



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 II – The Competition Commission's analysis of the CAA's regulation of designated airports

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The Competition Commission's analysis of the CAA's regulation of designated airports

Introduction

Background

1. In its Final Report, the Commission assesses the impact that the “system of economic regulation” – i.e. the regulatory framework and the operation of it by the CAA – has had, and whether it is a feature that has adverse effects on competition. As the Commission considers that the system of economic regulation is such a feature, it goes on to make a number of recommendations to the CAA and to Government. The Commission also analyses a number of other features, notably BAA's ownership of a number of UK airports, and proposes associated remedies.

Document purpose

2. This paper considers only the Commission's analysis of the impact of the system of economic regulation on competition and, in particular, whether the CAA's role within the current regulatory system can reasonably be considered to have adverse effects on competition.
3. The CAA has prepared this paper to support its submission to the Government's review of economic regulation, so as to ensure that the review is fully informed about the operation of the current system of economic regulation, and that any reforms are based on a comprehensive appraisal of the facts and available evidence.
4. With this objective in mind, this paper focuses on areas of the Commission's analysis that were included in the Final Report and considers the apparent basis of the Commission's findings, focusing particularly on areas where the Commission's analysis was not discussed with the CAA.

Document structure

5. This paper is structured in three main sections. The first considers the analytical approach adopted by the Commission, and the second the individual findings made by the Commission. The third section provides a brief summary of the CAA's response to the recommendations issued to it by the Commission.

The Commission's approach

6. This section discusses the overall analytical approach adopted by the Commission to assess the impact that the CAA's regulation of airports has had on competition. It starts by setting out the 'test' that the Commission adopted for this analysis. This is followed by a description of the analysis presented in the Provisional Findings and how the Commission modified its

approach in the Final Report. This section concludes by arguing that the Commission has failed to reconcile its view that the CAA complied with its legal obligations under the Airports Act with its criticisms of the CAA under the Enterprise Act.

The ‘test’ adopted by the Commission

7. When assessing the impact of regulation on competition, the Commission focuses on comparing the actual outcomes that resulted from the operation of the current system of economic regulation against its assessment of the *effective* operation of an *effective* system of economic regulation. The Commission stated that:

“[the Commission] should compare the outcomes with those expected from an effective system of regulation and its effective operation, while acknowledging that effective regulation is always inferior to effective competition and no regulation.”¹
8. Under this approach, a feature can be identified as having adverse effects on competition if:
 - the system of economic regulation is not “effective”; or
 - the operation of the actual system of economic regulation is not “effective”.
9. In respect of the latter, the Commission narrows its analysis to consider only the CAA’s role in regulating airports. The Commission chooses not to investigate its own role and its impact on competition. This is a significant omission. The Airports Act splits the responsibility for the regulation of designated airports between the CAA and Commission, with the CAA focusing on price issues (with the Commission in an advisory role) and the Commission focusing on non-price issues.² This split of responsibilities clearly implies that the outcomes secured by the regulation of UK airports is the joint product of the decisions made by the CAA and the Commission, and specifically of decisions made by the CAA which have had regard to, and been influenced by, the recommendations of the Commission.
10. In respect of the system of economic regulation, by which the CAA means the statutory framework as set out in the Airports Act 1986, the CAA broadly agrees with the Commission’s findings that it is not “effective”, or, at least, that it could be made more effective. For example, the CAA agrees with the Commission’s recommendation that there should be a flexible licence-based

¹ Paragraph 6.4, ‘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’)

² The Commission has two principal price cap related obligations under Part IV of the Airports Act, to make a recommendation to the CAA of the appropriate price cap to apply to each designated airport and to make public interest findings. The CAA’s obligations under Part IV are to implement a price cap, having regard to the recommendations issued by the Commission, and to impose conditions to remedy the public interest findings, having regard to the Commission’s recommendations as to remedy.

system of economic regulation. The Commission also supported the CAA's calls for its statutory duties to be framed with a primary duty to protect the interests of consumers (i.e. passengers and other end users).

11. However, the CAA has significant concerns in respect of the Commission's approach and findings in respect of whether the CAA's regulation of airports has had an adverse effect on competition. This is discussed in more detail in the remainder of this paper.

The Commission's Provisional Findings

12. In its Provisional Findings³, the Commission argued that the CAA's economic regulation had led to a distortion to competition between airlines, due to:

"...the way in which the CAA has given effect to its four statutory objectives in fulfilling those duties. Notably, limiting its activities unduly in relation to the first three objectives and emphasizing the fourth (which is to impose the minimum restrictions consistent with achieving its other objectives) has adversely affected competition through the impact on airlines and passengers of inadequate investment and service standards."⁴

13. In response, the CAA requested that the Commission explain the arguments supporting this provisional finding. In particular, the CAA requested that the Commission set out the causality that led from the CAA's actions to the alleged impacts of inadequate investment and service quality on competition between airlines, and to set out clearly:

- the outcomes (such as the airports' investment performance) that have fallen short of the level to be expected in a well-functioning airport market; **and**
- the action or inaction on the part of the CAA that contributed to any such shortfall; **and**
- the effect that the CAA's impact on outcomes has had on competition (and, reflecting the limited focus of the Commission's finding, the impact on airline competition, in particular).

