate protections for passengers and airlines.

3.36 If concerns related to a lack of adequate competition, and the airport in question therefore possessed and abused a position of significant market power, this could either be addressed by moving the airport into Tier 1, or by general competition law, as supplemented by sector-specific protections such as the ground handling directive. Further, if the airport in question were accused of not adhering to relevant consumer protection legislation – including both general consumer protection such as provisions regarding unfair contract terms or aviation specific provisions such as regulation protecting the interests of passengers with reduced mobility (PRM) – the CAA would have direct powers to enforce compliance and take action against non-compliance with the relevant legislation.

3.37 It, therefore, appears that the purpose of Tier 3 might only be to implement measures relating to national or local environmental protection. However, as discussed in chapter 2, the Government has confirmed that such issues would best be addressed by measures other than economic regulation. Rather, economic regulation should focus on issues relating to consumer detriment resulting from market power. This suggests that the tiered framework could be simplified – either under the Government's proposed

approach or the CAA's suggested alternative – by removing the third licence tier.

- 3.38 Should the Government retain the third tier, the CAA is concerned that the checks and balances proposed by Government are insufficient to address the wide-ranging discretionary powers for the CAA to impose Tier 3 licences on small airports. As there is no clearly specified test, it would increase significantly the regulatory uncertainty for small airports. Even though the CAA currently would not be minded to impose such licences, this approach could change and the CAA's powers need to be subject to appropriate accountability provisions. Equally, the type of licence conditions the regulator could impose on Tier 3 licencees seem to be as wide-ranging as for Tier 1 airports, again increasing significantly regulatory uncertainty for small airports.
- 3.39 As the CAA is of the view that all possible issues could be usefully addressed by means of other regulation or general competition and consumer legislation, the CAA does not think that a third tier is necessary or beneficial.

#### *Implementation of the initial licences*

- 3.40 The CAA agrees that the initial licences could usefully be issued by the Secretary of State. Due to their importance, the CAA suggests that the initial licences are also made subject to parliamentary scrutiny, to ensure that they fulfil the purpose that Parliament envisaged when introducing the new licensing regime.
- 3.41 The CAA looks forward to working with Government to develop an appropriate set of initial licences.

#### *Statutory undertakers*

- 3.42 The CAA considers that the Government's review of the regulatory regime also needs to include the future status of airports as "statutory undertakers". Under the current Airports Act regime, any airport that holds a permission to levy airport charges<sup>29</sup> is afforded the status of a "statutory undertaker". Currently over 60 airports hold such permissions based on their meeting the turnover threshold of Part IV of the Act. Consequently, such airports have rights and obligations as statutory undertakers under various pieces of legislation including (but not limited to):
- the General Permitted Development Order 1995;
  - the Climate Change Act 2008; and
  - as proposed for the preparation of National Policy Statements under the Planning Act 2008.

---

<sup>29</sup> Airports in Great Britain with a minimum turnover of £1m in two of the last three consecutive years must hold a permission to levy charges issued by the CAA.

- 3.43 The consultation document does not make clear whether the prospective licences would replace the current permissions to levy airport charges, or whether Government intends to retain this process in parallel to the licensing regime. The CAA notes that the consultation document indicates that the existing permissions held by Heathrow and Gatwick would be maintained but is silent on other airports.
- 3.44 As the permission to levy charges confers significant rights on airports, the CAA considers that this question needs to be addressed as a matter of priority, to provide clarity to airports on whether or not they can expect to retain such rights.

### **Concurrency powers**

- 3.45 The CAA welcomes the Government's proposals to extend the CAA's powers to apply UK and EC competition law to airports. This proposal will usefully complement the introduction of a licence-based framework and help to ensure that the regulation applied to each airport remains proportionate.
- 3.46 This is because such powers would allow the CAA to make appropriate trade-offs between detailed (ex ante) regulation of conduct through licence conditions and reliance on (ex post) enforcement of competition law. This would allow the CAA to adopt a phased approach to any reduction in sector-specific regulation, by increasing the resources devoted to the monitoring and enforcement of general competition law.
- 3.47 However, the CAA considers that – in line with the Government's proposals – the scope of the CAA's concurrent powers should be limited to the supply of airport infrastructure services at UK airports, and should not extend to the supply of airline services. The CAA's role in respect of the commercial operation of airlines is significantly less than that for airports, reducing the benefits that might be generated from extending the CAA's competition powers to cover airlines.
- 3.48 Whilst not discussed in the consultation document, the CAA sees merit in supplementing concurrent competition powers with the ability to make market investigation references to the CC, under the Enterprise Act. This would provide the CAA with a power to refer features of the airports market that adversely affect competition to the CC for further investigation. This, in turn, would enable the CAA to address features of the airports market that are not working well for consumers, armed with the ultimate power to refer issues to the CC for detailed formal investigation. Reflecting this broader focus, the CAA sees merit in defining the scope of these powers somewhat more broadly than for Competition Act concurrency, so as to ensure that action can be taken to address any features of the UK airports market that affect competition.

## Compliance and enforcement powers

- 3.49 The CAA supports the principles outlined in the proposal and the intention to put in place similar sanction and enforcement powers that apply to other regulated sectors in the UK.
- 3.50 The current regime lacks the flexibility afforded to other economic regulators and, as a result, limits the CAA's ability to respond in a proportionate manner to potential non-compliance. For example, under the current regime non-compliance with the airports accounts condition is a criminal offence requiring prosecution rather than enforcement through a regime of civil penalties. Further, the current regulatory framework only provides the CAA with limited powers to investigate non-compliance, or to compel the provision of information, including in some instances by limiting the CAA's powers to act only where it receives a complaint.
- 3.51 The CAA supports the proposal to grant the CAA the power to revoke an airport operator's economic licence. However, the CAA notes that such a sanction would be reserved only for the most egregious of abuses. This implies that the regulatory framework needs to provide the CAA with alternative – and less severe – sanctions, so as to enable it to adopt responses that are proportionate to the harm caused by the airport's non-compliance. For example, the CAA could be granted broad discretionary powers to apply financial penalties for non-compliance through civil powers. As these powers can be readily tailored to an estimate of the magnitude of the harm caused, they benefit from greater credibility that they will be applied in practice.
- 3.52 As such, the CAA supports the 'sliding-scale' approach to sanctions and enforcement based on a combination of both civil and criminal penalties, as this would provide the CAA with sufficient flexibility to encourage compliance and to impose penalties that are proportionate to the level of non-compliance. The CAA approach should be supplemented by clear information gathering powers to enable the CAA to undertake proportionate monitoring and, where appropriate, to undertake enforcement activity. The combination of this approach will enable the CAA more easily to implement the principles outlined in the Hampton and McCrory Reviews.

## 4. Ensuring accountability

- 4.1 A new regulatory regime will need to provide an appropriate degree of accountability, in order to establish confidence in the overall regime and to provide a stable framework to attract investment.
- 4.2 Accountability can be established in a number of ways, including through determining a clear set of statutory duties, the subject of chapter 2. This chapter focuses on two additional measures relevant to this objective: updating the appeals mechanisms (and making greater use of sunset clauses).

### Appeals mechanism

#### *The need to change the current regime*

- 4.3 The CAA welcomes the Government's proposals to modernise the current system of appeals. The CAA considers that, whilst the current framework – whereby price controls are automatically referred to the CC – provides considerable scrutiny of the CAA's proposals, aiding overall accountability, only limited rights of appeal are provided to affected parties to challenge the CAA's price cap decisions or the public interest findings made by the CC. In particular, these rights are limited to judicial review of the CAA's (or CC's) decisions and do not provide regulated companies with the right to reject a CAA decision, for example on price caps, and thereby prompt an independent review of the proposed decision (often referred to as an "appeal" to the CC).
- 4.4 More generally, the current split of responsibilities for airport regulation between the CAA and CC reduces the overall flexibility and accountability of the regime, whilst also resulting in a convoluted and time-consuming price control process.
- 4.5 Under a reformed regulatory framework, which should provide the CAA with greater flexibility and discretion to regulate airports, it is important to ensure that there is an appropriate balance between regulatory discretion and accountability. A modernised appeals regime could form a useful element to achieving an appropriate balance, whilst also offering the potential to streamline the current cumbersome process whereby price controls are automatically subject to review by two regulators.
- 4.6 However, while the CAA acknowledges the importance of appeals in ensuring the accountability of the regulator, they need to be seen in the context of other measures that hold the regulator to account, such as the regulator's accountability to Parliament, Judicial Review and ensuring that the regulator has a set of clear statutory duties.
- 4.7 Care, therefore, needs to be taken to ensure that updated appeals processes complement the overall package of reforms and, in particular, encourage

timely regulatory decisions that reflect the proposed statutory duties. It is, in short, important to ensure that the appeals regime improves regulatory decision-making and avoids providing affected stakeholders with a tool that can be used to protect their own commercial interests, rather than the interests of passengers.

