



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

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

**Supporting Paper I – Constructive Engagement**

**May 2009**

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# Constructive Engagement in the regulation of airports

## Introduction

1. Constructive Engagement is the CAA's term for the process of structured discussion and negotiation between airport operators and airlines, which produced information relevant to the CAA's economic regulation of designated airports. Since 2005, Constructive Engagement (hereafter termed CE) has generated substantial interest in regulatory circles, both within the aviation industry and more broadly, as well as generating some controversy about its aims, conduct and outcomes. CE is continuing, at least at Heathrow and Gatwick, to provide a framework for airport-airline dialogue on strategic airport development and investment issues. A variant of the process is also currently being implemented by the CAA for the NATS price control review.
2. Against this background, the CAA considers that it would be a useful input to the DfT's review of airport economic regulation to provide a comprehensive survey of CE in recent UK airport regulation, setting out the aims, processes, outcomes and reasons for the varying outcomes, along with some thoughts for the future. This paper provides such a survey. It is written as a supporting paper to the CAA's overall response to the DfT's consultation on airport economic regulation, and the conclusions of this paper inform the CAA's recommendations to the DfT on the future legislative framework for and conduct of airport regulation.
3. The CAA sets out in this paper:
  - The original purposes of CE, set against the historical context of UK airport regulation and the structure of the aviation industry;
  - The scope of CE activities and the outcomes produced at each airport;
  - The ways in which CE was integrated with the work of the CAA and the Competition Commission during the price control reviews for each airport;
  - The outcomes from CE and their implications for airport regulation;
  - The problems which CE posed and/or faced;
  - Some thoughts on what lessons might be learned at this stage from the experience to date of CE.
4. In setting out this survey and assessment, the CAA will focus in particular on the roles and incentives of all the parties to CE: airport operators and airlines. Economic regulation in all sectors has hitherto focused very largely (and understandably) on the regulated entity. The challenge and opportunity in the airport sector was to harness the insights and inputs from the airlines as well as the regulated operator, so that the regulator could be better informed

about the range of outcomes desired by each airport's direct customers, and thereby better understand what might be delivered for the airport's and airlines' end users, the passengers. The market positions of airlines at each of the price-regulated airports, their commercial incentives and their willingness to engage are therefore important factors to consider, alongside the role and incentives of the airports, when assessing the outcomes from CE and its place in economic regulation.

5. The conduct and outcomes from CE have been subject to some criticisms in recent years, most notably from the Competition Commission as part of its market inquiry into BAA's airports, and also by easyJet as part of its legal challenge against the CAA's March 2008 price control decision for Gatwick Airport. This paper does not aim to address these criticisms head on, but rather sets out the facts and assessment thereof as the CAA currently sees them.
6. The paper focuses primarily on CE at the three BAA airports (Heathrow, Gatwick and Stansted). It touches on the initial stages of CE at Manchester but, as the airport was de-designated by the Secretary of State before the results of CE were required by the CAA, there is significantly less evidence on which to base any assessment of its success or otherwise.

### **Context for CE**

7. BAA was privatised in 1986 and its three largest airports (Heathrow, Gatwick and Stansted) were made subject thereafter to a price regulation regime under Part IV of the Airports Act 1986, as was Manchester Airport. The first price controls were set by Government, and thereafter by the CAA, each time following a mandatory reference to and inquiry by the Competition Commission, the recommendations of which were advisory but binding on the CAA's final price determinations.
8. The overall theme of the first decade or so of price regulation was delivering greater cost efficiency, and hence falling prices in real terms. This was achieved through fairly standard application of an RPI-X price formula, informed by standard regulatory scrutiny of BAA's and Manchester Airport's respective business plans, augmented by evidence and views from consultation with airlines and passenger groups. At BAA's airports, capital expenditure was focused on making better use of the existing runways and terminals, whilst plans were being developed and taken through planning inquiry for a major new terminal at Heathrow to provide substantial additional passenger-processing capacity. Plans were also developed, although in the end not implemented, for a hub for British Airways at Gatwick. Manchester Airport was successful in obtaining approval for and subsequently building a second runway (at relatively moderate cost<sup>1</sup>) which provided additional capacity.

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<sup>1</sup> Project cost of £180m in 2001 prices, some 25 per cent of the Manchester regulated asset base at the time.

9. By the end of the 1990s, though, it appeared to the CAA that the incentives from a 'standard' application of RPI-X price regulation were unlikely to be sufficient to encourage investment in new capacity, particularly at Heathrow and to a lesser extent Gatwick, which would be required to meet growing demand. In the Q4 price review (2001-2003, which set prices for the period 2003-2008), the CAA therefore explored a number of alternative regulatory approaches, which were together designed to incentivise each airport operator to bring forward investment in new capacity and service at the right time and place to meet demand. The most controversial of these ideas, so called 'dual till', was not in practice implemented, it having failed to gain support from the Competition Commission. Other significant structural reforms, notably 'stand alone' regulation of each airport separately, and more intrusive regulation of service quality, were introduced as a result of this review.
10. The conduct of the price review left many stakeholders, notably the airlines, concerned that the regulatory process had moved too far towards somewhat abstract economic constructs, discussed in inaccessible technical language, and too far away from the more pressing requirements of delivering substantially better physical infrastructure, service quality and cost efficiency. Airlines also expressed frustration at their inability to influence the strategic direction of the price review. The CAA recognised these concerns, and also the opportunity to reassess the process by which airport regulation is developed and consulted upon. It was also apparent that other means, than the novel economic incentive structures previously mooted by the CAA, would be needed to create the right incentive framework to encourage BAA to bring forward timely investment which met the needs of airlines and passengers.

### **Developing CE – learning from the past**

11. As a way of 'clearing the air' and drawing a line under the Q4 review, as well as building an evidence base for a new approach, the CAA initiated an assessment of the Q4 price review in 2003. Following written submissions from interested parties and interviews at operational and senior level within stakeholder organisations, the CAA issued in May 2004 a consultation paper 'Airport Regulation: looking to the future – learning from the past'<sup>2</sup>.
12. This document, as the title suggested, combined both a backward-looking assessment of the conduct and outcome of the price reviews then recently concluded, as well as a fairly well developed set of proposals for changes to the process for the next set of airport price reviews, which were then due to conclude in spring 2008. Although in consultation mode, the CAA had concluded at this stage, from its industry dialogue and own assessment, that there was a good case for seeking to harness airport-airline engagement at the outset of the next price reviews as a means of delivering better

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<sup>2</sup> [www.caa.co.uk/docs/5/ergdocs/erg\\_ercp\\_airportregulation.pdf](http://www.caa.co.uk/docs/5/ergdocs/erg_ercp_airportregulation.pdf)

developed business plans for each airport and ultimately better informed regulation, more responsive to the needs of users.

13. The CAA's stated aims for reform were to ensure that:

- the CAA regulation of designated airports remains proportionate and cost-effective given the commercial nature of the parties on both sides of the regulatory bargain;
- there is a clear definition of the role and responsibilities of other parties within the regulatory process;
- the CAA leaves the greatest scope for constructive engagement between the commercial parties as the best means of fulfilling its statutory duties;
- the position of smaller users, new entrants, and passengers is protected.

In addition, it also highlighted at the outset the necessary limitations of regulation in solving all of the challenges in delivering better airport infrastructure and services, and called upon all parties to play their part in contributing to both regulatory and commercial engagement to shape airport development and operation.

14. The core of the CAA's May 2004 proposals were to structure and conduct the next airport price control reviews so that there was "scope for airlines (in conjunction with airports) to play a more proactive role, in the context of a framework set by the CAA. They should be better placed than the regulator in terms of their knowledge, operational experience and commercial focus to deal with those issues which most directly affect the cost and quality of the services they receive. This recognises that where information is both imperfect and imperfectly distributed, determining who is best placed to do what is central to making good decisions. It is also important in ensuring that regulatory burdens and staffing are kept to the necessary minimum"<sup>3</sup>. In addition, the CAA also committed to improving the clarity and presentation of its own regulatory material, and to sharpen up various organisational aspects of the price review process.