14. In respect of the first, the CAA also requested that the Commission reconcile its views on service quality and investment with the Commission's contemporaneous views on these issues which supported its recommendations to the CAA as part of the price control reviews of BAA's London airports.⁵

³ 'Provisional Findings Report', Competition Commission, 20 August 2008

⁴ Paragraph 7.41, 'Provisional Findings Report', Competition Commission, 20 August 2008

⁵ The CAA argued that, as the Commission's role in the regulatory system was explicitly undertaken against the same duties as applied to the CAA, the Commission's recommendations provided useful contemporaneous evidence both of the extent to which the CAA's decisions had adversely affected competition and of the performance of and incentives faced by BAA.

15. To illustrate this point, the CAA noted that in 2002 the Commission reached the view that BAA's investment performance at Heathrow, Gatwick and Stansted was not unreasonable, stating that:
- “[the Commission believes that the public interest] complaints raised with us have to be seen against a level of [BAA's] investment performance we regard as broadly satisfactory”; and that
- “in [the Commission's] view, except for the delays in T5 that have been largely outside its control, BAA cannot be regarded as having systemically under-invested during Q3.”⁶
16. The CAA notes that subsequently, during Q4, BAA's capital expenditure across its designated airports exceeded the amount allowed for by the CAA and the allowance recommended by the Commission. This was primarily driven by an acceleration of investment at Heathrow T5 to meet the updated plans of British Airways, and notwithstanding some scaling back of investment at Stansted compared to previous plans.
17. The Commission also commented on the level of service quality offered at BAA's airports, stating that:
- “We do not believe the average level of service in Q3 has been poor.”⁷
18. The CAA has argued that service quality at Heathrow has, at times during Q4, been below acceptable levels and that investment has been below the level that would be expected in a well-functioning market. However, in both cases, there are significant factors external to the regulatory system that help explain these shortcomings: notably, the unforeseen (and unforeseeable) step-change in mandatory security clearance procedures at UK airports in 2006 and the delays caused by the planning regime to investment in Terminal Five. Moreover, the CAA did identify at the Q4 price review that the previous application of price cap regulation had not provided sharp enough financial incentives on the airport operator to deliver capital projects in a timely fashion, or to link airport charges with variable service quality. With the support of the Commission, the CAA put in place regulatory measures in 2003 to address both issues. It strengthened both sets of measures in 2008, again with the support of the Commission.
19. This appears to question whether there is evidence of a systematic pattern of under-investment and inadequate service quality – based on the Commission's contemporaneous assessments – which would undermine the causality implied by the Commission's findings.
20. Furthermore, in respect of the link between the CAA's action (or inaction) and outcomes at UK airports, the CAA noted that its decisions had broadly

⁶ Paragraph 2.406, “BAA plc: A report on the economic regulation of the London airports companies (Heathrow Airport Ltd, Gatwick Airport Ltd and Stansted Airport Ltd)”, Competition Commission, 2002

⁷ Paragraph 2.445, CC Q4 Report

followed the Commission's recommendations, including in respect of the regulation of service quality performance. Further, where the CAA departed from the Commission's recommendations on material aspects of regulatory policy, it was to implement regulation that reduced distortions to competition. Indeed, the CAA cited two particular examples where its regulation of designated airports had the specific object of promoting competition, namely:

- the CAA's decision to apply stand-alone price caps, bringing to an end the previous approach whereby Heathrow and Gatwick subsidised the operation of Stansted (a decision subsequently endorsed by the Commission in its Q5 review); and
- the CAA's decision not to set the Q4 price caps at Manchester as tightly as the Commission itself had recommended, so as to avoid harming the development of competition from airports such as Liverpool (a decision subsequently vindicated by the Government's decision to de-designate Manchester Airport).

21. In both cases, the CAA decided not to follow the Commission's recommendations and in both cases – the CAA argued – competition would have been harmed if the CAA had implemented the Commission's recommendations. It could, for example, have been more difficult for the Commission to realise the gains from the break-up of BAA if the group was continuing to implement anti-competitive cross-subsidies between the designated airports. Further, it should be noted that the CAA's regulation of Manchester Airport encouraged competition to develop to a sufficient degree to allow the Secretary of State to 'de-designate' the airport, removing the price cap from the airport.
22. Overall, therefore, the CAA argued that on the major policy issues, over the last 20 years of economic regulation of airports, the CAA's decisions had promoted – and did not adversely affect – competition.
23. The CAA argued that this called into question the Commission's view that there was a causal link between the CAA's regulation and adverse effects on competition between airports and/or between airlines.

The Commission's Final Report

24. The CAA has not been able to identify an explanation in the Commission's Final Report of the causal link between its regulation and the alleged inadequate service quality and investment and the resulting distortion to competition between airlines.

25. However, the Commission does set out an argument as to how inadequate investment and/or service quality could have adverse effects on airline competition, arguing that:

“the cost and quality of UK airports, and the extent to which airport facilities are appropriate to meet the often divergent requirements of airlines, can therefore significantly affect the competitive position of airlines. Deficiencies in regulation, resulting from charges higher than necessary, do therefore, in our view, have an [adverse effect on competition] between airlines and, ultimately, on passengers.”⁸

26. However, the Commission does not set out an explanation of how the CAA’s role in applying the current regulatory system – as opposed to the nature of the current regulatory system or, indeed, other factors such as the planning regime – has *caused* the alleged adverse effect on competition. In fact, in the Final Report, the Commission does not attempt to set out this causal link, instead stating that:

“[the Commission has] separated [the system of economic regulation and the way it is operated] as it is a reasonable approach to analysis but [the Commission acknowledges] that it is not easy to disentangle them and we do not do so when we reach our conclusions on features.”⁹

27. This change in approach between the Provisional Findings and the Final Report makes it difficult for the CAA to engage with the Commission’s analysis, as there is no clear proposition to analyse. The Commission does, however, consider the issue of the relationship between the Airports Act and its findings under the Enterprise Act, which is discussed immediately below. The Commission also presents a series of individual findings, which are discussed in the next section of the paper, from paragraph 37.