- 4.8 To achieve this, reform of the appeals regime needs to address a number of challenges that have the potential to undermine rather than strengthen the transparency and accountability of the regulatory regime.
- 4.9 First, the appeals regime needs to be proportionate to the importance of the decisions that are being taken by the regulator, and their impact on consumers and other affected parties. Under a reformed regulatory framework, the CAA would be likely to be taking a number of different decisions, including deciding: whether an airport should be included within Tier 1; to introduce or modify licence conditions; and whether to take enforcement action against licence conditions or under general competition law. There should be no presumption that the same appeals processes would be appropriate for all of these decisions, and the CAA welcomes the Government's recognition of this important principle.
- 4.10 Second, it is likely that an appeal will expose a number of parties to additional costs and that these costs are likely to have a greater impact upon the licensed airport than on other affected parties. For example, the costs (including both internal as well as legal costs) of a substantive merits-based appeal whereby the CC undertook a complete re-assessment of the CAA's decision would fall mainly on the licensed airport operator, with individual airlines only facing a fraction of the costs. This asymmetry in incentives between the licensed airport operator and its airline customers need to be addressed by the appeals mechanism.
- 4.11 Third, regulatory decisions typically involve the exercise of a considerable degree of judgement where there is unlikely to be a single "correct" answer. This raises the practical question of how any award of costs would operate, as in many cases it will not be possible clearly to identify whether the appellant was "right" to trigger the appeal process. In addition, it increases the chance that an appeals body will – if it needs to reach its own, independent assessment of the answer – tend to depart, at least in some respect, from the original decision.

#### *Options for a reformed appeals regime*

- 4.12 When identifying the appropriate system of appeals, it is useful to distinguish between a number of different forms of appeal:
- **process appeals**, such as provided by Judicial Review;

- **merits-based appeal**, where the regulator’s decision (rather than the process it followed) is assessed to identify whether it reasonably discharges the relevant statutory duties; and
- **referral of a decision** to an alternative body for the decision to be re-assessed.

4.13 Whilst this distinction is somewhat stylised, it illustrates that there are a number of different ways in which an updated system of appeals could be introduced. In particular, the appeals regime needs to establish the appropriate degree of discretion to afford to the regulator. The current approach (Judicial Review) allows affected parties to challenge the merits of a decision only where a regulator has acted “irrationally”.<sup>30</sup> In contrast, the ‘referral’ approach used in other regulated sectors results in the regulators original decision being set aside and obliges the CC to retake the decision, without affording any further discretion to the regulator (which could in principle result in the same outcome, or one that differs slightly or substantially from that proposed by the regulator).

4.14 Between these two extremes, it is possible to construct a range of procedures whereby the regulator’s decisions will be subject to appeals to varying degrees, thus affording the regulator more or less discretion to take decisions that it considers best meet its statutory duties. For example, the appeals regime could permit appeals where the regulator has failed to demonstrate that it acted “reasonably”. These differences in approach are far from semantic, as they fundamentally affect the responsibility afforded to the CAA for the economic regulation of airports. Too much discretion could undermine accountability but too little could reduce the role of the CAA to such a degree that the appeals body becomes the *de facto* decision-making body.

4.15 Against this background, the CAA has considered the Government’s proposals for appeals processes for: the decision to move an airport into or out of Tier 1; and decisions to modify a Tier 1 licence condition.

#### *Whether an airport should be regulated under a Tier 1 licence*

4.16 The CAA supports the Government’s proposals to subject the decision to move an airport into or out of Tier 1 to a broad right of appeal. This is an important decision that has the potential substantially to affect the degree of regulatory oversight to which an airport is subject, with consequent impacts upon the interests of the airport operator, airlines and passengers. Moreover, such decisions are likely to be relatively infrequent, suggesting that the potential costs associated with a broad-based appeal are likely to be proportionate to magnitude of the decision.

---

<sup>30</sup> The other grounds for challenge mainly concern procedural matters.

- 4.17 This suggests that the right to appeal a decision to remove an airport from Tier 1 or to extend Tier 1 regulation to an additional airport could be extended to any affected party, including: the airport directly affected, any competing airports, affected airlines, nominated customer representative bodies (such as BATA or BARUK) and consumer representative bodies (such as AUC or Passenger Focus).
- 4.18 However, the CAA considers that the appeal should take the form of a ‘merits-based’ appeal, rather than representing a ‘referral’ of the decision to an alternative decision-making body for it to be re-assessed from first principles. Whilst the exact threshold for the appeal would need to be determined carefully, the CAA proposes that an appeal should be permitted if the CAA has failed to demonstrate that the original decision is “reasonable” when assessed against its statutory duties. A successful appeal would result in the decision being struck down, with the issue remitted to the CAA for further consideration.
- 4.19 Such an approach appears to be more closely aligned with that typically adopted by the Competition Appeals Tribunal (CAT). On this basis, and in light of the likely focus of these decisions on the degree of market power, the CAA supports the proposal for the CAT to be the appellate body.

#### *Appeals to modifications to Tier 1 licence conditions*

- 4.20 In contrast to the decision as to whether or not to apply Tier 1 regulation to an airport, the experience of other regulated sectors suggests that licence modifications are likely to be much more frequent than changes to the scope of detailed economic regulation. In addition, under a flexible, licence-based framework, licence modifications could be used to implement a very broad range of regulatory interventions, on price, service quality and investment. For example, they could be used to introduce price controls, to implement updated price controls (as part of a periodic review) and also to address particular service quality problems. The appeals regime needs to reflect this diversity and ensure that it does not undermine the flexibility that a licence-based regime can bring.
- 4.21 The consultation document seeks views on three different options, which are discussed in turn below.

#### *Option 1 – extending broad rights of appeal*

- 4.22 Option 1 would result in the extension of the right of appeal against any licence condition change to all affected parties, including the airport licensee, airlines and customer representatives. Presumably, to the extent that competing airports were also affected, they would also enjoy these appeal rights
- 4.23 This option provides the greatest degree of scrutiny of the regulator’s decisions, but consequently also the lowest degree of discretion to the

regulator to take decisions that it considers best meet its statutory duties. Depending upon the detail of how the appeal is structured, this approach could undermine timely and efficient decision-making, prompting appeals whenever the commercial interests of any party are harmed. This risk is particularly acute if the appeal takes the form of a ‘referral’ of the decision to another body for a new assessment from first principles. Such an appeal would be time consuming and be likely to result in a final decision that – to some degree at least – differed from the CAA’s. In such circumstances it would be difficult to identify whether the appeal was “successful” and so to award costs against the unsuccessful party. Without a clear award of costs, there would be no effective deterrent against a party triggering an appeal simply to delay the implementation of a measure that was not in its commercial interests.

- 4.24 An alternative approach to appeals under Option 1 would be to adopt the ‘merits-based’ model set out in paragraph 4.12, whereby affected parties would be granted the right to challenge whether decisions were “reasonable”. Importantly, restricting an appeal in this way would afford the regulator an appropriate level of discretion as to how to translate its statutory duties into detailed proposals. Such an approach would also introduce a clearer notion of whether the appeal was “successful” and thus provide for the award of costs, reducing the risk of vexatious appeals.
- 4.25 This latter approach would also have the benefit of reducing the overall cost burden of the appeals process and meet the Governments stated aim of reforming the current process whereby all issues are automatically reviewed by the CC. A broad-based right of appeal combined with a ‘referral’ for reassessment would have the practical effect of near-automatic appeals to the CC, reflecting the asymmetrical distribution of costs faced by the licensee, the low cost to triggering an appeal and the likelihood that regulatory decisions are unlikely to align with the commercial interests of all parties. This would fail to address one of the current shortcomings of the regulatory framework, namely the division of roles and responsibilities between the CAA and CC, as appeal would be likely to become a semi-automatic feature of the regulatory process. Moreover, due to the asymmetrical distribution of costs, the possibility of appeal by airport customers could affect relationships between the airport operator and customers, adding to the distortions and costs of regulation.

#### Option 2 – providing appeal rights to the licensee

- 4.26 Option 2 would extend the right of appeal on all licence conditions only to the airport licensee. If this approach mirrored that adopted in other sectors, this would take the form of a ‘referral’-type appeal, with the CC setting the original decision aside and taking the decision afresh.
- 4.27 The main benefit of such an approach is that it affords the right of challenge the regulator’s decisions to the party most directly affected. In addition, it

reflects the fact that an appeal typically exposes the regulated company to considerable cost and uncertainty.