15. The CAA set out its preliminary views on the roles and responsibilities of the three main parties: the CAA, the airport operator, and the airlines. The proposed approach to future price reviews was designed:

- "to empower users and airports to take more ownership of the regulatory process;

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<sup>3</sup> Ibid, paragraph 9

- to place more responsibility on designated airports to demonstrate that their plans reflect their current and future users' preferred combinations of outputs and service levels under various budget options;
  - to focus the CAA's contribution on underpinning, rather than supplanting, airport/airline strategic interactions; and
  - to make the regulatory process complementary to normal commercial interactions (rather than a potential distortion of them)"<sup>4</sup>.
16. The CAA went on to spell out what each party would be expected to contribute. There was some emphasis on the responsibilities of the airlines to contribute actively, with evidence, and to seek to reach solutions with the airport operator, rather than 'stand off' in the expectation of the regulator breaking any impasse in negotiations. At this stage, the CAA emphasised the opportunity afforded by CE (as it came to be termed) for airlines and airport to agree key strategic inputs into the price review, which the CAA would be most likely to incorporate into its final decision. There was less attention on the scope of the agreement(s) and the consequences of any shortfalls in agreement.
17. While the merits of CE were clearly articulated by the CAA in its May 2004 paper, there was also recognition of the inevitable limits which the statutory framework would place on CE. First and foremost, the CAA retained the legal function to set price caps, and to do so within the framework of duties set out in the Act.
18. Second, unlike in other regulated sectors, there was a mandatory reference to the Competition Commission before the CAA's final proposals and decision-making. The CAA considered that this should not be a barrier to a prior process of CE which could inform the Commission and hence the Commission's recommendations to the CAA: "If airports and airlines can demonstrate that they have reached a consensus view and agreed costings on key issues, it could be expected that the Competition Commission – like the CAA – would take that seriously into account in reaching its own conclusions, providing it was clear that the industry consensus was in user interests overall. After all, in other regulated industries, the Competition Commission is only involved at all in these processes where there is disagreement"<sup>5</sup>.
19. Finally, the CAA recognised that a consensus could emerge between the airport operator and those (larger) airlines involved in CE which would nevertheless be against the reasonable interests of users more widely, including smaller airlines, new entrants and passengers. At this stage, the CAA expected the airport and airlines involved in CE to demonstrate how any agreement would be in the interests of users as a whole.

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<sup>4</sup> Ibid paragraph 21

<sup>5</sup> Ibid paragraph 35

20. Following consultation, the CAA issued a further document on CE in December 2004, 'Airport regulation: Looking to the future – learning from the past, Review of responses to the CAA's Consultation Document'<sup>6</sup>. This set out the key issues which had emerged during consultation and the CAA's emerging thinking thereon, summarised as follows<sup>7</sup>:

- *“The degree of information to be provided by the airports* and how that fits with the information already made available to airlines. It will be important for successful negotiation that airports provide what is required in a timely way. But it will also be important that airlines tailor their demands to what is really needed, not least to ensure that they can effectively process it. This is an area where less can often be more.
- *“The need for senior level engagement by the parties.* Existing consultation mechanisms are designed to deal with more detailed tactical issues than the strategic engagement required to feed into price setting. Such fora can process a lot of the detailed work but cannot act in a vacuum. BAA has already indicated that its engagement will be led by the most senior levels at each of the airports. There will need to be a commensurate response from the airline side; even if the precise mechanics differ between airports. It is not for the CAA to provide tailor-made processes. Rather, such processes will need to reflect the importance airlines, individually and collectively, really place on the service levels and associated prices they want from airports.
- *“The central objective to which the parties should be working.* The CAA is clear. There should be scope for agreement between airports and airlines on the key variables of capex, opex and service quality feeding into the CAA's price determination. Engagement has, therefore, to be seen in that context. The aim is not just another consultative process.
- *“The role of the CAA.* The CAA will ultimately set the prices for the designated airports based on the key parameters negotiated by the parties. It will also lead on key issues, such as cost of capital and regulatory policy, where it has the comparative advantage. It will also invest significant time and effort in setting up the processes and framework within which the parties will engage. But from that point it will leave the stage to commercial negotiation. If, of course, agreement proves impossible it will need to take a view. It is not the CAA's intention to arbitrate between two positions in the event of disagreement. Rather it will decide according to its statutory duties on the merits of the case taking account of evidence assembled by the parties but ignoring any premium that either or both may have been prepared to pay to secure agreement. To do otherwise would prejudice the positions of those prepared to negotiate in good faith. As a result

<sup>6</sup> [www.caa.co.uk/docs/5/ergdocs/erg\\_ercp\\_airportregulationdec04.pdf](http://www.caa.co.uk/docs/5/ergdocs/erg_ercp_airportregulationdec04.pdf)

<sup>7</sup> Ibid paragraph 2.2

there can be no assurance that the decision will lie between the positions of the parties.”

21. In sum, at this stage the CAA envisaged a fairly comprehensive scope for CE (including opex, for example, which was subsequently largely excluded from CE). It saw its role as setting the framework, the agenda for CE and the terms of engagement, and then reaching final decisions based on the outputs from CE as well as its own assessment of the cost of capital. There was little sense of the degree of interaction between the CAA and the CE processes at each airport which resulted in practice. On the subsequently vexed question of the flow of information from airports to airlines, the CAA noted that the flow of information would be an important element contributing to the success of airport-airline negotiations and that, for CE to succeed, both the airport operator and airlines needed to work in an effective manner.
22. The CAA also noted that at some designated airports, there appeared to be substantial disagreements between airport operator and airlines<sup>8</sup>. It recognised that it would only be worth proceeding with CE where there was a realistic prospect of some substantive agreements being reached, and that if relations had deteriorated to the extent that such an outcome were not plausible, then the CAA may resort to a traditional regulator-led price review. At this stage, the CAA did not explore more deeply the incentives which might influence the behaviour of airlines or airport operators and lead to apparently intractable disagreement on airport development and pricing.
23. It is apparent that the CAA’s concept of CE was evolving at this time (unsurprisingly for an innovative idea which was being developed through an iterative dialogue with the industry). The original vision that CE could, indeed would be likely to, deliver a comprehensive set of agreements between airport operator and airlines about future development, capacity, investment and service, was changing to one where agreement would be an added benefit, but not the central rationale for CE. This development was also supported by a greater emphasis by the CAA on the legal framework within which CE would operate, notably the fact that the CAA would have to satisfy itself that any agreement or proposals emerging from CE satisfied the CAA’s own statutory objectives. These include duties to all users, not just those airlines party to CE discussions.

## **CE mandate**

24. After a period of further work in early 2005, the CAA published in May 2005 its ‘blueprint’ for CE, in the document ‘Airport regulation – the process for constructive engagement’<sup>9</sup>. This set out the CAA’s proposals, for subsequent implementation in the price reviews starting summer 2005, in four main areas: regulatory approach, division of responsibilities, guidance on the process of CE and regulator-led joint working, and protection of users’

<sup>8</sup> An indirect reference to Stansted, where incumbent low-cost airlines were challenging BAA’s proposals for a second runway, following the Government’s air transport White Paper of December 2003.

<sup>9</sup> [www.caa.co.uk/docs/5/ergdocs/erg\\_ercp\\_airportregulation\\_may05.pdf](http://www.caa.co.uk/docs/5/ergdocs/erg_ercp_airportregulation_may05.pdf)

interests. Reflecting feedback on its earlier consultative proposals, this regulatory statement set out more precisely the framework for the then forthcoming price control reviews, delineating the respective roles of the CAA, designated airports and airline users, and placing CE clearly within the legislative framework established by the Act. In particular, the ultimate decision-making role of the CAA was emphasised, placing CE clearly as an input to the CAA in reaching its regulatory judgements.