The Airports Act 1986 and adverse effects on competition

28. In addition to its overall findings in respect of economic regulation and the CAA’s role, the Commission makes a number of statements on the performance of economic regulation. In particular, the Commission makes clear that economic regulation has delivered benefits, stating that:

“...the overall effects of economic regulation were likely to have been positive when viewed against the likely outcome of common ownership without regulation.”¹⁰

29. Further, the Commission also stated that it:

“...stresses that we are not, at any point in this report, suggesting that the CAA has acted contrary to its legal obligations under the Airports Act.”¹¹

⁸ Paragraph 6.56, CC Final Report

⁹ Paragraph 6.5, CC Final Report

¹⁰ Paragraph 6.4, CC Final Report

30. This raises a question as to how the Commission can both consider that the CAA has complied with its statutory obligations and yet also consider that it has, at the same time, had an adverse effect on competition. The consistency in the Commission's arguments depends upon the degree to which a set of regulatory outcomes can be consistent with the Airports Act whilst not being consistent with the Enterprise Act.
31. The CAA's legal obligations, set out in Part IV of the Airports Act 1986, require it to perform two main functions:
- to impose a price cap on airports designated by the Secretary of State, having regard to the Commission's recommendations; and
 - to apply conditions to designated airports to remedy the effects of any public interest findings identified by the Commission.
32. The Airports Act also requires the CAA to discharge these functions in the "manner which it considers is best calculated" to meet four objectives.¹²
33. Further, these objectives are framed in terms of the users and operators of all UK airports, obliging the CAA to consider the impact of its regulation on competition between airports. The CAA has also argued that the development of effective airport competition is likely to further the reasonable interests of airport users. Indeed, the CAA's decisions clearly reflect this, as is illustrated by its approach to the Q4 price control at Manchester Airport and by the decision to implement stand-alone regulation of BAA's designated airports. Specifically in relation to investment, the CAA's duty "to encourage investment in new facilities at airports in time to satisfy anticipated demands..." clearly resembles the outcomes that would be expected in a well-functioning, competitive airport market and which the Enterprise Act seeks to promote.
34. In light of the role that the promotion of competition is likely to play in the CAA's assessment of its statutory duties under the Airports Act, this raises the question of how the CAA's price control regulation of designated airports can comply with the obligations under Part IV of the Airports Act whilst also being considered to have had an adverse effect on competition. The Commission briefly considers this issue and argues that the CAA:
- "has given little recognition to our being obliged to conduct [the] investigation under the Enterprise Act, which may explain some of the differences [between the view of the Commission and of the CAA]".¹³

¹¹ Paragraph 6.46, CC Final Report

¹² These objectives are: (a) to further the reasonable interests of users of airports within the United Kingdom; (b) to promote the efficient, economic and profitable operation of such airports; (c) to encourage investment in new facilities at airports in time to satisfy anticipated demands by the users of such airports; and (d) to impose the minimum restrictions that are consistent with the performance by the CAA of its regulatory functions. The CAA is also required to take into account such of the international obligations of the United Kingdom as may be notified to it by the Secretary of State.

¹³ Paragraph 6.57, CC Final Report

35. This statement is not correct. The CAA discussed this issue at length with the Commission both at oral hearings and in correspondence between the two organisations. The CAA understands and recognised clearly that the CAA and Commission undertake price control reviews under different legislation to the Enterprise Act and that, in principle, this could lead to assessments made under the Enterprise Act that apparently conflict with those made under the Airports Act.
36. However, in practice, the Airports Act and Enterprise Act are both framed in a way that considers the impact of regulation on competition, as discussed above. Consequently, there appears to be little scope for the CAA to comply with its obligations under the Airports Act and yet still be found to have had an adverse effect on competition under the Enterprise Act. More significantly, the findings made by the Commission under the Airports Act provide a useful contemporaneous assessment that should inform its findings under the Enterprise Act.

The individual findings made by the Commission

37. The Commission identifies a series of findings which “*taken as a whole*, lead us to conclude that regulation is a feature which restricts competition” [*original emphasis*], namely:
- (a) “the failure to engage with airlines and BAA where there was a need to facilitate the processes of consultation at all three airports;
 - (b) the failure and then termination by the CAA of Constructive Engagement at Stansted with no considered figure for capital expenditure put to us by the CAA for us to be able to conduct our quinquennial review;
 - (c) repeated reliance on the argument that the threat of capital expenditure being removed from the RAB at the next quinquennial review was sufficient incentive on BAA to undertake appropriate investment and justification for the CAA not being involved in the interim, when the evidence is that only one capital expenditure project has ever been removed from the RAB (the atypical case of the personalized transit system at T5);
 - (d) lack of clarity for BAA as to the real meaning in the eyes of the CAA of what constituted adequate consultation (see paragraph 22(a) of Appendix 7.2);
 - (e) repeated concerns that to intervene would fetter the CAA’s discretion at the next quinquennial review;
 - (f) the cumulative effect of the above in the lack of regulatory involvement and certainty; and