### Option 3 – providing the right to appeal a change in a charging principle

- 4.28 Option 3 supplements option 2 with an ability for affected parties to appeal either an airport operator's charging principles and/or a statement by the CAA of the "fundamental" principles upon which price control decisions are based. These two options focus on two very different issues, and are discussed separately below.
- 4.29 The first aspect of Option 3 would involve placing an obligation on the airport operator to codify a set of charging principles. Changes to this set of charging principles would then be subject to some form of appeals mechanism. The principal problem with this proposal is that it appears only to envisage regulation in the form of price control. This would significantly reduce the ability of the regulator to tailor regulation to the individual circumstances of each airport. So, whilst the CAA considers that it should be permitted to introduce a charging principles licence condition, it does not support limiting the flexibility of the overall regime by making this a requirement of all Tier 1 airports.
- 4.30 The second element of Option 3 would be to require the CAA to identify a set of "fundamental principles" against which modifications could be appealed. The consultation document does not define further what form such a statement would take, the required specificity of the statement or what constitutes a change in a "fundamental" principle. The CAA considers that a workable approach would need to restrict the list of "fundamental principles" to a limited number of high-level issues, clearly differentiated from the decisions that the regulator takes in the course of undertaking a periodic price control review. Such high-level issues could include:
- the choice between a single till and a dual till approach;
  - the choice between a stand alone and a system regulation approach; and
  - the decision whether to apply a price cap or to restrict regulatory intervention to price monitoring.
- 4.31 The CAA considers that the lack of differentiation in the current proposals could introduce considerable risk that the regulatory framework became inflexible and/or unworkable in practice. It therefore encourages Government to clarify its proposals to address these risks.

### *Summary – appeals processes*

- 4.32 The CAA supports reform to the current system of appeals. However, care must be taken to avoid introducing a system that undermines flexibility and introduces unwarranted cost and uncertainty.

- 4.33 The success of the appeals regime will depend upon how the various aspects of the detailed design interact and whether these provide a balanced set of incentives to all parties whilst also improving overall accountability.
- 4.34 With this in mind, the CAA recommends that, at this stage, the Government focuses on developing an appeals regime that establishes an appropriate balance between the 'breadth' of the right of appeal and the 'depth' of the scrutiny undertaken by the appeal body. In particular, the CAA considers that the Government should rule out the combination of a very broad appeal right with a very deep level of scrutiny, as such a combination appears likely to undermine the success of the overall regime.
- 4.35 However, there appear to be a range of alternatives – with either more limited appeal rights (i.e. limiting the 'breadth') or alternative forms of scrutiny by the appeals body (i.e. limiting the 'depth')– that might provide a more balanced approach. Further analysis should focus on how best to combine these two factors.

### **Maintaining proportionate regulation and the use of sunset clauses**

- 4.36 The experience of other sectors suggests that over time there is a tendency for licences to become increasingly complicated. This has prompted some regulators to launch reviews with the aim of simplifying these licences. Against this background, and to ensure that regulation remains proportionate, the CAA proposed in its earlier submissions to the Government's review a number of ways of mitigating the risk of regulation becoming disproportionate, including the use of sunset clauses, the inclusion of the Principles of Better Regulation into the regulatory regime, and other checks and balances.
- 4.37 The CAA, therefore, agrees with the Government that the regulator should review the necessity of applying a Tier 1 licence at regular intervals. Such a proposal is consistent with the Government's proposal to give the CAA an obligation regularly to review its regulatory burdens and remove regulation where it has become unnecessary (see paragraph 2.106 above). As discussed above, the CAA considers that such an obligation could be laid down in primary legislation. The use of sunset clauses could provide an automatic prompt for such reviews of the necessity and form of regulation and individual licence conditions at appropriate intervals.
- 4.38 However, the CAA cautions against prescribing the frequency of these reviews, as this will vary depending upon the nature of each piece of regulation and how rapidly relevant circumstances might be expected to change.

*(page left intentionally blank)*

## 5. Passenger representation

- 5.1 The CAA welcomes the Government's emphasis on placing passengers (and other consumers of air transport services) at the heart of the regulatory system. This is supported both by the proposals to give the CAA a clear primary duty to passengers and by reinforcing the role of the representative body.
- 5.2 In addition, under the current regulatory framework, the CAA has taken a number of steps to ensure that the CAA's regulation appropriately reflects passenger interests. For example, the CAA has recently carried out an internal review of its approach to consumer policy and made a number of recommendations for strengthening and broadening the scope of passenger representation at the local and national levels.
- The CAA should increase the amount of research and evidence gathering it undertakes on consumer issues to inform its regulatory decisions. This could usefully be complemented by research undertaken by the passenger representation body.
  - The national passenger representation body should increase its direct links with UK airports, most obviously through the passenger services subcommittees at the UK's four largest airports: Heathrow, Gatwick, Stansted and Manchester. In this way, the consumer body could better tap into and understand the significance of passenger issues at these large airports and determine whether there are issues across these airports that should be addressed. It should then use its profile and influence to promote the passenger interest at these airports. The passenger representation body could also usefully develop procedures to identify any significant passenger issues at airports across the UK.
  - The passenger representation body should be provided with additional resources to research passenger issues in air travel so that it can provide evidence of passenger issues (including consumer detriment) to prioritise its work.
- 5.3 The CAA supports the Government's proposals to enhance and strengthen the role of the passenger representation body and for it to assume the two complementary functions of complaints handling and consumer advocacy. A strong passenger representative body, with expertise in services provided by airlines, airports and other service providers in air travel, is important to complementing the CAA's developing consumer policy role.
- 5.4 The CAA notes the Government's proposals to make passenger representation in aviation part of the passenger representation body for rail and bus, Passenger Focus. However, before deciding upon the appropriate institutional arrangements for the consumer representative body, it would be useful to first define clearly the roles that should be undertaken and then to consider which body should take on these roles.

- 5.5 The CAA recognises the Government's arguments about the advantages of such a joint passenger representation body, in particular the ease of reference for passengers to one single consumer body in transport and that there are overlaps and interfaces between different modes of transport. However, the CAA believes that the Government's proposals also need to consider carefully some sector-specific aspects of aviation when developing detailed proposals for the future form of passenger representation.
- 5.6 In particular, there are a number of relevant differences between aviation and other modes of transport such as bus and rail that affect the appropriate role of, and approach adopted by, the consumer body, some of which are set out below.
- Aviation is a private and highly competitive industry whereas rail and bus are largely subsidised by Government with often limited competition. This means that consumers already have significant choices as to their carrier, class of travel and airport, providing consumers themselves with a means by which their voices are heard. The CAA notes that Passenger Focus has also recently taken over responsibility for coach services where there is greater competition than in the rail and bus sector. Nevertheless, there will clearly be a need for Passenger Focus to develop its approach to deal with the issues arising in the aviation industry.
  - Surface transport services largely operate domestically whereas aviation is largely operated internationally, with a large body of international legislation and standards applying to it that would need to be well understood by the passenger representation body.
  - Consumers of aviation services are not limited only to air passengers but also include consumers of airfreight and mail services. This consumer group is distinct in its needs and characteristics from passengers. Unless the remit of the passenger representation body were broadened, there would be a need to recognise that the CAA's responsibilities are framed more broadly.
  - The CAA already undertakes an extensive passenger survey which – although not primarily focussed on consumer-related issues – has been used as a cost-effective means by which to obtain information about passenger preferences and views.
- 5.7 Competition between airlines and between UK regional airports has served consumers well and it will fall to both the CAA and the passenger representation body to ensure that the potential benefits from the break-up of BAA flow to consumers.
- 5.8 The proposal to transfer the (updated) role of the passenger representative body to Passenger Focus would also need to address a number of practical problems, for it to be successful. One particular issue is funding. The

consultation document suggests that the representative body for aviation passengers is funded through the airport licence fee. This is potentially an equitable mechanism for ensuring that the costs are spread across the industry.

- 5.9 However, Passenger Focus is currently funded by central Government, which raises the issue of how the two different funding schemes would interact. It would appear to be difficult to have separate funding arrangements for passenger representation in the different modes within a single organisation, without complex cost allocation and apportionment systems. Careful consideration must be given to providing transparency and accountability of expenditure, without becoming disproportionately costly, to ensure that the aviation industry does not end up funding work relating to rail and bus passengers. Whilst this would reduce the direct burden of Passenger Focus on central Government funding it would not be equitable and would risk unfairly disadvantaging UK airlines relative to non-UK airlines (even where these airlines were competing on identical routes, potentially wholly within the UK).
- 5.10 In light of the need to analyse and consider these complex issues in greater detail, the CAA looks forward to further engaging with Government and the AUC to developing further proposals on passenger representation.

*(page left intentionally blank)*

## Annex A. Detailed responses to the consultation questions

### Chapter 6 - Statutory remit for the economic regulation of airports

**Q6.1** *Does the proposed hierarchy of the duties – with a single primary duty supplemented by a set of further duties that the regulator should also consider when seeking to achieve its primary duty – provide sufficient certainty over the regulator’s priorities? Are there alternative arrangements which would provide additional regulatory clarity?*

A6.1.a The CAA welcomes the Government’s proposals for introducing a single primary duty towards consumers, supplemented by a set of secondary duties. Such a structure is consistent with that of other sectoral regulators and provides clarity about the primary purpose of economic regulation – the interests of consumers.

**Q6.2** *(a) Do you agree with the proposed primary duty? Do you have any comments on the drafting of the primary duty?*

A6.2.a The CAA welcomes the Government’s proposal to put consumers at the heart of economic regulation through framing the primary duty in this way.