25. The May 2005 document set out the division of responsibilities between the parties. The CAA envisaged that some of the work usually carried out by the regulator would instead be taken forward by the airports and their airline customers through a process of 'constructive engagement'. The coverage of CE was specified as identifying:
- volume and capacity requirements;
  - the nature and level of service outputs;
  - opportunities for operating cost efficiencies;
  - the nature and scale of the investment programme;
  - the efficient level of future capital expenditure associated with that programme;
  - the revenues from non-regulated charges by the airport to airlines over the price control period; and
  - the elements of service quality and investment to which specific financial incentives should be attached and – depending on what progress can be made – the details of such financial incentives.
26. The CAA considered that "in this way, the normal business of commercial airport/airline interaction should be reinforced by the regulatory process, rather than interrupted by it"<sup>10</sup>. The CAA also envisaged that work on benchmarking aspects of airports' operating costs would be regulator-led, but in close co-operation with the airports and the airlines with remaining work – principally the financing inputs of the price control and the financial tradeoffs that underpin them – being taken forward by the regulator in its traditional role.
27. The rationale for the division of work between CE, the CAA, and the third category of regulator-led joint working was to allocate issues according to where they might best be assessed and where there was potential for agreement. In the CAA's view, the bulk of the operating expenditure scrutiny and assessment was best conducted by itself, for several reasons:

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<sup>10</sup> Ibid, executive summary page 6

- Airport-airline debates in this area would be likely to descend to ‘zero-sum’ negotiations – every pound of efficiency savings ‘given up’ by the airport would be a pound off the airlines’ charges, with relatively little interaction between the operating expenditure analysis and the provision of operational service and resilience to airlines;
- There were commercial confidentiality considerations around some of the underlying information, for example on security processing and on employment practices and industrial relations, which mitigated against sharing of information widely with airlines, which would have been necessary to inform CE; and
- The CAA did not consider that the airlines would bring any particular commercial or operational insight into the assessment of the airport’s core operating expenditure, including as it did many areas outside the view of the airline executives who were involved.

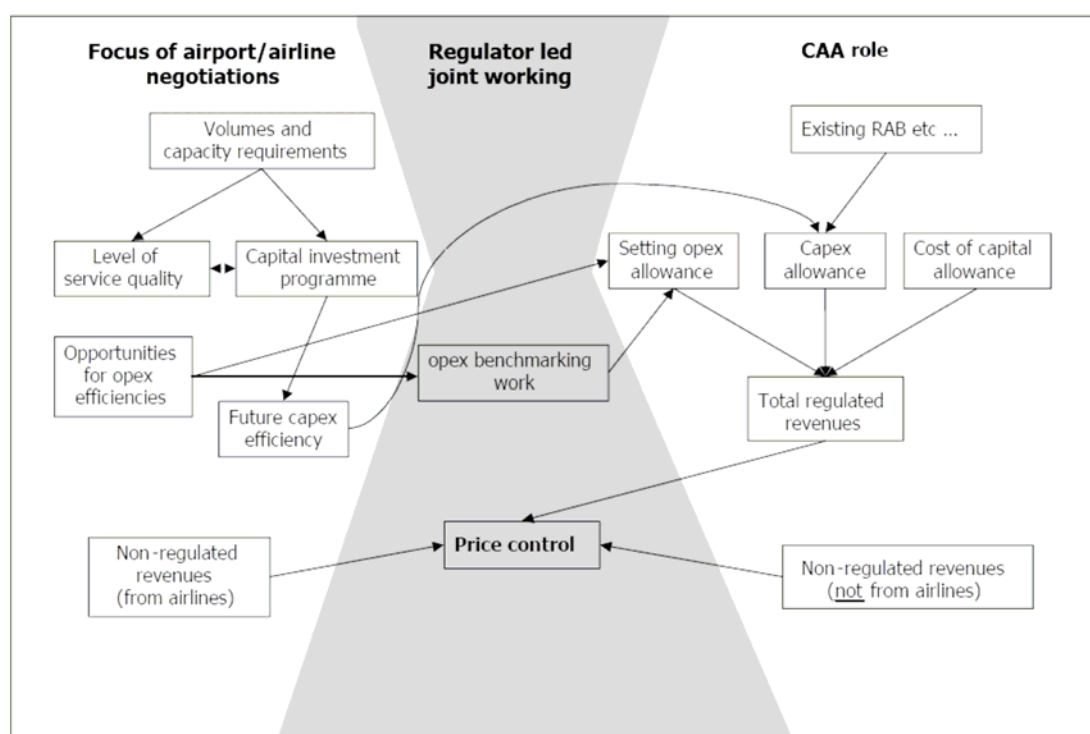
The CAA did, though, involve the airlines in joint oversight of a consultancy project which identified important aspects of each airports’ operations which had significant impact on airlines’ own operations (and costs) and/or on passenger experience. This study provided benchmark analysis at the process level, often terminal by terminal, against which to judge the relative efficiency of the designated airports against other UK and European airports, and some other mass transport operations.

28. In practice, though, particularly in the latter stages of the Heathrow and Gatwick price reviews, it became apparent that the costs of delivering enhanced and more resilient service levels in security processing were significant, and also varied significantly with relatively modest changes in modelling assumptions and service standards. As such, the CAA recognised that there was then a good case for involving the airlines directly in CE discussions and negotiations with each airport, so that joint recommendations about service quality were made in light of joint understanding about the potential cost implications (even if agreement on costs was not, in the end, achieved). This additional CE process took place from July 2007 through to the end of January 2008.
29. The other key issue which the CAA reserved to itself was the cost of capital and regulatory finance policy more generally. Again, this was primarily due to the ‘zero sum’ nature of the debate around the cost of capital, with BAA and the airlines each deploying their own consultants to argue the rate up and down respectively. In the CAA’s view, there was no prospect of CE delivering any agreement in this area, and no additional insight which might be gained over and above the evidence which the parties would submit anyway to the CAA’s own regulatory consultations.
30. With regard to the conduct of CE at each airport, the CE re-affirmed its earlier stance that discussions between airport and airlines were likely to be more productive if the CAA were not a party to such negotiations, or an invigilator

of them. The CAA stated that “it is for the airports and airlines to determine precisely how they take forward their responsibilities, including the phases of negotiation, their timing and who represents each side”<sup>11</sup>.

31. The relationship between the work of airport-airline CE, the CAA’s own analysis and the so-called joint working between CAA and airports and airlines was summarised in the following diagram<sup>12</sup>:

**Figure 1 Airport, airline and CAA roles under Constructive Engagement**



Source: CAA

32. The agenda for CE and the relationships between the various workstreams were (as discussed below) broadly adhered to at Heathrow and Gatwick airports during the first 12-18 months of CE activity (and at Manchester, albeit curtailed by the DfT’s de-designation review and decision). In the latter stages of CE, though, there was a much greater degree of interaction and feedback between a number of workstreams, notably opex projections for security processing, service levels in these areas, and the capital infrastructure provided. There was also considerable interaction around the capital expenditure programme, in light of both airlines’ concerns about ‘affordability’ in light of the overall price control proposals then emerging from the Competition Commission and the CAA, and BAA’s concerns about the financeability of the growing investment programme. At Stansted, however, the CE discussions foundered on the fundamental issue of volume and capacity requirements (the very first workstream on which all others depend).
33. In response to concerns expressed during the consultation process in 2004 and early 2005, the CAA articulated in May 2005 more clearly its views on

<sup>11</sup> Ibid, executive summary page 6

<sup>12</sup> Ibid, Figure 3.1

the incentives of airlines to operate in passengers' interests, and the protections which the CAA would rely on to ensure that users' reasonable interests were furthered<sup>13</sup>. The central protection was that provided by the competitive market for airline services, which would tend to align airlines' interests with those of passengers. The CAA recognised though that dominant airlines might attempt, with the airport operator, to restrict increases in airport capacity in order to create barriers to new entry and thereby sustain prices and margins above market levels. It also highlighted the scope for airport-airline agreements through CE to affect passenger interests adversely, for example in terms of service quality.