(g) the evidence that almost every airline we have spoken to (including BA, Virgin, Star Alliance and the LCCs) regards the CAA as inadequate.¹⁴

38. This section considers each of these findings in turn, and the analysis that is presented to support them. However, at a more general level, when taken as a whole it is not clear how these disparate findings relate to service quality or investment outcomes or – more importantly in the context of assessing the CAA’s impact on competition – the extent to which the CAA’s action (or inaction) has led to service quality or investment outcomes that have adversely affected competition.
39. More generally, the CAA considers that the above list of findings needs to be considered in the wider context of the full set of the CAA’s regulatory policy decisions. For example, the Commission focuses on the differences between the way that the CAA implemented Constructive Engagement and the Commission’s (ex post) assessment of the “effective” approach. The impact of this difference should be viewed alongside other areas of departure between the CAA and Commission, and the CAA’s own regulatory initiatives. The CAA considers that, on balance, its decisions have materially supported the development of competition, notably by ending the practice of anti-competitive cross-subsidy between the airports (against the Commission’s advice), but also by introducing mechanisms such as Constructive Engagement (a CAA initiative, that went substantially further than recommended by the Commission in Q4¹⁵).

Engagement with airlines and BAA

40. The Commission cites the following to support its AEC finding on regulation:
- “(a) the failure to engage with airlines and BAA where there was a need to facilitate the processes of consultation at all three airports”
41. The Commission appears to base this view largely on its assessment of airport-airline consultation during the Q5 price control reviews, through the process of Constructive Engagement.
42. In particular, the Commission takes the view that the objective of Constructive Engagement should have been to secure agreement between the airport operator and airlines. The Commission’s current view needs to be seen in context. First, it contrasts somewhat with that expressed at the time of the Q4 price control review, when the Commission stated that “although effective consultation is important, given the disparate views and interest of airlines it is unrealistic to believe BAA should have sought ‘agreement’ on the

¹⁴ Paragraph 6.59, CC Final Report

¹⁵ The Commission did not make a public interest finding in respect of consultation at the Q4 review, commenting that “given the constraints and uncertainties of the last five to six years, BAA could not have done significantly more in its consultation processes...” (paragraph 2.424, CC Q4 Report) and instead recommended that “the CAA examine whether current procedures under section 41 of the Airports Act can be made more effective in resolving disputes between airports and users and whether it has more scope to be involved in relationships between airlines and users aside from its formal role under that section of the Airports Act” (paragraph 1.17, CC Q4 Report).

CIP [Capital Investment Plan]¹⁶. Second, the CAA determined the objective of Constructive Engagement following extensive consultation with all industry stakeholders, including the Commission. As set out in Supporting Paper I¹⁷, the CAA decided that the objective of Constructive Engagement was to deliver inputs into the price control process which would improve the quality of the information available to the CAA (and Commission). Whilst agreement between the airport operator and airlines was a desirable outcome, it was not the objective of the process.

43. Indeed, the CAA made clear at the time that one potential outcome for Constructive Engagement would be an agreed position but also clear documentation of areas of disagreement, where these existed, to enable the CAA and Commission to analyse these issues further. This recognised that, ultimately, it would be for the CAA – having regard to the recommendations of the Commission – to make the final decision on the appropriate price control. In practice, even where the parties did not agree (for example, on questions of the cost/service quality trade-off for passenger security processing), the results from Constructive Engagement in the form of each side's views and observations of the evidence were very valuable to the CAA in weighing up its regulatory assessment.
44. The CAA's role in CE was determined following consultation with stakeholders. As discussed in Supporting Paper I, this role was for the CAA to put in place a mechanism to encourage airport-airline negotiation. A deliberate decision was taken to delimit the CAA's role, so that it was not an active participant in the Constructive Engagement from the outset, in order to maximise the chances for commercial negotiation between the airport operator and airlines. Indeed, one of the key defining features of CE – distinguishing it from more usual forms of regulator-led consultation – was the limited role of the CAA during airport-airline negotiations.
45. The CAA's approach to CE was discussed with the Commission's staff¹⁸ in some detail during and after the consultation process. The Commission staff were also asked for its views on a draft of the decision document, which set out the Constructive Engagement process to be adopted.
46. At no time did the Commission staff raise concerns about the proposed scope of CE, other than observing that it was unable to commit to making use of the outputs of CE, due to the legal framework within which it was operating.
47. However, against this background, in the Final Report the Commission reaches the view that:

¹⁶ Paragraph 2.423, CC Q4 Report

¹⁷ Supporting Paper I to 'The Civil Aviation Authority's response to the Department for Transport's consultation', May 2009

¹⁸ Due to the constitution of the Competition Commission, it is not possible to secure its opinion outside of a particular inquiry.