A6.2.b The proposed primary duty rightly focuses on:

- consumers of air transport services at all UK airports, not just at those being regulated; and
- both existing and future consumers. This is particularly important given that investment decisions have a significant long-term impact on the quality of service being delivered for years to come in the future.

A6.2.c The CAA also welcomes the Government’s proposal that the duty should include a reference to competition as the best means available to promote the interests of consumers. The prospective break-up of BAA presents a unique opportunity for enhanced airport competition. The regulatory framework needs to support the development of such competition.

A6.2.d Regarding the drafting, the CAA suggests that the primary duty refer to “consumers of air transport services” instead of “consumers of passenger and freight services”, to ensure that all possible consumers are captured. Alternatively, the CAA suggests replacing “freight services” by “cargo services”, so as to include mail transport services, which are distinct from freight services.

**(b) Do you agree with the proposed approach of putting the passenger experience at the centre of the regulatory regime with additional rights for airlines and enhanced consumer representation?**

A6.2.e As discussed above, the CAA strongly agrees with the DfT’s proposals aimed at putting consumer interest at the heart of economic regulation.

- A6.2.f The CAA considers that the active participation of airlines is an essential part of the regulatory process. By virtue of their relationship with passengers, airlines (and airports) will continue to be important stakeholders when implementing economic regulation. Airlines (and airports) inevitably know more about their passengers' preferences than the regulator. So without their active involvement in the regulatory process, regulation of airports would be less likely to achieve outcomes that are in passengers' interests. The CAA would expect any regulatory system to continue the current approach of formal consultation supplemented, where appropriate, by processes such as constructive engagement, and by a range of less formal discussions with airlines (and other stakeholders).
- A6.2.g As such consultation is consistent with the principles of Better Regulation, the CAA does not consider that consultation with airlines needs to be framed in the statutory duties. The CAA also notes that no other regulator has such a duty, although other regulators also consult extensively with stakeholders, including intermediate suppliers and customers of the regulated businesses.
- A6.2.h The CAA acknowledges that the new regime should address some of the weaknesses of the current regime regarding the scope for stakeholders to appeal regulatory decisions. Under the current regime, the CAA's price control decisions can only be appealed through Judicial Review. The Government's proposals regarding a reformed appeals mechanism are discussed further in response to questions Q8.1-3.
- A6.2.i The CAA supports the Government's proposals to enhance and strengthen the role of the passenger representation body. A strengthened consumer body could usefully complement the CAA's own research of consumer issues to inform regulatory decisions. The Government's proposals regarding a reformed passenger representation body are discussed further in response to questions Q10.1-2.

***(c) Is promoting effective competition the best way to promote the interests of consumers of airport services?***

- A6.2.j The CAA agrees with Government that competition is the best way to promote the interests of consumers and therefore welcomes the Government's proposal to reflect this in the primary duty, and that regulation should therefore aim to promote competition where possible. This would bring this important statement of the purpose of the economic regulation of airports into line with the formulation used in the other major sectors subject to independent economic regulation.
- A6.2.k Evidence that competition is indeed the best way to promote the interests of consumers of airport services can be found in the UK's regional airports market that exhibited strong growth, contributing to more choice between routes, airlines and service levels to consumers. In addition, the CC's report on BAA also recognised the potential for more competition in the South East and recommended the break up of BAA in order to permit this competition to develop. This has the potential to benefit passengers and to provide

sharper incentives to airports to innovate and to invest in improved service quality and capacity. Regulation needs to recognise and support this transition to a more competitive market by providing a framework which can adjust regulation as competition develops, so that it does not hinder changes in the market.

**Q6.3 *Do you agree that it is appropriate for the economic regulator of airports to have regard to environmental limits?***

A6.3.a Please refer to paragraphs 2.87 to 2.104 of the main document for a discussion of the Government's proposals regarding environmental issues, in particular paragraphs 2.87 to 2.95 for a general discussion of the relationship between economic regulation and environmental regulation and policy.

***Does the proposed duty provide sufficient clarity over the respective roles of the Government and the CAA? Does the proposed duty risk compromising the clarity of the regulator's primary duty?***

A6.3.b Please refer to paragraphs 2.97 to 2.99 for a discussion of the proposed secondary duty.

**Q6.4 *Given the proposed primary duty to promote the interests of consumers, is it necessary to have a further duty to ensure that all reasonable demands are met efficiently?***

A6.4.a The CAA does not have strong views about a secondary duty framed in this way. Meeting all reasonable demands in an efficient manner would clearly be in consumers' interests, so such a duty would be closely aligned with the primary duty towards consumers' interests.

A6.4.b By the same token, however, the CAA does not see a clear additional benefit from having such a secondary duty over and above the primary duty, as the proposed secondary duty would not change the way the regulator would carry out its functions under its primary duty to promote the interests of consumers. To avoid unnecessary duplication, the CAA suggests that such a duty is not required to ensure that reasonable demands are met.

A6.4.c If the Government were minded to introduce this duty, the CAA recommends clarifying the definition of "reasonable demands". The CAA interprets this phrase as referring to demands for airport services that are backed by consumers' willingness to pay in a well-functioning competitive airport market.

**Q6.5 *Given the proposed primary duty to promote the interests of consumers, is a further financing duty required?***

A6.5.a The CAA does not consider that it would be in consumers' interests to adopt a financing duty, or any accompanying measures such as Special Administration and licence conditions regarding financing. On the contrary,

the CAA has serious concerns about the effects on the allocation of costs and risks associated with airports' specific financing structures such a duty and the accompanying measures might have.

A6.5.b The main document discusses in detail the Government's proposed package of measures on financial resilience of airports, including the risks and costs accompanying these proposals, and sets out an alternative approach that builds on the CAA's current approach to airport financing. Please refer to paragraphs 31 to 37 of the summary and to paragraphs 2.10 to 2.61 of the main document.

**Q6.6 *What is the appropriate interpretation of a financing duty in the airports sector?***

A6.6.a The CAA generally agrees with the approach to assessing financing on a notional basis in the context of a RAB-based price control as set out in chapter 6 of the consultation document. It mirrors the CAA's current approach to assessing the cost of capital in the context of RAB-based price controls. However, the described approach is very limited, as it is only applicable in the context of RAB-based price controls.

A6.6.b As set out in response to the previous question, the CAA does not consider that a financing duty would be beneficial.

**Q6.7 *Does the proposed duty [to take account of guidance issued by the Secretary of State, and to assist in the delivery of airport infrastructure consistent with the National Policy Statement on Airports unless there are compelling reasons not to do so] provide the right balance between the roles of the Government and the CAA? Does the proposed duty risk compromising the clarity of the regulator's primary duty?***

A6.7.a The main document contains a detailed discussion of the proposed secondary duty for the CAA to "assist in the delivery of airport infrastructure consistent with the National Policy Statement on Airports unless there are compelling reasons not to do so". Please refer to paragraphs 2.62 to 2.86 of the main document.

**Q6.8 *We would welcome comments on the appropriateness of the proposed duties and in particular, whether they will allow for an effective and efficient regulatory regime that meets the Secretary of State's objectives for the Review. In considering the proposed duties stakeholders may wish to respond particularly on:***

- ***Whether the proposed duties provide a sufficiently clear framework for the CAA to operate within?***
- ***Whether the proposed hierarchy and number of duties for the CAA are appropriate?***
- ***Whether there are other factors or issues that should be included in additional specific duties?***

- ***Whether the initial draft wording for the duties is appropriate.***

***Whether the proposed duties provide a sufficiently clear framework for the CAA to operate within?***

- A6.8.a The proposed primary duty provides clarity that consumer comes first, and that competition would be the best way to achieving this goal.
- A6.8.b In principle, the proposed hierarchy of having one clear primary duty and other secondary duties contributes to clarity. Secondary duties can in principle help clarify the way in which a regulator would be expected to promote the interests of consumers. A good example of this is a secondary duty towards principles of better regulation.
- A6.8.c But secondary duties can also have adverse effects and create uncertainty. This would be the case where following the secondary duty could be inconsistent with the primary duty. An example could be following the NPS where the NPS promotes public interests that may not be consistent with consumer interests.
- A6.8.d Secondary duties can also create uncertainty about the regulator's actions if there is no clear match between duties and powers. An example could be an environmental duty but without the regulator having any specific tools or powers to deliver on this duty.
- A6.8.e Secondary duties can also create uncertainty if there is no clear interpretation of a duty. An example could be a financing duty. Although the DfT provided an interpretation, this is not the only one, and different market participants could rely on different interpretations.

***Whether the proposed hierarchy and number of duties for the CAA are appropriate?***

- A6.8.f As commented above, the CAA supports the hierarchy proposed by the DfT, that is to have one primary duty and a number of subordinate secondary duties.
- A6.8.g Regarding the number of duties, the CAA considers that clarity is enhanced by a small number of duties only. Equally, where secondary duties are an inevitable corollary of the primary duty, the CAA recommends that it is preferable to avoid duplication and drop those secondary duties.