34. The suggested safeguard in each case was transparency for the results from CE, requiring the parties to spell out clearly the impact on passengers and on smaller airlines and potential new entrants of the proposed service and investment plans which emerged from CE. The CAA did not itself provide any explicit guidance at this stage on how it would resolve any potential conflicts between various categories of users, but rather reiterated that, in reaching its regulatory judgements, it would consider this question explicitly, as required to do so by its duties under the Airports Act. At this stage, though, the CAA did not address directly the particular questions on alignment of airline interests which arose subsequently, namely:
- How to assess where users' overall interests lie when CE produced differing airline views about competing priorities for development at the airport (as emerged at both Heathrow and Gatwick and was apparent in early discussions at Manchester); and
  - The potential distortion to incumbent airlines' interests, and misalignment with those of passengers and new entrant airlines, which arose from the operation of the 'standard' approach to setting price controls based on historical and projected capital expenditure (as became apparent at Stansted).
35. The CAA also recognised that while it could hope for the best outcome (i.e. CE working and delivering useful and timely information for economic regulation of each airport), it should also plan for other outcomes. It thus committed to an early review of the progress being made at each airport in CE discussions<sup>14</sup>. This review, to be conducted in autumn 2005 after the first 4-5 months of substantive engagement, was designed to provide evidence on the extent of effective engagement, the rate of progress through the CE agenda, and thus the likelihood that useful results would be delivered to the CE during 2006. The CAA set out clearly at the outset its intention to revert to a standard regulator-led price review if, in the CAA's view, CE at a particular airport did not appear to be likely to succeed.

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<sup>13</sup> Ibid, chapter 5

<sup>14</sup> Ibid, paragraphs 4.29-4.31

**CE timetable – planned and actual**

36. The May 2005 regulatory statement marked the start of the price control reviews for the designated airports, and set out (in very broad terms) the timetable for the initial period of CE and parallel analysis by the CAA, followed by the development and consultation by the CAA on its proposals, the mandatory reference to the Competition Commission and the final round of CAA proposals, consultation and decision-making. In practice, though, the CE process turned out to be far more involved and protracted at Heathrow and Gatwick than originally envisaged, and considerably curtailed at Stansted.
37. At Heathrow and Gatwick, reasonably good early progress was made by the parties in establishing the groups and protocols for conducting CE. BAA provided staff and resources to assist, and the airlines also supported the process through the commitment of management time and (for the larger airlines) specialist regulatory resource. On the strength of a positive response from all parties and signs of progress, in December 2005 (in its initial airport review policy consultation) the CAA assessed that there were good prospects of CE delivering valuable inputs to the CAA's price review<sup>15</sup>.
38. Thereafter, external events served to cause some disturbance to CE, and to the price review as a whole. In February 2006, an investment consortium led by Ferrovial announced its intention to acquire BAA plc. The takeover was finally agreed in mid-summer 2006. Inevitably, CE discussions lost some focus and momentum during spring-summer 2006, which meant that it was no longer realistic for the parties to meet the CAA's original June 2006 deadline for the submission of results. In order to allow time for the new owners to assess the results of CE and to formulate their own regulatory business plans, the CAA extended in July 2006 the CE timetable to allow for a September 2006 submission (with consequent but smaller adjustments to later stages of the price review).
39. In August 2006, the UK Government raised the security threat level to air travel very considerably, which resulted in very significant additional passenger security processing requirements at all UK airports. BAA's London airports did not cope well, revealing more starkly than hitherto a number of weaknesses in service provision, operational management and the resilience of the airports. As a result, there was considerable debate within the industry, aviation policy circles and the media about the service offered at UK airports, and Heathrow in particular. This had the effect of re-opening the CE dialogue on service quality, raising its importance for the airlines (and for the CAA), and setting in train considerable additional further analysis and debate. In practice, this ran through the whole of the remainder of the price review. CE discussions on service standards and costs thereof continued throughout 2007 (including through the period of the Competition Commission's own investigation) and into early 2008, right up until the close

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<sup>15</sup> Airports review – policy issues, CAA, December 2005, paragraph 8.17

of the CAA's own final consultation prior to making its price control decisions in March 2008.

40. As discussed below, while the CAA was undoubtedly better informed by the end of this extended process about the views of airlines and airports on the issue of service provision and its potential costs, the protracted nature of the CE process and the perceived behaviour of BAA during this period gave rise to some misgivings on the part of airlines, which were shared by the Competition Commission, about the actions of BAA and about the CAA's role in overseeing CE and the resulting impact on the price review process.
41. Finally, in the context of Heathrow and Gatwick, the CE process was extended into 2007 and 2008 at each airport as a result of ongoing debates between BAA and the airlines about the strategic development of each airport and the consequent scale and shape of the investment programme for the next quinquennium. The CAA had not envisaged at the outset such continuing and iterative dialogue between CE and the regulatory process through to the latter stages of the price review, although it always recognised that airport investment plans were by their nature flexible to the changing requirements of users, and that the regulatory system should reflect this reality. As with service quality, though, the relatively late changes to plans and costs caused some concern to airlines at each airport and to the Competition Commission. The CAA's response was to become more closely engaged with the emerging outcomes from CE at the latter stages in the price review, and to provide regulatory guidance to the parties to encourage them to focus their work and to deliver timely evidence to the CAA's own decision-making process.
42. At Stansted, the CE process made very little progress in 2005 and in December 2005 the CAA concluded that<sup>16</sup>: "No substantive progress has been made in establishing the processes, structures and core issues for constructive engagement in the six months to date. Against this background, the CAA believes that there is a significant risk that the process will fail to provide the CAA with information material to the Q5 review in the six months that are left until the required submission of the Price Control Business Plan. In the absence of any substantive progress to date and the resulting balance of risk, it would be irresponsible of the CAA not to commence, early in the New Year 2006, its own scrutiny of the price control building blocks currently identified for CE. The CAA therefore concludes that the issues currently identified for constructive engagement at Stansted should revert to scrutiny by the CAA under a more traditional regulator-led process. In the course of that scrutiny, the CAA would be open to receipt of evidence from all parties, and to the possibility that dialogue between the airport and airlines in the first half of 2006 on topics identified for CE may lead to a substantive exchange of views, which could deliver evidence and potentially agreements which could be taken into account by the CAA."

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<sup>16</sup> Ibid, paragraph 8.17

43. In the event, although some dialogue did occur during 2006 and 2007 between BAA and the Stansted airlines around the strategic development of the airport, notably BAA's proposals for a second runway, and about operational performance, notably security processing, there were no useable outputs to inform the CAA's eventual price control options and its reference to the Competition Commission in April 2008. During the Commission's own inquiry, it managed to resurrect discussion between BAA Stansted and the Airline Consultative Committee on a focused agenda around capital expenditure in the coming quinquennium related to the current runway, which resulted in some agreement on a, limited, core set of investment projects. Finally, in the last few months of the price review, there was very useful CE-style consultation around the proposals for new service quality standards and rebates, with some innovative ideas being developed and agreed which subsequently were adopted by the CAA in its final price control decision.
44. In summary, the timetable for CE was considerably more protracted at each airport than originally envisaged, including at Stansted, where some useful outputs emerged in late 2008 and early after a hiatus in 2006 and 2007. As the price reviews at each airport progressed, there was also greater interaction between the CAA and the parties at each airport than perhaps had been originally envisaged, and the process became more iterative and responsive. We discuss further below the CAA's role in these latter stages, where the Competition Commission has criticised the CAA for being insufficiently involved in resolving impasses in negotiations and in ensuring timely and reliable information flow from the airport to the airlines.
45. The following table sets out the timetable, planned and actual, for CE at each of BAA's London airports:

<b>Date</b>	<b>Event</b>
May 2005	Constructive engagement – CAA statement on mandate and process
Summer	CE starts at Heathrow and Gatwick. Discussions about information required by airlines from airport operator at Stansted
December	CAA airports review policy consultation, including decision on progress review of CE
February 2006	Ferrovial-led consortium announces intention to acquire BAA plc
June	Original CAA deadline for submission of CE output and Regulatory Business Plan for each airport CE reports (entitled 'final results') from Heathrow and Gatwick
September	BAA submits business plans for each airport. Joint BAA/airline groups at Heathrow and Gatwick submit outputs from respective constructive engagement
October	CAA publishes revised timetable for BAA and Manchester price reviews
December	CAA initial price control proposals, drawing on CE outputs from Heathrow and Gatwick DfT announces review of designation status of Manchester and Stansted airports
February 2007	CE update from Heathrow
March	CE update from Gatwick CAA price control reference to Competition Commission for Heathrow and Gatwick