“We have acknowledged that Constructive Engagement has had some positive effects, and its introduction is to the credit of the CAA. But, in our view, it could have been more effective, had there been a more active role by the CAA during the process and a greater scope for airlines to judge the level of charges resulting from given levels of investment.¹⁹”

48. The CAA accepts that there are learning points arising from the application of Constructive Engagement in the Q5 review. Indeed, the CAA intends to undertake a detailed consultation with stakeholders with a view to building on CE’s achievements for future price control reviews. As part of this process, the CAA will consider the Commission’s views on how Constructive Engagement could be improved.
49. However, the CAA considers it inappropriate for the Commission to use its views on how Constructive Engagement could be improved to infer that the CAA adversely affected competition in the way that it was implemented, unless it can be established – without the application of hindsight – that the CAA’s original decisions were inappropriate. The Commission does not – and does not appear to – argue that this is the case. Moreover, even with the benefit of hindsight, it is not at all clear from the Commission’s reasoning how the CAA’s approach to Constructive Engagement in the period 2005-2008 led causally to past poor outcomes for airlines in terms of investment and service quality which, in turn, adversely affected airline competition.
50. The Commission explicitly recognises that Constructive Engagement improved the regulatory process. In addition, the application of Constructive Engagement to UK airports was, both at the time and subsequently, acknowledged as an innovative move. It seems, therefore, that the Commission’s criticisms – and the alleged adverse effect on competition – are based on an ex post assessment that the CAA failed to implement a new regulatory approach precisely as the CC would – with hindsight – have wished it to be implemented.
51. An alternative interpretation of the Commission’s view is that the CAA should have changed its approach to CE during the process. The CAA did in fact do so in a number of key areas (as described below). However, it retained the overall structure of CE that had been established following detailed consultation with stakeholders, and to which the CAA had consciously and deliberately committed itself. Indeed, the likely success of CE relied upon a degree of commitment from all parties – including the CAA – to keep to the framework that was determined. This structure explicitly restricted the CAA’s role to reviewing the outputs of CE, rather than taking part in the process of determining these outputs.
52. The CAA did become more actively involved in directing and focusing the agenda and process for CE in latter stages of the Heathrow and Gatwick price reviews. From summer 2007 to spring 2008, the CAA led a number of

¹⁹ Paragraph 6.24 CC Final Report

tripartite discussions at each airport on the outstanding issues related to service quality standards and costs, with the aim of encouraging productive dialogue and timely evidence for the regulatory process. Over this period, the CAA also conducted detailed scrutiny of the airports' overall capital programmes and some capital investment projects, such as of the proposed Pier 7 project at Gatwick, and fed the results back to the parties. This scrutiny was informed by the output of CE, which set out the issues of agreement and disagreement, and was progressed through consultation with the airport operator and airlines. The CAA would characterise these actions as greater intervention by the regulator in the CE process, designed to produce the best available information on which to make regulatory decisions, and conducted within the overall framework for CE established at the outset of the process. In addition, the CAA notes that the role it adopted appears closely to resemble that subsequently adopted by the Commission in the Stansted review.

53. Furthermore, the CAA notes that during the Commission's review of Heathrow and Gatwick, the Commission chose not to intervene in the process of CE, leaving it to operate as originally designed. Indeed, if the Commission took the view that the operation of CE, up to the date of the CAA's reference, had been against the public interest it was open to the Commission to make an adverse public interest finding. The Commission did not make such a finding for either Heathrow or Gatwick. In justifying these decisions, the Commission argued that:

"We [the Commission] acknowledge that we did not make any public interest findings in our Heathrow/Gatwick Q5 report: any such findings could only have related to the period up to the date of the reference to us; and even at the date of our report, six months later, the processes at each airport were still ongoing.²⁰

54. This appears to make clear that the Commission had not identified any areas of CE that were acting against the public interest up until the time of the CAA's price control reference and also took the view during its six-month inquiry that the CE processes should be allowed to operate. .

The failure of Constructive Engagement and the scrutiny of Stansted capex

55. The Commission cites the following to support its AEC finding on regulation:

"(b) the failure and then termination by the CAA of Constructive Engagement at Stansted with no considered figure for capital expenditure put to us by the CAA for us to be able to conduct our quinquennial review"

56. The Commission raises two issues here. First, that the CAA 'terminated' CE at Stansted and, second, that this 'termination' led to the CAA's reference to

²⁰ Paragraph 6.24 CC Final Report

the Commission not containing a 'considered figure' for capital expenditure. These are considered in turn.

Termination of CE at Stansted

57. In respect of the first, it is not correct to state that the CAA 'terminated' CE at Stansted. In accordance with its stated approach, the CAA reviewed whether to rely on CE and decided that "there was a significant risk that the process would fail to provide the CAA with information material to the Q5 review"²¹. As a result, the CAA commenced work on an alternative approach, although it made it clear that it was still open for the airport operator and airlines to continue with a process of consultation and discussion, and "to deliver evidence and potentially agreements which could be taken into account by the CAA".²²
58. However, the Commission cites its experience during the Stansted price control and that it was able to 'rekindle' CE at Stansted. The Commission cites its positive experience to support its criticism of the CAA, arguing that it: "took the step of rekindling the process and saw considerable progress" which "indicates that CAA efforts in this direction might have had similar success at an earlier point."²³
59. The CAA acknowledges the limited progress that the Commission made on the scrutiny of the Stansted capital expenditure programme (albeit limited to 'care and maintenance' capital expenditure of less than £100 million over the next quinquennium). However, the Commission's role in this process appears to reflect the role that the CAA took in the Heathrow and Gatwick price control reviews, where it adopted a regulator-led approach to the scrutiny of areas where airport-airline discussions under CE did not result in agreement.²⁴ Consequently, it cannot be inferred from the Commission's experiences that the CAA should have modified its approach to CE, when the actions taken by the Commission accorded with the CAA's original CE design.
60. Furthermore, it is the nature of commercial negotiations that some areas of disagreement will only be resolved towards the end of the process. It cannot, therefore, be inferred that greater involvement of the regulator sooner would have increased the likelihood that agreement would be reached. Indeed, for the reasons set out above, this involvement could have undermined negotiations and reduced the likelihood that agreement would be reached.
61. The degree of airport-airline agreement in the Commission's regulator-led approach to the scrutiny of the capital investment programme also needs to be put in context:

²¹ Paragraph E45, "Airports Review: Policy Issues", December 2005.

²² Paragraph E45, "Airports Review: Policy Issues", December 2005.

²³ CC Final Report, A6(1), paragraph 18

²⁴ This is discussed in more detail in Supporting Paper I to the CAA's response to the DfT's March 2009 consultation.

- the ‘agreement’ covered approximately 6 per cent of BAA’s original forecast capital expenditure programme for Q5, and excluded all costs relating to the SG2 programme²⁵;
 - there was no agreement on two major elements of the original SG1 programme – the departures hall extension and a cargo shed – which represented around 37 per cent of the original proposed expenditure²⁶; and
 - airlines disagreed strongly with the Commission’s recommendation that an allowance be made within Q5 for £40 million of costs associated with the SG2 programme.
62. Furthermore, as discussed in Supporting Paper I, CE is best suited to instances where there is a degree of alignment between the incentives of the airport operator and airlines. The CAA extensively analysed the incentives faced by the airport operator and airlines at Stansted, and shared this analysis with the Commission. This analysis demonstrated that, in respect of the SG2 project, there was a fundamental misalignment of incentives between the airport operator and the incumbent airlines. This meant that CE was less likely to deliver useable outputs for SG2 than for the SG1 capital expenditure.
63. Consequently, the CAA does not consider that the Commission is correct to infer from the, relatively limited, degree of agreement secured from a Commission-led process to discuss SG1 that a similar CAA-led process to discuss the wider capex programme – in particular SG2 – would have been successful.

The lack of a ‘considered figure for capital expenditure’

64. In respect of the second argument – which had not been put to the CAA by the Commission in advance of the publication of its Final Report – the CAA notes that in December 2007, the CAA met Commission staff to discuss the scrutiny of capital investment. In this meeting, it was decided that the CAA would undertake – through its consultants – scrutiny of the SG1 element of Stansted’s capital expenditure plans. This evidence was later made available to the Commission. It was also agreed that the Commission would take the lead on the scrutiny of capital expenditure relating to SG2, as the Commission had decided to undertake scrutiny – using its consultants, ASA – of a number of aspects of the SG2 programme, as part of its market investigation.

²⁵ BAA’s Q5 capital investment plan amounted to £1,366 million (2007/08 prices). The Commission’s recommendations to the CAA were that an allowance be made for £85 million (2007/08 prices) for SG1 capex, and a further £41 million for SG2 related expenditure, the latter was disputed by Stansted airlines. These figures were then subject to a further minor adjustment to take account of differences between RPI and construction price inflation.

²⁶ The departures bay and cargo shed were forecast respectively to cost £51.7 million and £37 million, compared to an original (2008 CIP) plan of £238.8 million (all in 2007/08 prices).

65. The CAA accepts that its reference to the Commission did not contain a single 'proposed' figure for capital expenditure at Stansted, or for the two principal components (SG1 and SG2). However, in light of the fact that the regulatory framework does not oblige the CAA to do so and, perhaps more importantly, the overall allocation of work that had been agreed with the Commission's staff, the CAA does not consider that the Commission can infer from this any failure on the part of the CAA. More generally, the alleged link between the nature of the CAA's reference to the Commission and an outcome that has adversely affected competition is obscure and is not explained in the Final Report.

The reliance placed on ex post disallowance of capital investment

66. The Commission cites the following to support its AEC finding on regulation:
- “(c) repeated reliance on the argument that the threat of capital expenditure being removed from the RAB at the next quinquennial review was sufficient incentive on BAA to undertake appropriate investment and justification for the CAA not being involved in the interim, when the evidence is that only one capital expenditure project has ever been removed from the RAB (the atypical case of the personalized transit system at T5)”
67. The Commission's statement that the CAA considered the threat of capital expenditure disallowance to provide a “sufficient incentive on BAA” incorrectly characterises the CAA's position. As is clear from recent price control decisions, the CAA has implemented a number of measures designed to improve BAA's incentives to invest, including: the threat of spend not being allowed into the RAB at the next quinquennial review (as the Commission notes); the decision to introduce a mid-quinquennium review of consultation and capital expenditure; the use of capital investment triggers; and a 'claw back' mechanism designed to ensure that investment is not postponed or cancelled for reasons of financial stringency. It follows that the CAA does not believe that any one of these is, in the Commission's words, “sufficient incentive”: they are a package.
68. Further, the element of the CAA's overall approach that is identified by the Commission is a standard feature of the RAB-based, RPI-X approach to setting price controls – an approach endorsed by the Commission in all of its recommendations to the CAA in respect of airport regulation and by the Commission in its reviews of price controls in utility sectors.
69. More specifically, the policy adopted by the CAA in Q4 implemented a recommendation made by the Commission. It is unclear how the Commission can now take the view that the CAA's approach was unreasonable when it accorded with the contemporaneous view reached by the Commission itself.
70. There is also an implication that the CAA should have disallowed capital expenditure at one or more of the designated airports. In all of these cases,

the Commission undertook its own review of the appropriate capital expenditure allowance for the airports in question and there are no examples in any of the twelve price control reviews by the Commission of BAA airports²⁷ of the CAA allowing capital expenditure against the (contemporaneous) advice of the Commission.