***Whether there are other factors or issues that should be included in additional specific duties?***

- A6.8.h The CAA does not consider that other duties are necessary.

***Whether the initial draft wording for the duties is appropriate.***

- A6.8.i The CAA commented on all duties but one in response to the previous questions. The secondary duty yet to be addressed is the duty *“to have regard to principles of better regulation and any other principles appearing to represent the best regulatory practice, and to consult with stakeholders, including airlines.”*
- A6.8.j As set out in paragraph 2.105 of the main document, the CAA welcomes the Government’s proposal that the CAA should have a duty to have regard to the principles of Better Regulation. This would follow best practice in other regulated sectors and would replace the CAA’s current duty “to impose the minimum restrictions necessary consistent with performance by the CAA of its functions”. The CAA considers that these two formulations should have broadly the same effect (e.g. targeted and proportionate regulation), but as the principles of Better Regulation have become a well established and understood guideline, the CAA agrees that they should be incorporated in its statutory duties.
- A6.8.k The second part of the proposed duty would place a specific duty on the CAA to consult with stakeholders, including airlines. The CAA considers that a requirement to consult properly with stakeholders is inherent in the application of the Better Regulation principles around transparency and accountability. Including such a requirement as an explicit duty could increase administrative complexity, as legislation would need to specify the circumstances in which, and stakeholders with whom, the CAA would be under an obligation to consult. The CAA is not aware of any other economic regulator having a similarly general duty to consult included in its statutory remit. The CAA would therefore recommend not including this in its statutory duties.
- A6.8.l For the avoidance of doubt, the CAA will in any case continue, in line with best regulatory practice, involving – and consulting with – affected stakeholders in its regulatory decision making processes.
- A6.8.m The consultation document further proposes to introduce a duty – through an amendment to the Regulatory Enforcement and Sanctions Act 2008 (RESA08) or through primary legislation<sup>31</sup> – on the CAA regularly to review the regulatory burdens it imposes (with regard to economic regulation), to reduce any that are unnecessary and to report on its progress annually. This is discussed in the main document in paragraphs 2.106 to 2.108.

---

<sup>31</sup> The CAA notes that other economic regulators are subject to the relevant provisions of the RESA08. Therefore it would seem reasonable to apply the relevant provisions also to the CAA’s economic regulatory activities for airports. However, the CAA sees some attraction in seizing the opportunity that the reform of the regulatory framework offers to ensure that all duties are specified in one single place. Therefore, the CAA would regard provisions in primary legislation governing the CAA’s remit and function as the preferable mechanism to introduce such requirements.

## Chapter 7 - Designing a flexible, fair and effective enforcement regime

### Q7.1 *Do stakeholders agree with the proposed approach to developing a new licensing regime for airports?*

- *Do you agree with the proposed tiers for the licenses, including the criteria and thresholds that will be used to determine which tier an airport will be in?*
- *Do you agree that the criteria for determining whether an airport has a Tier 1 licence should be enshrined in Primary Legislation?*
- *Do you agree that the regulator should retain the option of regulating small airports that have substantial market power with a Tier 1 licence, including a price control, subject to the satisfaction of the criteria set out above and the appeal process?*
- *Do you agree that the regulator should be able to impose a Tier 3 licence on certain small airports that would allow market power at these airports to be addressed whilst stopping short of price control?*

A7.1.a The CAA supports the DfT's proposal to introduce a licence-based regime whereby airports are regulated through imposing licence conditions. It affords the regulator with the flexibility to apply proportionate and targeted regulation and addresses some of the main weaknesses of the current regime, namely:

- the restricted flexibility around the regulatory 'tools' applied to airports;
- the restricted flexibility around the airports to which additional regulation is to be applied or for which regulation can be relaxed; and
- the prescribed five-yearly time frame for reviews of the price controls imposed on designated airports.

A7.1.b The main document discusses in detail the Government's proposals for a tiered licence regime. It includes a modified approach that the CAA considers would better meet the Government's objectives to target detailed economic regulation only to those airports that warrant such regulation and to ensure that the framework implements current and prospective European legislation. Please refer to paragraphs 3.4 to 3.41 of the main document.

#### *Statutory undertakers*

A7.1.c The consultation document is not clear whether the prospective licences would replace the current permissions to levy airport charges, or whether Government intends to retain this process in parallel to the licensing regime. This is discussed in the main document in paragraphs 3.42 to 3.44.

**Q7.2 Do you agree with the principle of using the proposed licence regime for the economic regulation of airports to implement certain aspects of the Airport Charges Directive?**

A7.2.a As discussed above in response to Q7.1, the CAA welcomes the intent of the Government's proposal to implement the Airport Charges Directive (ACD) through the licence regime and implement many of the provisions (where possible) through licence conditions on airports. However, as noted above, rather than determining both the conditions and scope of a Tier 2 licence through the ACD alone, the CAA believes there is an alternative approach to a licensing regime that will build a framework that is more robust to future changes in EC regulation. The details of this alternative approach are set out in paragraphs 3.24 to 3.27 of the main document.

**Q7.3 We would welcome comments on these initial thoughts about the conditions that should be included in the license for each tier.**

*Licence conditions for Tier 1 airports*

A7.3.a The CAA welcomes the DfT's proposal that the regulator should have the flexibility to apply a wide variety of licence conditions where doing so constitutes proportionate and targeted regulation. The proposed conditions to be contained in a Tier 1 licence are discussed in the main document in paragraphs 3.20 to 3.24.

*Tier 2 licence provisions*

5.11 The main document discusses the proposed Tier 2 licence conditions as well as the CAA proposed modification in paragraphs 3.26 to 3.29.

5.12 The proposed environmental reporting condition is discussed in paragraphs 2.100 to 2.104 of the main document.

*Tier 3 licence provisions*

5.13 As discussed in the main document, the proposed Tier 3 is not clearly defined either by reference to thresholds or possible licence conditions. The CAA does not consider a Tier 3 to be necessary or indeed proportionate.

**Q7.4 We view the introduction of the proposed licensing regime as being beneficial to consumers although we understand that there will be associated implementation costs. What do you think the likely scale and value of these costs will be?**

A7.4.a The CAA noted the Impact Assessment published alongside the consultation document. The CAA has been preparing initial costing estimates for the implementation and operation of the DfT's proposals for the new regime that it previously shared with Government and is looking forward to engaging with the DfT to developing further the Impact Assessment. A summary is provided below.

- A7.4.b Apart from direct administration and implementation costs resulting from the proposed new regime, the CAA urges the DfT also to consider costs arising from interventions in markets and competition, either by the regulator or by the Government, that are not yet included in the current Impact Assessment.
- A7.4.c The CAA is looking forward to engaging further with the DfT on the technical detail of the Impact Assessment.

#### CAA cost estimates

- A7.4.d The CAA notes that its economic regulation unit has to date maintained a comparatively low cost base, and the CAA has no interest to expand its organisation beyond what is absolutely necessary. As the CAA is funded through fees levied on industry, its cost base is also subject to regular challenge from industry stakeholders – a process which has proved to be an effective discipline on costs over the years.
- A7.4.e Estimates of additional CAA costs arising from the implementation of the DfT's proposals for a new regulatory regime vary greatly depending on assumptions about the implications of some of the DfT's proposals where these are not yet fully formed.
- A7.4.f The CAA provided cost estimates for three scenarios about the potential future requirements of the new regime. The assumptions underlying the three different scenarios are summarised in table 1 below.

CAA response to DfT consultation on economic regulation of airports

	Assumptions on...	Low	Central	High	Notes
Duties	Interpretation of secondary duty on environment	No additional requirements on CAA.		CAA required to take action to ensure compliance with any environmental regulation or to incorporate non-monetised environmental externalities in its regulatory decision-making.	
	Interpretation of secondary duty on financing	The CAA has discretion whether or not to apply ring fencing and other financing conditions to tier 1 airport licences.		Pessimistic case: <b>all</b> tier 1 licences have to include ring fencing and other financing conditions.	
	Interpretation of secondary duty regarding investment	CAA assesses investments as it does currently		CAA needs to undertake additional analysis to justify decisions taken against investments defined in the NPS	Although the “optimistic” case would cost the CAA less, we don’t think that this would be in alignment with the CAA’s primary duty.
	Interpretation of secondary duty on consultation	The CAA designs its consultation processes as it sees fit.		If CAA were required to intervene more in airport/airline negotiations, this could require some additional resources and expertise.	
Licence regime: set up, operation and enforcement	Development of airport market	Faster than expected development of competition allows “de-designation” of LHR and LGW early.	Competition develops gradually	Development of competition is held up and develops more slowly than expected. Additional airports are “designated”	Regulation can be withdrawn the more competition develops in the South East (both inter and intra airport competition)
	Number of concurrency cases	Few cases arise due to effective deterrent effect and/or increased competition.	Some cases arise	Awareness of competition act results in a higher number of cases.	There could be some trade off involved between sectoral regulation and application of concurrent powers – the less regulation, the more competition cases? The number of cases might also depend upon how effective the development of competition is in practice.
	Compliance, enforcement and sanctioning mechanisms, including financial penalties	Compliance and enforcement mechanism based on complaints-driven approach.	Some degree of regular monitoring involved	Extensive proactive auditing and monitoring	The DfT’s proposals do not in detail outline the compliance and enforcement mechanisms and requirements. For example, a complaints-based regime would be less resource intensive than a regime involving regular audits and monitoring.