Date	Event
July	CE update from Heathrow and Gatwick
September	Competition Commission report to CAA
October	CE update on service quality from Heathrow
November	CE update on service quality from Gatwick CAA final proposals for Heathrow and Gatwick
January 2008	CE final submissions from Heathrow and Gatwick DfT decision that Manchester be de-designated and Stansted remain designated for price control CAA consultation on price control options for Stansted
March	CAA final price control decisions for Heathrow and Gatwick
April	CAA price control reference to Competition Commission for Stansted
July-September	Competition Commission convenes discussions between airport operator and airlines on future capital investment at Stansted (excluding any second runway plans)
October	Competition Commission report to CAA
December	CAA final proposals for Stansted, including request for airport-airline engagement on specifics of service quality regime and enhanced consultation requirements
February 2009	Agreed submission to CAA from airport and airlines on service quality regulation
March	CAA final price control decisions for Stansted

46. For Manchester Airport, the CAA extended on October 2005 the Q4 price control period by one year (to end March 2008), to enable the Manchester price review to fall out of phase with those for the BAA airports. It also slightly extended the timetable for CE in light of the adjustments to the BAA airports' timetable following the takeover of BAA plc.
47. In practice, Manchester Airport took to CE with some enthusiasm, seeking to build on its improving relations with airlines and to differentiate itself from what it perceived as some of the weaknesses of BAA's airports in their engagement with airlines. The airport established appropriate joint groups for discussion and negotiation with the airlines. It also started to broach some significant issues raised by the opportunities for terminal redevelopment more closely attuned to the needs of particular types of airline, while at the same time keeping the overall investment levels affordable at a time when it was losing traffic growth to regional rivals. Manchester did submit a substantive report the CAA by end May 2007 and there appeared to be every prospect that CE could have contributed to the CAA's regulatory assessment in the price review, if that had proved necessary. In practice, given the direction of the DfT's designation review, the CAA suspended the price review timetable in mid 2007 pending the outcome of the review (delivered in January 2008). The eventual decision to de-designate Manchester brought the price review, and hence the need for CE inputs, to a premature end.
48. The Manchester CE timetable and related events is summarised in the following table:

Date	Event
August 2006	Manchester CE starts with initial provision of information from airport to airlines

Date	Event
December	DfT announces review of designation status of Manchester and Stansted airports
January 2007	CAA issues policy consultation on Manchester price review, in which it concludes that CE is making sufficient progress for the CAA to rely on the outputs to inform its regulatory assessment
February	Original deadline for completion of CE
May	CAA issues policy update for price control review, and defers any further substantive work on the price review until at least end 2007, pending the DfT's decision on the designation status of Manchester Extended deadline for completion of CE – Manchester submits CE report to CAA
January 2007	DfT decision that Manchester be de-designated and Stansted remain designated for price control

### *CE process – general themes*

49. From the above discussion of CE timetables, planned and actual, a number of general themes emerge:
- Despite the best endeavours of the CAA to map out a timetabled plan for CE, inevitably the actual passage of CE followed a more protracted and involved route. This required a high degree of flexibility on the part of all parties, and a degree of trust in the other side.
  - The CE timetable and process were exposed to many external shocks and events which might have derailed the process entirely, but which in practice were accommodated through flexing the agenda, process and/or timetable for the subsequent rounds of CE and the CAA's own regulatory proposals and consultations. Some of these shocks (notably the takeover of BAA plc by the Ferrovial-led consortium and the resulting delays to CE discussions) placed some strain on the confidence of the airlines in the ability of Heathrow and Gatwick senior management to deliver the process<sup>17</sup>. But, in practice, CE dialogue continued and, with time, BAA was largely able to re-engage with airlines.
  - CE became a process of 'learning by doing' for all parties, including the CAA, with reflection and feedback between the regulator and the airport and airlines at a number of key stages. Some issues were found to take longer to resolve than originally envisaged, and some required iteration between CE and the CAA to home in on conclusions which were broadly, if not universally, supported.

### **What did CE deliver**

50. The following section describes the various outputs of CE, focusing on Heathrow and Gatwick, the two airports where the CE process ran

<sup>17</sup> Less of an issue at Stansted as CE was not active during 2006, and the airlines had already reached an impasse in 2005 with BAA plc management about the strategic direction for the airport's development.

throughout the price control review. It also touches on the contrasting situation at Stansted, where CE never got started in earnest, but where some useful results from airport-airline dialogue were eventually delivered some years later right at the end of the price review process.

### *Strategic vision for airport development*

51. Although not requested by the CAA as an output from CE, at Heathrow and Gatwick the airport operator and airlines spent considerable effort in the early stages of CE debating the strategic vision for the airports' development and reaching a consensus view. The resulting statements on the jointly-desired nature of the airport, its services, facilities and plans for development served a useful purpose for the rest of the CE debate by providing a clear reference point against which to assess, for example, competing investment projects or alternative service standards. Inevitably, the translation of the strategic vision into concrete plans led to greater debate, as different parties placed different interpretations on the strategic visions and their implementation.
52. At Stansted, there was a fundamental difference of view between BAA, promoting an early second runway and rapid expansion in capacity thereafter, in line with the Government's 2003 White Paper, and the incumbent airlines, seeking low cost provision of incremental capacity to support their own expansion plans. This difference, in part exacerbated by the impact of traditional price regulation in which airport charges are a direct function of historical and projected capital expenditure, prevented CE from being established in 2005. It is interesting to note that, once the strategic question of the airport's medium and longer term development had been put to one side, then the airport and its airline users were able to re-engage constructively (under the auspices of the Competition Commission's inquiry) to agree on a shorter term vision for the efficient operation of the airport in the next five years.

### *Traffic forecasts*

53. At Heathrow and Gatwick, considerable joint analysis was undertaken in the early stages of CE which led to a fair degree of consensus around the key drivers of traffic growth at each airport and a better understanding among the airlines of the dynamics of BAA's own model. This led to a degree of convergence between the parties by the middle of the price review. Events then tended to push the parties apart. For example, following the security crisis of August 2006 and the anticipated disruption of Heathrow from March 2008 following the opening of Terminal 5 and subsequent airline relocations, BAA sought to argue that Heathrow traffic growth could be subdued for a while. The airlines, however, argued the opposite, that Heathrow with T5 and better service standards would see a boost to traffic, further enhanced by the EU-US Open Skies deal which liberalised US air services from Heathrow. Similarly, at Gatwick, initial consensus broke down somewhat towards the end of the price review as each side sought to interpret new factors (notably the potential loss of US traffic to Heathrow).

54. Nevertheless, CE provided a valuable set of inputs for the CAA, as evidenced by the fact that the CAA did not, in practice, need to construct its own forecast from scratch. The transparency and scrutiny of differing views which the CE process had generated provided sufficient evidence for the CAA to reach a balanced view of traffic forecasts at Heathrow and Gatwick. This entailed assessing the factors adduced and giving different, reasoned weights to each in reaching a CAA view on likely future demand.
55. At Stansted, debate around traffic forecasts was at the heart of the fundamental disagreements between BAA and the airlines. In economic terms, there were strongly differing views about the degree of price sensitivity of passenger traffic to airport charges. In commercial and political terms, the incumbent low cost airlines were strongly opposed to the development of a second runway as early as and at the cost which BAA had proposed, which they considered was not necessary or affordable by Stansted users. This debate found expression in the analysis of traffic forecasts and what these might imply for the capacity of the airport, the need for capacity-enhancing investments for the current runway and terminal, and the timing of a second runway. These debates were not confined to the CAA-led price review: they also formed one of the central issues in the planning inquiry for the expansion of the airport on its current runway, and would be likely to be contentious in the planning inquiry for a second runway.