71. The Commission appears to argue that the CAA should have taken an active involvement in the control of capital investment between price control reviews. The CAA is not aware of the Commission raising this issue at previous price control reviews. However, at the Q4 review, the Commission did recognise the limitations on the powers available to the CAA to act between price control decisions, as noted in paragraph 85 below.
72. The Commission also incompletely summarises the regulatory scrutiny to which any capital investment is subject. In particular, the Commission enjoys powers under the Airports Act to identify any course of conduct that has acted against the public interest. BAA's investment performance is, therefore, subject to periodic scrutiny by the Commission.
73. This split of responsibility between the two airport regulators – with the CAA focusing on price issues and the Commission focusing on non-price issues – serves in practice to delimit the ability of the CAA to act (within-period or otherwise) across all of the areas of the operation of a designated airport. For example, as noted above, the Commission stated its view at the time of the Q4 price control that BAA's investment performance was “broadly satisfactory” and that “BAA could not have done significantly more in its consultation processes”. This indicates that – based on the evidence available at the time – there was no reason to suspect that greater regulatory involvement on these issues was needed, particularly in light of the substantial increase in the level of investment which followed the completion of the Q4 review.

Lack of clarity about what constituted adequate consultation

74. The Commission cites the following to support its AEC finding on regulation:

“(d) lack of clarity for BAA as to the real meaning in the eyes of the CAA of what constituted adequate consultation (see paragraph 22(a) of Appendix 7.2)”
75. The Commission refers here to the following material that it presented in Appendix 7.2 of its Final Report:

“Although it initially attempted to engage the airlines on the choice of runway development, BAA developed its airport masterplan without engaging with the airlines, prior to launching its public consultation on seven runway options. We quoted evidence in our Stansted report that BAA believed that the CAA had agreed to this approach in its June 2004 consultation document

²⁷ Covering three airports in four separate reviews (Q2, Q3, Q4 and Q5).

on the regulatory treatment of initial expenditures on new runway capacity (and subsequently in its January 2005 and June 2005 documents, the latter being revised in July 2005), which stated that part of the purpose of the preliminary expenditure was, in itself, to generate options, and to that extent may reasonably be regarded as the price that must be paid for effective subsequent consultation. The CAA said in its comments on the provisional findings that its various regulatory statements on the treatment of preliminary expenditure associated with the development of options for a second runway at Stansted could not possibly bear such an interpretation: these documents were focused on preliminary spend, i.e. the funding of the initial optioneering work and the issues around consultation on that category of expenditure, and did not address the scope of BAA's subsequent consultation on the substance of the runway options. But we also note that, in the course of 2004, the relationship between the airlines and BAA deteriorated significantly, due to fundamental disagreements (e.g. in relation to forecasts), and had totally broken down by the time BAA initiated its optioneering work."²⁸

76. The Commission accurately reproduces the CAA's argument that questions whether it was reasonable to consider that BAA held a genuine belief that the CAA had agreed to its approach in its June 2004 consultation document (or otherwise). The CAA also notes that even if this belief was genuine, the fact that BAA had mistakenly entered into it, and had not sought to check its understanding with the CAA, says more about BAA's approach than it does about the CAA's operation of the regulatory system.
77. Furthermore, the Commission does not address the CAA's argument, namely that the CAA's publications cannot bear the interpretation given to them by BAA. The Commission refers to the fact that relationships deteriorated between the airlines and BAA. However, this observation – which, as discussed above, appears to reflect a fundamental misalignment of incentives – does not appear to address the CAA's point.

Concerns that intervention would fetter the CAA's discretion

78. The Commission cites the following to support its AEC finding on regulation:
- “(e) repeated concerns that to intervene would fetter the CAA's discretion at the next quinquennial review”
79. The CAA's intervention in the airports market has not been significantly affected by concerns that it would fetter its discretion at subsequent price control reviews. Rather, the CAA's role between price control reviews has been determined by the statutory functions conferred upon it. By virtue of the Airports Act, the CAA's functions are limited in nature and are substantially less flexible than those conferred on other sectoral regulators.