CAA response to DfT consultation on economic regulation of airports

Ctd.	Assumptions on...	Low	Central	High	Notes
Appeals	Mechanism – likelihood of vexatious appeals	No room for stakeholders to game the system	Some vexatious appeals	Stakeholders game the system extensively	The number of appeals will also depend on the group of stakeholders given the right to appeal licence condition modifications
Special administration	Impact on financing	Special administration does not trigger significant re-financing by BAA and requests for price control re-opener. BAA does not seek significant reappraisal of cost of capital CAA able to maintain current approach to regulation.	Special administration triggers significant re-financing by BAA and requests for price control re-opener. BAA seeks significant reappraisal of cost of capital. Prompts need for CAA to reappraise approach to regulating financial structures.		
Reformed consumer representation and enhanced consumer policy role for CAA	Degree of enhancing the CAA's consumer policy role	Develop consumer policy role as proposed by CAA review	Develop consumer policy role "significantly" beyond this", including CPG taking on role of "critical friend"	Develop consumer policy role as in central case, and a part of the current AUC is retained as an internal "critical friend"	Making consumer advocacy and complaints handling for aviation part of Passenger Focus is likely to have implications for the CAA's en route charges that currently recover some of the cost for the AUC.
Environmental reporting	Degree of CAA control and oversight	CAA does not take an active role beyond ensuring compliance with publication requirement		CAA audits environmental reporting and ensures environmental compliance by airport operators	This is linked to the interpretation of the secondary duty on the environment above.
Service quality reporting	Degree of CAA control and oversight	CAA does not take an active role beyond ensuring compliance with publication requirement		CAA audits reporting	This is linked to "tougher" compliance monitoring above.

*Low case*

A7.4.g The low case scenario represents the lower bound of the possible additional cost for the CAA – in other words it represents the unavoidable cost resulting from the DfT's proposed new regime.

A7.4.h The overall resource requirement for the CAA in the low case is 9-10 additional Full Time Equivalents (FTE) and an additional research budget of £40,000-£80,000 on an ongoing basis, and 2.5-3.5 additional FTE one-off requirements. Additional costs in the low case are mainly driven by additional resources for the operation of the new licence-based regime and the implementation of the CAA's enhanced consumer policy role. Assuming costs per FTE of £80,000<sup>32</sup>, this equates to £760,000-880,000 yearly additional costs and £200,000-280,000 one-off costs.

*Central case*

A7.4.i The central case represents the CAA's realistic expectation of required additional funding as it modifies some of the optimistic assumptions of the low case. In particular, a greater competition and appeals case load than in the low case is assumed, higher costs for compliance and enforcement activities as well as a further strengthened consumer policy role.

A7.4.j The overall resource requirement for the central case could range between 13-17.5 additional FTE, an additional research budget of £40,000-£80,000 and £200,000-£300,000 costs for external consulting and legal services on an ongoing basis, and 6-8 additional FTE one-off requirements. Assuming costs per FTE of £80,000, this equates to £1,280,000-1,780,000 yearly additional costs annually and £480,000-£640,000 one-off costs.

*High case*

A7.4.k The high case scenario represents the upper bound of the possible additional cost for the CAA. It depends on a number of assumptions that the CAA currently regards as unlikely, but they depend, at least in part, on the further development of the DfT's proposals and may thus be helpful to DfT in refining further its proposals. These include:

- mandatory application of financial resilience licence conditions;
- very high competition and appeals case load;
- an active role on environmental issues; and

---

<sup>32</sup> This figure reflects the direct employment costs (such as salary, pension, National Insurance, bonus) and some variable overhead, but it excludes for example full overhead costs for the CAA's corporate functions. If the number of FTE were to increase by a relatively large number, this may cause step increases in some overhead costs, for example for renting additional accommodation. Such costs are not included in this figure.

- retention of AUC to take the internal role and a “critical friend” to represent consumer views.

A7.4.l The overall resource requirement for the high case could range between 42-48 additional FTE, an additional research budget of £40,000-£80,000 and £500,000-£1,000,000 costs for external consulting and legal services on an ongoing basis, and 5-7 additional FTE one-off requirements. Assuming costs per FTE of £80,000, this equates to £3,900,000-£4,920,000 yearly additional costs and £400,000-£560,000 one-off costs.

A7.4.m The wide range of these estimates (ranging between £750,000 and £5m annual additional costs) illustrates that the proposals for the new regime need to be further defined before coming to final decisions, to give greater clarity about their cost impacts and consequently the overall balance of costs and benefits.

**Q7.5 We would welcome comments on the proposed process for changes to licence conditions. We would particularly welcome comments on the proposed process for collective licence modifications.**

- **Do you agree that in a reformed regulatory regime the Secretary of State should retain the right to refer changes to licence conditions, even where agreed by the licensee, to the Competition Commission? Is this an appropriate scope for an intervention power for the Secretary of State?**
- **Do you agree that where a proposed change of licence condition would apply identically to a group of airports that this change would come into effect if it was accepted by 80% of these airports representing 80% of total passenger numbers across the group?**

**Do you agree that in a reformed regulatory regime the Secretary of State should retain the right to refer changes to licence conditions, even where agreed by the licensee, to the Competition Commission? Is this an appropriate scope for an intervention power for the Secretary of State?**

A7.5.a The Government’s wider proposals for a reformed appeals mechanism are discussed in the responses to the questions on Chapter 8 below, including the range of stakeholders that should have a right to appeal regulatory decisions.

A7.5.b If the reformed framework for appeals ensured a sufficient level of accountability and recourse for affected parties, it is not clear to the CAA which gap the Government intends to address with the proposed right for the Secretary of State to refer changes to licence conditions to the CC.

A7.5.c The CAA notes that in other sectors, the Secretary of State has powers to veto proposed changes to licence conditions and refer them back to the sectoral regulator. It is not clear to the CAA why the Government did not propose the same mechanism for the airports sector.

A7.5.d The CAA therefore recommends that the Government clarify further:

- first, the gap in the new licence regime with a reformed appeals mechanism that such a reserve power for the Secretary of State is intended to address; and
- second, the differences between the airport sector and other regulated sectors that require changes of licence conditions being referred to the CC instead of back to the CAA.

A7.5.e Unless Government has identified significant gaps in the accountability, the CAA does not consider that such a reserve power for the Secretary of State is proportionate. On the contrary, it could even serve to increase the regulatory uncertainty if there was no clear and transparent guidance from Government about how the Secretary of State would consider whether or not to refer individual changes of licence conditions to the CC.

***Do you agree that where a proposed change of licence condition would apply identically to a group of airports that this change would come into effect if it was accepted by 80% of these airports representing 80% of total passenger numbers across the group?***

A7.5.f Based on the CAA's proposals for a 2-tiered licence based regime, there would not be any requirement for such a rule.

- Tier 1 airports would be regulated individually, with licence conditions targeted at their specific circumstances. Under such an approach the implementation of licence conditions applying identically to a group of Tier 1 airports would not be a proportionate way to regulate.
- As discussed above, Tier 2 licences are intended to contain only provisions of EC regulations such as the Airport Charges Directive and EC regulations related to ground-handling and passengers with reduced mobility. The CAA's proposal would involve granting the Secretary of State powers to incorporate EC regulations into the Tier 2 licence through the development of a statutory instrument that would link EC requirements to the development of Tier 2 licence conditions. Beyond these conditions, the CAA does not recommend giving either Government or the CAA powers to impose additional licence conditions. If Government were minded to impose any additional requirements uniformly on all airports that address other issues than market power, the CAA suggests that this should be done through primary legislation, after extensive consultation with all affected stakeholders.

**Q7.6 (a) Do you agree with the proposals to put in place similar provisions for sanctions and enforcement by the CAA for the airports sector that apply in the other main regulated sectors in the UK?**

A7.6.a The Government's proposals regarding sanctions and enforcement powers are discussed in the main document in paragraphs 3.49 to 3.50.

**(b) Would a maximum financial penalty for licence contraventions of 10% of the relevant undertaking's annual turnover be an appropriate upper bound?**

A7.6.b The CAA supports the 10 per cent maximum financial penalty for contraventions of licence conditions. To make it operable, a clear criterion for determining the undertaking's annual turnover would need to be established. This may be best achieved by giving the CAA the power to determine the definition for annual turnover, subject to consultation with stakeholders, to which the pro rata penalty will be applied.

A7.6.c In cases where the CAA is considering revocation of a licence, the framework should make it clear that any financial loss is distinct from the maximum financial penalty.

**(c) Are there any particular features of the airports sector that would justify or require a different approach to licence revocation?**

A7.6.d Please refer to paragraphs 3.51 to 3.52 of the main document for a discussion of the limited usefulness of licence revocation as a sanction and alternative measures.