#### *Service quality*

56. This was a productive workstream at both Heathrow and Gatwick, in which the airlines were able to bring their operational insights to bear in helping to press BAA for broader and higher service standards. The work was technical and specific to each airport, and drew on the specialist expertise of the airline and airport managers engaged in CE working groups. The outputs were rich in evidence and detail, and the CAA relied extensively on the substantive joint reports in framing its own regulatory proposals and decisions.
57. As noted above, the main area of contention was that of security processing, where changes to DfT security requirements alongside the desire of airlines, passengers and the CAA for a more robust level of service had resulted in very considerable increases in the cost of service provision. To address this, the CAA established a continuing CE workstream in summer 2007, with greater CAA direction, oversight and involvement than for the other CE topics, the aim of which was to assess jointly the various service options and associated costs. Notwithstanding the lack of agreement at each airport on the appropriate level of efficient costs to allow for in setting price caps, this extension of CE was valuable to the CAA in providing detailed airline scrutiny of each airport's service and cost modelling, which helped inform the CAA's own subsequent analysis and judgement.
58. At Stansted, there had been considerable friction between the airport operator and airline representatives about the resilience of service provision in recent years, notably passenger security processing after August 2006. In

light of sustained improvements in operational performance by 2008, though, a more productive dialogue had developed. Following the Competition Commission's recommendation that service quality regulation should be introduced at Stansted, as it had already been for Heathrow and Gatwick, the CAA was able to instigate a final round of CE to provide views and evidence on the scope and design of this regulation. The resulting joint proposal was very largely adopted by the CAA in its final price control decision.

### *Capital expenditure*

59. The debate around future capital expenditure was at the core of CE, and illustrated well some of the benefits from and challenges to CE. In summary, there was considerable convergence at both Heathrow and Gatwick on comprehensive plans for what should be built in the coming quinquennium and beyond, but much less consensus on the appropriate level of expenditure and its management by the airport operator.
60. An early output from CE was a technical study, commissioned by Heathrow airlines (but also relevant to the Gatwick and Stansted reviews, and paid for by BAA), which sought to identify how cost-efficient BAA was in delivering capital projects. It quantified further savings which should be achieved, and further improvements to BAA's management of project budgets and contingency allowances. This work was accepted by BAA and integrated into the capital budgeting on which the CAA and the Competition Commission relied.
61. There were four key CE submissions during the course of the price review which shaped the regulators' thinking on future investment at Heathrow and Gatwick: June 2006, February/March 2007, July 2007 and January 2008. The size and shape of the capital programme at each airport expanded considerably over this 18 month period, in part due to BAA reassessing airline and passenger needs for capacity and service and the facilities needed to deliver these, and in part arising from changing airline priorities.
62. The CE outputs on this topic were extensive and detailed, and towards the end of the price review included information on dissenting or minority airline views at each airport. The CAA sought to understand the reasons for the changes at each stage, and to comment on them where appropriate in subsequent regulatory statements and more informal feedback to the parties, for example in providing views on Heathrow inter-terminal connectivity projects, which might provide broader benefits to passengers but not to all airlines. In summer/autumn 2007, the CAA commissioned a technical assessment of the emerging plans at each airport, to provide expert advice on the risk to delivery of the overall programmes, and the extent to which BAA had adopted the improvements to programme and project risk management identified earlier in the price review. In light of this analysis and the CAA's regulatory proposals in November 2007, BAA made further revisions to the Heathrow programme, resulting in the deferral of some projects and the acceleration of others, with a net increase in the overall

programme and its estimated cost. At Gatwick, it maintained the autumn 2007 programme, following CAA endorsement thereof, including support for a substantial new pier which would support enhanced passenger service, but which was controversial with a number of airlines.

63. The CAA largely embraced the core consensus emerging from CE deliberations on capital expenditure. In marginal cases, the CAA assessed the evidence and conflicting views against its statutory duties in order to reach a view on the inclusion or timing of a particular project. In most cases, the CAA tended to include the investment as proposed by BAA, which some airlines had argued should be deferred. Other marginal cases involved projects which some airlines wanted to see accelerated and/or expanded. The CAA did not over-rule BAA on the timing and scope of major strategic projects (such as the Heathrow East Terminal, the opening date for which was subject to a number of postponements), but did use evidence from CE to promote more timely delivery of some smaller projects (for example, additional stands at Heathrow T5 satellite C). At Gatwick, the CAA endorsed BAA's significantly expanded investment programme, including support for a substantial new pier which would support enhanced passenger service, but which was controversial with a number of airlines.
64. While discussions on the scope and composition of the investment programme were generally productive, CE made much less progress on achieving consensus or useful evidence on the costs of particular projects and the investment programme overall. Recognising that this was a technical issue on which neither the airlines nor the CAA had extensive in-house expertise, both engaged external specialist advice to scrutinise BAA's plans and costings. This became an involved task, with complex and ambiguous results and few ready solutions. As such, there was little meeting of minds in CE at either Heathrow or Gatwick on whether the investment programme which the airlines supported was efficiently costed. The Competition Commission undertook significant work in this area, notably on contingency risk allowances and construction price inflation. The CAA also drew on expert advice which it deployed in the latter stages of the price review with the aim of informing the final round of CE.
65. In addition to the capital programme itself, the CAA also remitted to the final round of CE the task of identifying capital 'trigger' projects and milestones for these to which financial incentives would be attached, to encourage the timely delivery of infrastructure. This was a time-consuming and complex task at each airport, and the CE process appeared to work effectively in eliciting the views of all parties and reaching a broad consensus on the trigger projects and definitions of milestones. At the time of the CAA's final price control decision in March 2008, the milestone triggers were defined in high level terms only. The CAA commissioned a further round of CE in the period April-October 2008 at each airport, to deliver more detailed specifications of each project's outputs and a precise milestone definition. The results of this further detailed CE exercise formed the basis of the CAA's

proposals for Heathrow and Gatwick triggers in autumn 2008, and subsequently the CAA's decisions in February and March 2009 which completed the specification of the Q5 price controls at each airport.

66. At Stansted, while there was no effective CE process, at various stages in the period mid 2005 to early 2009 there were attempts by BAA, airline representatives and latterly the Competition Commission to initiate consultation about airport development plans. Very little progress was made on the second runway proposals, but there was some productive engagement on investment to support the current runway.
67. Discussions on the proposed second runway were not productive, with fundamental differences between the airport operator and airlines about the strategic direction and pace of development tending to hinder effective exchange of views about investment plans and options. This process has been the subject of considerable regulatory scrutiny and criticism of BAA, notably by the Competition Commission in its Stansted price control report<sup>18</sup> and in its BAA market investigation<sup>19</sup>. The CAA also assessed the outcome of consultation on strategic capital investment and, while critical of BAA, also identified problems with the airlines' approach to consultation. The CAA sought to understand the underlying causes of these tensions (arising from the parties' respective market positions and the interaction of capital expenditure with price caps under a standard price-setting approach) and to frame alternative regulatory approaches which might mitigate these tensions<sup>20</sup>.
68. With regard to investment to support the airport as currently configured, with its single runway and terminal, there was productive dialogue between BAA and the airlines. Although the process of consultation had not always been orderly, the outcomes of earlier dialogue in the period 2003-2008 suggested that BAA was becoming more responsive as an airport operator in the scale, timing, and specification of investment projects to support current airline and passenger operations. (although this CAA assessment was challenged and criticised by the Competition Commission in its own analysis as part of the Stansted price control review and BAA market investigation, as previously cited). By shortening the focus of consultation to a five year horizon, setting aside second runway plans, and omitting any larger scale projects whose primary objectives were non-aeronautical returns, the local airport management and airline representatives were able in summer 2008, under the auspices of the Competition Commission, to consult and reach agreement on a relatively small investment programme<sup>21</sup>. The output from this regulator-led process then formed the basis of the Commission's

<sup>18</sup> Stansted Airport price control report to the CAA, Competition Commission, October 2008

<sup>19</sup> BAA market investigation provisional findings and possible remedies, Competition Commission, August 2008; final remedies proposals, December 2008, final report, March 2009

<sup>20</sup> See, for example, Stansted Airport price control reference, CAA, April 2008, price control proposals, December 2008, and CAA responses to Competition Commission provisional findings, September 2008, and to final remedies proposals, January 2009

<sup>21</sup> Less than £85 million (2007/08 prices) compared to the initial proposed capital expenditure programme for Q5 of £1,366 million (2007/08 prices) and to the regulated asset base of over £1 billion

recommendations to the CAA for the Stansted price controls, which in turn were incorporated in the CAA's price caps (albeit without the full cost 'building block' rationale employed by the Commission).