**Q7.7 Do you agree that the CAA should have concurrent competition law powers for airport services in the UK?**

A7.7.a The CAA welcomes the Government's proposals to extend the CAA's powers to apply UK and EC competition law to cover airports. This is discussed in further detail in paragraphs 3.45 to 3.48 of the main document.

## **Chapter 8 - Enhancing accountability**

**Q8.1 We would welcome views on the proposed approach to allowing appeals regarding CAA decisions about whether an airport should have a Tier 1 licence and regarding licence modifications. We would particularly welcome comments on which parties should have the right to appeal and on which decisions particular parties should have the right to appeal. We would also welcome views on the most appropriate approach to ensure that appeals are neither frivolous nor vexatious.**

A8.1.a Chapter 4 of the main document discusses in detail aspects of the proposed appeals mechanisms for the new regulatory regime, including detailed considerations regarding the parties that should have the right to appeal and on which decisions particular parties should have the right to appeal.

A8.1.b Paragraphs 4.16 to 4.19 discuss the proposed approach to allowing appeals regarding CAA decisions about whether an airport should have a Tier 1 licence, and paragraphs 4.20 to 4.31 discuss the proposed options for allowing appeals regarding licence modifications.

**Q8.2 Do you agree with the proposal that the CAA would be required to consider the regulatory status of a Tier 1 airport at the end of each price control period (the sunset clause)?**

- **Do you agree with the proposal that CAA decisions about whether an airport should have a Tier 1 licence should be subject to a merits based appeal to the CAT?**
- **Do you agree that access to merits based appeal on the CAA's decision about whether an airport should have a Tier 1 licence should be granted to all parties with a material interest, including the licensee, airlines, specified consumer groups and other airport operators?**
- **How should provision be made in the new regime to deter frivolous or vexatious appeals?**

A8.2.a The main document discusses the proposals regarding sunset clauses in paragraphs 4.36 to 4.38, and paragraphs 4.16 to 4.19 discuss the proposed approach to allowing appeals regarding CAA decisions about whether an airport should have a Tier 1 licence.

**Q8.3 As set out at the beginning of this section, we would welcome stakeholders' comments on how the right of appeal on licence condition changes should be framed. The three options we would like specific feedback upon are:**

- **Option 1 – Rights to a merits-based appeal on all licence modifications granted to all parties with a material interest, including the licensee, airlines, specified consumer groups and other airport operators;**
- **Option 2 – Rights to a merits-based appeal on all licence modifications granted to the licensee. A right of appeal for other parties with a material interest (including airlines, specified consumer groups and other airport operators) on a limited range of issues, including – but not limited to – the CAA's decision on whether an airport should be subject to a Tier 1 licence. Within this option there are sub options relating to how appeal rights could be extended beyond the licensee upon which we would welcome stakeholders' views. Two sub options, that are not necessarily exclusive are:**
  - **A right of appeal on the CAA's decision to endorse an airport operator's statement of charging principles setting out how a price control once set will be translated into the detail of airport charges.<sup>33</sup>**

---

<sup>33</sup> This option has been proposed by the Review's independent Expert Panel.

- ***A right of appeal on a statement of principles by the CAA setting out the fundamental basis on which price control decisions are made (as set out at paragraph 8.7).***
- ***Option 3 – Rights to a merits-based appeal on all licence condition changes granted to the licensee. Other parties with a material interest (including airlines, specified consumer groups and other airport operators) granted access to a merit based appeal on the decision whether an airport should have a Tier 1 licence but not to licence modification decisions.***

A8.3.a Paragraphs 4.20 to 4.31 of the main document discuss the proposed options for allowing appeals regarding licence modifications.

**Q8.4 *Does a procedure which involves either the agreement of the licensee only or a determination of the public interest by the Competition Commission properly take account of airline and other third party views?***

A8.4.a As discussed in Chapter 4 of the main document, the CAA considers that a proportionate appeals process would differentiate the access to appeals according to the type of regulatory decision, in order to take proper account of airline and other third party views.

A8.4.b The current split of responsibilities for airport regulation between the CAA and CC, whereby the CC makes public interest findings and the CAA determines the price control and remedies to the CC's public interest findings, reduces the overall flexibility and accountability of the regime, whilst also resulting in a convoluted and time-consuming price control process. Therefore, the CAA supports the Government's proposals to change this system by replacing the automatic reference to the CC with a merits based appeals process.

**Q8.5 *Should airlines and other third parties have a specific right to be consulted on proposed licence modifications?***

A8.5.a This is discussed in paragraphs 4.22 to 4.25 in the main document.

**Q8.6 *Do you agree that Tier 1 and 2 airports should be required to submit an annual report to the CAA and other environmental regulators about their environmental performance? Are there any specific requirements that you consider should be in such a licence condition?***

A8.6.a This is discussed in paragraphs 2.100 to 2.104 in the main document.

**Q8.7 The Government is considering applying the Compliance Code to CAA's economic functions. Are you in favour of extending the coverage of the Code in this way? Please give reasons to support your views.**

A8.7.a The Regulator's Compliance Code, issued in December 2007, is already applied to some of the regulatory functions of the CAA by virtue of the Legislative and Regulatory Reform (Regulatory Functions) Order 2007. These include the CAA's safety and consumer protection functions but not those relating to economic regulation. The Government is considering placing the CAA under a statutory duty to have regard to the Code when exercising its economic functions. While the CAA already follows better regulation principles in its approach to economic regulation and has already indicated that it supports the proposal to give these statutory force through a secondary duty on the CAA, it does not see a strong case for being placed under an *additional* statutory duty to have regard to the Code noting that:

- the primary purpose of the Code was to implement the recommendations of the Hampton report which did not cover any of the independent economic regulators (including the economic functions of the CAA);
- each of the other UK sector regulators (ORR, Ofgem, Ofcom, Ofwat and Postcomm) is excluded from a statutory obligation to have regard to the Code by virtue of section 24(5) of the Legislative and Regulatory Reform Act 2006; and.
- the CAA has a strong track record of investigating areas where the regulatory burden could be reduced to ensure that economic regulation remains proportionate and considers that the current cost of its economic regulation activities compares well to that of other UK regulators.

## **Chapter 9 - Aligning airport services with passengers' needs**

**Q9.1 What specific information gathering powers will the regulator need to facilitate an effective Constructive Engagement process? What information do airlines require to empower them to influence investment programmes in the interests of consumers?**

A9.1.a In general, a regulator needs wide-ranging information gathering powers to carry out the full range of its regulatory functions. Therefore, any information gathering powers for the CAA should not be framed in the context of facilitating consultation processes between airports and airlines alone but more widely, for the purposes of carrying out all of its regulatory functions. Such a duty would confer similar rights to those currently defined in section 73 of the Airports Act 1986.

- A9.1.b The information that airports need to make available to airlines is a matter of detail of the definition of the future regulatory processes, based on the degree of market power held by the individual airport. The CAA therefore considers that this level of information should not be defined in primary legislation but left to the regulator to determine on the basis of extensive consultation with stakeholders. This would be consistent with the CAA's approach adopted for the Heathrow, Gatwick and Stansted price controls that included detailed schedules for the process of consultation. Nevertheless, the CAA notes that the EC's Airport Charging Directive requires some specific information to be made available by airports to airlines, including for example the methodology used for setting airport charges, the overall cost structure with regard to the facilities and services to which airport charges relate and the predicted output of any major proposed investments in terms of their effects on airport capacity.
- A9.1.c It also needs to be recognised that airports, to produce much of their information, rely in turn on information provided to them by their airline customers. Furthermore, the CAA notes that the EC's Airport Charging Directive also places a requirement on the regulator to ensure that airport users provide airports with specific information before consultation, including forecasts as regards traffic the composition and envisaged use of their fleet, their development projects and their requirements at the airport concerned. This would also need to be part of a consultation schedule.

**Q9.2 *Is there a need for the CAA to consider extending SQRs beyond those activities under the direct control of the airport operator? What would be an appropriate mechanism for doing so?***

- A9.2.a The CAA welcomes the Government's policy objective of improving the passenger experience across passengers' entire end-to-end journeys and acknowledges that a wide range of service suppliers beyond airport operators contribute to the passenger experience.
- A9.2.b The CAA currently can only impose Service Quality Regimes (SQRs) to remedy a public interest finding made by the CC as part of their role in the quinquennial price control reviews for designated airports. Consequently, most UK airports are currently not subject to SQRs.
- A9.2.c Under the future proposed licence regime, SQRs could only be applied to airports holding a Tier 1 licence, on the basis that they held significant market power. The CAA considers that to be an appropriate restriction of the CAA's flexibility as competition is the better means to promote passengers' interests than imposing regulation, including SQRs.
- A9.2.d Extending SQRs to other activities under the control of other service providers would also only be justified, in principle, if providers of these other activities would pass the regulated status test proposed for Tier 1 licences. The CAA is not clear which activities the Government has in mind that it would propose to make subject to additional SQRs. The following groups

seem to be of particular interest, but the CAA does not consider that there are strong arguments to propose introducing SQRs on any of them.