### *Non-regulated aeronautical charges*

69. Under the single till approach to airport price regulation, regulated airport charges are typically set as the residual of the projected efficient costs of operation less revenues from two sources: so called commercial revenues (shops, car parking, property) and non-regulated aeronautical charges (specific services and facilities provided by the airport to airlines and charged separately on a per use basis). The CAA remitted discussion on the latter to CE, as these covered detailed airport-specific issues involving trade-offs between cost, service, resilience, etc, on which airlines would have operational insights. (Analysis of airport commercial revenues was led by the CAA, and not remitted to CE, given the lack of interaction with airline operations and the commercial confidentiality of some of the evidence).
70. Good progress was made in CE on this topic at each airport. This resulted in better understanding by the airlines of the cost drivers for each charge, agreed projections of charges and the basis of projection, and a commitment from each airport to more effective consultation with airlines on an annual basis regarding any changes to the scope or level of such charges. The CAA adopted these CE outputs into its final proposals and decisions at Heathrow and Gatwick. A similar outcome was achieved at Stansted, following the Heathrow / Gatwick model, albeit without the prior process of CE.

### **Criticisms of CE**

71. The Q5 price control reviews at each of BAA's designated airports were unusually contentious (as indicated by the actual legal challenge to the CAA's decision on Gatwick and threats of legal challenge at Heathrow and Stansted). There was a range of factors, mainly external to economic regulation (such as the prospect of new runways at Stansted and Heathrow, the opening of T5, competitive dynamics in the airline market, the takeover of BAA plc, the Competition Commission's market inquiry, enhanced security concerns and the Government's review of economic regulation) which meant that the Q5 reviews would always have been challenging, whatever approach the CAA adopted. It is therefore unsurprising that the process and outcome of the Q5 reviews have attracted criticism in general. Given that the CAA had introduced the innovation of CE, though, it was perhaps inevitable that CE would itself become the focus of much of this criticism from the parties, and more broadly. The survey of such criticism should be considered in that context.
72. The airlines at Heathrow and Gatwick expressed a number of frustrations and concerns about the process and outcome of CE:

- Information flow from each airport was often too little too late, which hindered the airlines from engaging effectively;
  - BAA often presented its own preferred solution rather than explore jointly with the airlines a range of potential options;
  - While there was productive discussion about the outputs desired from capital facilities and services, debate around the efficient costs of delivering such made much less progress, with the airlines complaining about BAA's defensive and non-transparent approach to justifying its cost projections;
  - Significant changes to the scope and costs of capital and service plans in the latter stages of the price review gave rise to suspicions among some airlines that BAA was 'gaming' the process, by deliberately holding back information until the last moment and thereby reducing the ability of the airlines to scrutinise it effectively;
  - Some airlines expressed frustration with the lack of engagement by the CAA in the CE process, and argued that the CAA should have been stricter in its oversight and discipline of BAA's behaviour, and should have stepped in sooner to resolve emerging differences on substantive and process issues;
  - CE, while broad in scope, did not cover some very major issues (notably operating expenditure, commercial revenues and cost of capital). Without these inputs, some airlines found it difficult to negotiate on CE issues, such the capital programme or service regime, without knowing the likely overall level of airport charges. This was particularly an issue in the latter stages of the price review, when significant changes in the costs of security processing combined with changing scope of capital plans led to marked increases in projected airport charges. It was also a concern at earlier stages, when airlines were seeking to understand the charging implications of a very broad range of strategic options for the capital programme.
73. The Competition Commission echoed many of these criticisms in its own analysis as part of its market investigation of BAA's airports<sup>22</sup>. In its finding that the system of airport economic regulation had an adverse effect on competition, the Commission argued that the CAA had been inadequately active in its regulation of BAA's designated airports. It suggested that the CAA should have stepped in to help airlines obtain full and timely information to enable more effective CE, and to resolve disputes between BAA and the airlines on the cost, scope and specification of capital projects. In particular, the Commission placed considerable store on achieving agreement from CE, and that any outcome short of this was something of a failure, and one that could and should have been rectified by the CAA.

<sup>22</sup> See for example BAA airports market investigation – a report on the supply of airport services by BAA in the UK', Competition Commission, 19 March 2009 (the 'CC Final Report'), paragraph 6.59

74. BAA has been less vocal publicly in criticising CE. At the level of airport management, it appears to the CAA that it has attempted to implement CE in the spirit intended by the CAA. Subsequent to the Q5 price reviews, each of Heathrow and Gatwick managements has sought to embed CE into their ongoing dialogue with airlines on airport development. They also appear to be taking steps to improve the level of transparency and to involve airlines earlier in strategic investment options. At the corporate level, BAA has tended to support CE as a useful process, and to justify its actions within CE as it took place at Heathrow and Gatwick<sup>23</sup>. It has also defended its part in CE in the context of the legal challenge brought by easyJet against the CAA's price control decision for Gatwick<sup>24</sup>.
75. Former BAA directors have been more vocal in their criticism of CE. Most notably, Mike Toms (former group director for planning and regulation) has criticised<sup>25</sup> CE for delivering little beyond what regular consultation would have done, and for giving undue emphasis to the views of incumbent airlines at each airport. He argued that by doing so, the CAA had allowed the interests of airports users more broadly, including passengers, new entrant airlines and future users, to be under-represented, with the result that investment in new capacity, which could be a platform for more effective airline competition in future, could have been held back.
76. Beyond the airport sector, the concept of CE has recently attracted growing interest from a number of regulatory economists and practitioners. Professor Stephen Littlechild has been exploring the extent to which outcomes negotiated between regulated utilities and their customers in a range of countries and sectors could supplement or even substitute for direct economic regulation. In this work, he has sought to draw on the experience of CE in the UK airports sector<sup>26</sup>. The energy regulator Ofgem has also been examining CE and its potential relevance for price control of energy networks, as part of its current review of the RPI-X regime after 20 years of operation in the sector<sup>27</sup>. The potential for CE to elicit a richer information base for the regulator has been cited positively. It has also been noted that, given the current legal frameworks which require the regulator to impose controls in line with statutory duties, then CE might only be informative and not determinative for UK price controls (unlike the situation in some North and South American jurisdictions where CE-style agreements can become binding).

<sup>23</sup> See for example BAA response to Competition Commission's provisional findings, BAA, September 2008, paragraphs 5.13-5.20

<sup>24</sup> . Judicial review brought by easyJet against the CAA's March 2008 price control decision for Gatwick Airport. This case was heard by the High Court in March 2009 and remains (as at 18 May 2009) *sub judice*.

<sup>25</sup> Toms' lecture to the Institute of Economic Affairs' Beesley lecture series, October 2008

<sup>26</sup> Constructive engagement and negotiated settlements - A Prospect in the England and Wales water sector?, August 2008. Note that Professor Littlechild has also acted as an economic adviser to the CAA

<sup>27</sup> Ofgem RPI-X@20 review, working papers published at [www.ofgem.gov.uk/Networks/rpix20/Pages/RPIX20.aspx](http://www.ofgem.gov.uk/Networks/rpix20/Pages/RPIX20.aspx)

77. It should also be noted, in passing, that the CAA has mandated a variant of CE, termed customer consultation, as a core part of the current NATS price control review<sup>28</sup>. Similarly to airport CE, the CAA has set out a broad agenda of issues on which NATS and its airline users might productively exchange views and evidence, with the aim of producing useful inputs to the CAA's regulatory review. Two key differences between this approach and that adopted in the airports context are, first, that NATS has committed from the outset to an 'open book' approach under which all of its operating costs would be open to airline scrutiny, and, second, that there is a clearer distinction in time between the individual phases – i.e. between the customer consultation process and the subsequent CAA-led regulatory proposals and consultation – something which is reinforced by the nature of the legal framework put in place under the Transport Act 2000.

### **Assessment of CE problems**

78. The following section reviews some of the key problems encountered by CE and provides a provisional assessment. It should be noted that the CAA has yet to undertake a full 'lessons learnt' exercise on the Q5 reviews – and would not expect to do so until all of the price control reviews and all related legal processes are completed – but intends to undertake such a review, consulting with interested parties.

#### *Why did CE fail at Stansted?*

79. As noted above, CE failed to establish itself at Stansted, although there was a partial resumption of CE-style consultation at the very end of the price review, on a limited set of topics. The ostensible reasons for the failure of CE to start were disagreements about the scope of the information set to be provided by BAA to the airlines as a precursor to discussions and about the terms of engagement for CE. In the CAA's view, though, there was an underlying distortion to the incentives of airport and airlines at Stansted respectively, which arose from the operation of the standard approach to setting prices based on historic and projected capital expenditure: BAA's interests lay in early expansion funded in advance by current users, while airlines' interests lay in benefiting from their incumbency at the airport and not funding capacity for new entrants. The prospects for CE were likely to have been further diminished by the perceived stance of BAA in promoting development of a second runway at Stansted primarily on the grounds that this was Government policy, without building a solid base of user support and demonstrating commercial viability.
80. This issue has been explored in some depth by the CAA in the context of the recent price control review, notably in its reference to the Competition

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<sup>28</sup> NATS (En Route) plc price control review for Control Period 3, 2011-2015, CAA Policy Update, February 2009

Commission and its final proposals<sup>29</sup>. In practice, the failure of CE (certainly at the outset in 2005 and 2006, as originally envisaged) did not in the event cause major problems for the completion of the price review. Initially, the CAA took over the CE topics and started its own analysis and commissioned expert scrutiny. Subsequently, as the CAA's analysis of the competitive constraints facing the airport and the incentives created by RAB-based regulation developed, the CAA focused on developing an approach to the price control that provided more appropriate incentives on the airport operator and incumbent airlines, and on requesting that BAA provide a commercial business case for the SG2 project, rather than on the detailed scrutiny of the cost of individual capital investment projects. Over time, as demand forecasts reduced, BAA's preferred timing for SG2 to become operational in 2015 was increasingly likely to be delayed, reducing the need to resolve the regulatory treatment of the project at the Q5 review.

### *Flow of information*

81. The inadequacies of information flow from BAA to the airlines have been a consistent complaint of many airlines involved in CE, and of the Competition Commission. This issue can be divided into two main problems: first, the timeliness, scope and depth of the regular flow of information to support CE, and second, the provision of information about changing circumstances and/or BAA plans.
82. On the first, it is apparent from airline comments that many have been frustrated about the approach taken by BAA to providing information. Whatever the motivations behind it, to the airlines it has appeared at times that BAA has not been sufficiently forthcoming in providing the right information at the right time, often seeming to supply just sufficient to seek to support a BAA view without necessarily providing a broader information set to support shared analysis. This concern (which has been long standing at all price regulated airports) was partially addressed by the 2003 agreement on enhanced consultation and information disclosure, part of the Q4 price control settlement. CE, despite leading to a step up in information flow from BAA, also exposed the gaps and weaknesses in this consultation protocol. As a result, this agreement has been significantly strengthened, in line with airline requests, at Heathrow and Gatwick. At Stansted, a similar protocol has been imposed as part of the Q5 price control.
83. On the second, the problem was in part an acute example of the first underlying concern. When the factors around a key service or capital project are changing, it should have been apparent to BAA that there was a greater need for a more 'open book' approach with the airlines, one which recognised and exposed the uncertainties, but also sought to bring the airlines alongside BAA to help work through options to a solution, given the

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<sup>29</sup> Stansted Airport price control review, CAA reference to the Competition Commission, CAA, April 2008; CAA price control proposals for Stansted Airport, Supporting paper I - Illustration of airport and airline incentives, December 2008

new information. This might have engendered a greater degree of trust between BAA and the airlines involved. In the absence of such an approach, some airlines were able to characterise BAA's behaviour as 'gaming', an assessment which the Competition Commission readily accepted. In the CAA's view, there were valid reasons for the changes (for example to the costs / service / resilience trade-offs for passenger security processing, or to the evolution of the plans for Heathrow East Terminal), but BAA did not manage to maintain the airlines' trust as well as it could have done in communicating the rationale for change.

84. But it should also be noted that in any extended regulatory process such as a price review, particularly one subject to so much externally-driven change, initial assumptions, plans and projections are almost bound to change as the review progresses, in light of new information and updated assessments by all parties. This dynamic aspect of CE, and the need to plan for and manage an iterative process between CE and the regulator throughout the price control process, the extent of which was not envisaged in the CAA's initial proposals for CE, and may thus have come as a surprise to all. When it became apparent that CE had evolved into a multi-strand dialogue between the CAA and each airport and its airlines, the CAA did put in place new structures, processes and timetables, with the aim of channelling the work effectively and encouraging timely information flow from BAA.

*Airline-airport disagreement over underlying assumptions*

85. On a number of topics, although the airports and airlines managed to reach relatively close consensus on a high level view (for example, headline traffic projections, or the strategic outline of the Heathrow East project), this level of agreement proved to be somewhat shallow and fragile. Subsequent changes to input variables (or at least debate around them) led to weakening consensus, rather than to the more productive alternative of a joint reassessment in light of new evidence. This problem in turn went back to the underlying assumptions supporting the analysis (e.g. traffic forecasting – where each side had differing views about the key drivers).
86. Although CE provided a rich set of data and several 'snapshots' in time of airport-airline views (including consensus on some issues), it was less able to provide a dynamic tool for joint appraisal of new information or different weights given to different factors. In practice, such an exercise could be quite resource intensive (as proved to be the case in the joint BAA-airlines analysis of security processing service levels and costs in the end game of the Heathrow and Gatwick reviews). One response was for the airlines to delegate responsibility for engagement to a lead airline which was resourced for the task. Another response, for capital projects, was to establish joint airport-airline boards for each strategic project, so that executives from the affected airlines could build up expertise and the airport could understand more clearly airlines' requirements from the project.

## Emerging issues

87. This paper has attempted to survey the genesis, development, implementation, results and drawbacks of CE, from the perspective of the CAA, but also reflecting critiques made by participants and other regulators. From this preliminary assessment, a number of issues emerge which might help explain what happened in CE to date, and inform its future application in airport regulation or more broadly.
88. First, CE was clearly a learning process for all those involved, both as individuals engaged in a novel process, but also as organisations, many of which had deeply entrenched stances and positions. CE called for a different way of working which, at its best, encouraged information-sharing and joint problem solving. This contrasted with the adversarial regulatory positioning which characterised much of the dialogue at previous price control reviews (and was also present at the Q5 review on issues such as opex efficiency and cost of capital).
89. One of the challenges for the CAA was to be able to recognise and acknowledge this learning process as CE evolved, providing timely feedback on what had and had not worked well to date, and guidance on the next stage of CE, if need be updating the 'rules of the game' Striking the right balance of intervention and leadership, but without prejudging debate or stepping into arguments prematurely, was an important part of the learning for the CAA.
90. Second, as previously noted, a good degree of flexibility and adaptation was required by all parties, both to address the issues thrown up by CE itself and to cope with the various external shocks to the process. Early efforts at Heathrow and Gatwick to build trust between airport operator and airlines and to embed new ways of working in formal joint structures proved to be valuable subsequently in helping CE to withstand subsequent stresses. It should be recognised that, for all the difficulties and perturbations of the process, a good degree of trust was established at these airports (and also at Manchester), overcoming some fairly long-held suspicions on the part of airlines about the airport operators' motives and capabilities. By contrast, the absence of such flexibility on all sides at Stansted was a central aspect of the failure of CE to establish itself there.
91. Third, disagreement between the parties can be just as valuable an input into regulatory decision-making as agreement, and in some cases might be said to be more valuable, in that it exposed more clearly differing views which might have been hidden within a consensus. It also meant that evidence was carefully examined and laid out, again helpful to the regulator.
92. Fourth, the quality, depth, breadth and timeliness of information were all key to effective CE. Where the airport operator fell down on these factors, CE suffered and airlines lost confidence in the process. Conversely, where airlines were not able to give timely, evidenced and specific feedback on

each airport's plans, then CE did not make much progress or produce many useful insights. It became apparent during 2005-2008 that the standards for consultation and information disclosure, set by the CAA for BAA's airports in 2003, needed to be bolstered (through agreement at Heathrow and Gatwick, and through public interest condition at Stansted). This did not invalidate the results of CE to 2008, but should improve the outcomes of future CE.

93. This survey is necessarily preliminary and provisional, and would benefit from revisiting and updating in light of a full debrief of all parties, which the CAA intends to undertake.