- Airlines. The CAA agrees with the CC that it is unlikely to be appropriate to impose SQRs on airlines as they operate in a generally competitive market.
- Ground handling service providers. Ground handlers at airports are already subject to the EC Ground Handling Directive that is aimed at removing barriers to entry for ground handlers and that ground handlers are allowed to compete at airports. The CAA has powers to enforce the provisions of this Directive at UK airports.
- Surface access providers. Trains are already subject to regulatory oversight by the ORR, the rail sector regulator. Buses as well as taxis are, as all other service providers, subject to general competition law is enforced by the OFT. They are not subject to any specific sectoral regulation as they are not deemed to hold significant market power that would justify the additional regulatory burdens.
- Immigration and customs. The UK Border Agency has sole responsibility for these functions. As it is another public body with the function to ensure safety and adherence with immigration law, the CAA has no role to regulate their services for economic purposes.

A9.2.e Therefore, the CAA does not consider that SQRs need to be imposed on other service providers. The fact that other service providers contribute to the overall passenger experience is not sufficient to impose SQRs on them.

A9.2.f However, the CAA notes that there is a need to define carefully the range of activities that are deemed to fall within a regulated airport business and those that are not captured. The CAA considers that the current definition of regulated activities as set out in the Airports Act 1986 has some shortcomings that may reflect the change in the nature of airport services and the development of competition for some services over the last 20 years. The CAA is looking forward to engaging further with the Government on these issues.

**Q9.3 *How could the SQR metrics be changed to provide a better fit to the outcomes that affect passengers' experience. Should someone other than BAA monitor the SQR metrics?***

A9.3.a The CAA welcomes the Government's suggestion that "the more flexible powers for the CAA to develop price and service quality regulation at Tier 1 airports should help to facilitate more targeted and appropriate service quality regimes." If Government gives the regulator a clear statutory duty towards passengers that is complemented by a flexible licensing regime, the regulator can take these issues forward on an individual basis for all airports that it regulates through a Tier 1 licence.

A9.3.b The CAA does not consider that there is a need for Government to come to a view on these matters of detailed regulation in the context of devising a new overall framework for regulation. Furthermore, these matters will be subject to change over time, and the existing SQRs as defined in the recent price control reviews will need to adapt to such changes, in particular as competition between some airports may develop further.

**Q9.4 *How might incentives upon airport operators to deliver appropriate levels of service quality be improved in the new regime to produce better outcomes for consumers?***

A9.4.a The CAA considers that the same arguments as for Q9.3 apply.

**Q9.5 *We would welcome comments both on the merits of allowing terminal competition and the best way for the regulatory framework to permit such competition.***

A9.5.a The CAA supports the Government's view that the option of developing competition between terminals should be accommodated by the new regulatory regime. In principle, the regulatory framework should not serve to limit the degree of innovation in operational or business models in the airports sector.

A9.5.b The CAA considers that this requires a careful definition of the activities that are to be captured by airport regulation. The provision and operation of airport infrastructure can include a large variety of individual services, from take-off and landing of aircraft to providing parking space and retail facilities. The CAA's initial view is therefore that a broad definition of the regulated activities (such as "provision and operation of airport infrastructure"), supplemented by the ability for the Secretary of State to add further activities through secondary regulation at a later stage if necessary, would be preferable to a detailed list of activities, for a number of reasons.

- There would be no presumption that all airport infrastructure needed to be owned by the same entity and would therefore allow for runways and terminals to be owned separately.
- A broad definition could also address the risk that operators can divert monopoly rents to fringe activities that are not captured through regulation. In the current price controls, this risk is mitigated by the application of the single till approach in which commercial revenues of the airport operator are set off against total operating costs for aeronautical activities that fall within the scope of price control regulation.
- As businesses and markets develop and innovate over time in ways that cannot always be foreseen, there needs to be an option for the legislator to amend any definitions to adopt regulation to changes in the market.

A9.5.c The CAA is looking forward to engaging further with the Government on this important issue.

**Q9.6 *The DfT would welcome the feedback of stakeholders on the issues raised relating to airports' financial resilience, in particular:***

- ***Should the DfT introduce a Special Administration regime for the airports industry?***
- ***Are airports sufficiently important assets for the Government to take steps to ensure their continued operation? If the Government were to introduce Special Administration for airports how should this be designed and implemented? Do you believe that a staged implementation of the Special Administration regime over a period of time would be helpful?***
- ***Should the regulatory regime be reformed to allow the regulator to introduce licence conditions to ring-fence regulated assets?***
- ***Should the regulatory regime be reformed to allow the regulator to introduce licence conditions obliging regulated businesses to maintain an investment-grade credit rating and if so in what form?***
- ***How might such provisions be introduced to minimise disturbance to existing financing arrangements?***

A9.6.a This is discussed in paragraphs 2.10 to 2.61 in the main document.

## **Chapter 10. Enhancing consumer representation within the aviation sector**

**Q10.1 *Do you agree with the proposal to give Passenger Focus responsibility for consumer policy advocacy with regards to airlines and airports, funded through airport licence fees? In particular, we welcome views on the proposal for Passenger Focus to develop and support a network of consumer panels at leading airports.***

A10.1.a This is discussed in Chapter 5 of the main document.

A10.1.b Consumer representation in air travel is currently provided by:

- passenger service committees (within the Airport Consultative Committee structure) at major UK airports; and
- the consumer representation body in air travel (a role performed by the Air Transport Users Council).

A10.1.c The AUC currently focuses its work on resolving complaints made by passengers against airlines' services and in particular in relation to denied boarding and cancellation. It is not resourced to undertake a wider role. The CAA considers that there is considerable scope for expanding and strengthening the AUC's role to cover general air passenger concerns including those relating to services provided by airport operators. There is

also scope to make better use of the passenger services committees at major UK airports particularly through engagement between the national passenger representation body and passenger committees at these airports.<sup>34</sup>

A10.1.d BAA and MAG supply passenger services committees at their airports with a significant amount of information on passenger complaints and surveys that offer valuable sources of information on key issues at these airports. The CAA has proposed that the national passenger representation body makes use of these existing committees rather than develop and/or provide administrative support to additional consumer panels.

A10.1.e Regarding the level of additional funding that will be needed, the CAA is currently working with Passenger Focus, the AUC and DfT to determine the additional passenger research that could usefully be undertaken in air travel. Once this exercise has been completed, the CAA will be in a better position to determine how much additional funding is required.

A10.1.f Government currently funds Passenger Focus's advocacy work for bus and rail passenger representation, whereas it proposes that passenger representation work for aviation be funded by the industry, and therefore ultimately the passengers. If Passenger Focus were to take on the role of the passenger representation body for aviation, the CAA cautions that the allocation of funding needs to be made transparent, to provide the aviation industry with confidence that the two different funding streams are separated stringently according to their purposes. This is particularly important in areas in which overlaps between the sectors occur. For example, high-speed rail is increasingly recognised as being a competitor for air travel on some domestic routes within the UK and routes where rail links with Europe are well developed. This may lead to some wider passenger advocacy work and research being carried out supporting integrated and cross-modal end-to-end journeys, the funding of which would need to be clarified from the outset.

**Q10.2 *Do you agree with the proposal to give Passenger Focus responsibility for complaints handling on airline and airport issues alongside its policy advocacy function?***

***How can we best ensure the expertise and sector knowledge in relation to EU air passenger rights built up over time by the AUC is retained?***

A10.2.a The CAA agrees with Sir Joseph Pilling's Strategic Review of the CAA that complaint handling sits well with the body responsible for passenger advocacy in air travel whether this role is performed by the AUC or Passenger Focus. Handling complaints in air travel will help the passenger representation body identify trends in consumer detriment in air travel on which it can place pressure on industry and the CAA to take action. The

---

<sup>34</sup> Passenger services subcommittees already exist at the UK's four largest airports (Heathrow, Gatwick, Stansted and Manchester) and at a number of the other larger UK airports. Passenger issues at the smaller airports are considered as part of the wider committee agenda.

AUC has developed expertise in handling complaints on denied boarding and cancellation and it is important that sufficient training is provided to any new passenger body so that this expertise is maintained both in terms of passenger issues, legal expertise and operational knowledge of the aviation sector.

A10.2.b Consumer rights are becoming an increasing focus across both UK and EC jurisdictions. New EC legislation on air passenger rights include persons of reduced mobility and, most recently, the Air Services Directive has introduced requirements for transparent pricing practices for online ticket sales. The CAA will be the enforcement body for this new legislation. The CAA also intends to take the leading role for enforcing general consumer protection regulations in the aviation sector (a role currently carried out by the Office of Fair Trading).<sup>35</sup> A passenger representation body will need training to complement the CAA's growing role and focus on consumer protection.

---

<sup>35</sup> The CAA is an enforcement body for consumer protection under Part 8 of the Enterprise Act 2008.