²⁸ Paragraph 22(a), Appendix 7.2, CC Final Report

80. The CAA acknowledges that changes in regulatory policy are typically restricted to the time of price control reviews, at which point proposals are subject to extensive consultation and to review by the Commission. It is also at this point that the Commission undertakes its review of public interest issues. The CAA has, therefore, been mindful of the risks associated with significant changes in regulatory policy mid-quinquennium which would not benefit from such processes of consultation and review and, ultimately, would be exposed to the risk that they would subsequently be modified. However, the CAA has, on occasion, provided guidance within a price control period. For example, in the case of unplanned capital expenditure at Stansted during Q4, the CAA issued some guidance on the factors that, at that time, it considered that it could have regard to when determining the appropriate treatment for such expenditure. When issuing this guidance the CAA noted that before taking any subsequent it was required to make a reference to the Commission and have regard to its recommendations.²⁹
81. The constraint on the CAA's flexibility therefore flows from both the statutory framework and also from the fact that within-period decisions fall outside of the formal processes of consultation and review by the Commission, rather than from the CAA adopting an unreasonable position within that statutory framework. As such, the CAA has sought to identify in the Final Report the analysis supporting the Commission's finding in this regard but has been unable to do so.
82. The Commission's findings in this respect could be based on its understanding that the CAA was concerned about the role that the Commission envisaged for the CAA in updating the information protocol at Heathrow.³⁰ However, as this refers to a future regulatory policy, rather than being evidence of the CAA's past behaviour, this observation could not be used to support the Commission's finding.
83. More fundamentally, the Commission did not check its understanding of the CAA's position prior to publishing its Final Report, and has erred in its summary of the CAA's position in respect of this proposed remedy. The CAA set out its views on this proposed remedy to the Commission orally and in writing, and did not raise concerns about fettering its discretion.
84. It is also possible that the Commission is referring to its views on the role that the CAA should have taken within the Constructive Engagement process. As discussed above, CE was designed following an extensive period of consultation. The CAA's role was determined following that consultation and was designed to facilitate airport-airline negotiation. The CAA's role was deliberately limited and was not constrained by concerns that to do otherwise would fetter the CAA's discretion.

²⁹ 'Regulatory treatment of preliminary expenditure on new runway capacity', CAA, March 2006

³⁰ Paragraph 10.259, CC Final Report

85. Finally, the CAA finds it hard to reconcile the Commission's finding with the fact that, at the time of the Q4 review, the Commission itself recognised the limitations on the CAA's powers to intervene between price control periods, observing that without a public interest finding from the Commission, there were significant limitations on the CAA's statutory powers, stating:

"[The Commission adverse public interest finding] does not include Stansted [but] the CAA should consider the case for introducing appropriate standards at Stansted, **although it could not do so within Q4 without the agreement of BAA.**"³¹ [*emphasis added*]

The lack of regulatory involvement and certainty

86. The Commission cites the following to support its AEC finding on regulation:
- "(f) the cumulative effect of the above in the lack of regulatory involvement and certainty"
87. This observation is the product of the preceding findings which, in light of the earlier analysis, appear to be of questionable validity.

The views of airlines on the adequacy of the CAA

88. The Commission cites the following to support its AEC finding on regulation:
- "(g) the evidence that almost every airline we have spoken to (including BA, Virgin, Star Alliance and the LCCs) regards the CAA as inadequate."
89. The CAA does not dispute that it has received extensive criticism from a number of airlines during the Commission's various inquiries.
90. However, the CAA considers that before inferences can reasonably be drawn from this criticism about the impact of the CAA's regulation on competition it is important to understand the underlying evidence to support these criticisms, including the commercial positions of the airlines. Furthermore, the Commission should have ensured that it based any inferences on a comprehensive summary of the views of all stakeholders across a range of the CAA's decisions and across a broad time period. It would also have been important to seek the CAA's views on the evidence, prior to reaching its findings. Whilst other reviews – such as that undertaken by Sir Joseph Pilling and the Transport Select Committee – took such an approach, the Commission did not.
91. This potential for the Commission's analysis to be based on a biased sample is further illustrated by the fact that the CAA has – on occasion – taken decisions that do not feature in the Commission's analysis but that have closely aligned with the then commercial interests of airlines, such as by

³¹ Paragraph 2.480, CC Q4 Report

implementing stand-alone regulation and by significantly reducing the allowed cost of capital at Heathrow and Gatwick airports.

92. It is also clear that the simple act of attracting criticism from any particular group of stakeholders is not a reliable indicator of whether decisions are appropriate. This is demonstrated by the fact that the CAA has attracted criticism from airlines for adopting policies that the Commission has subsequently endorsed. For example, the CAA attracted significant criticism from a number of airlines for arguing that it should have a primary duty towards passengers, rather than towards passengers and airlines. However, on this point, the Commission changed its proposals to move away from its original recommendation for a primary duty to airlines and passengers towards one framed in terms of passengers' interests alone – aligning its position with that of the CAA. Presumably, the Commission must now consider that the CAA was right to adopt its original position and that airline criticism on this issue was not a reliable indicator of what the appropriate policy should be.
93. The Commission also supports its findings with a number of new arguments, which had not been previously discussed with the CAA. In particular, the Commission introduces the argument that the CAA “gave insufficient weight to the interests of airlines in a number of key issues”. The Commission then cites three proposals that the CAA made, none of which were implemented:
- *“Proposing the dual till rather than single till approach in the Q4 review despite strong airline arguments against this”*
It is somewhat surprising that the Commission cites this as an example of the CAA’s failure to consider the views of airlines when, following consultation and receipt of the Commission’s recommendations, the CAA decided not to implement a dual-till approach
 - *“Proposing the de-designation of Stansted... wholly contrary to the view of the Stansted airlines”*
It is clear that the Stansted airlines did not support the de-designation of Stansted Airport. However, the CAA rejects the Commission’s implication here that a regulatory policy is only justified if it serves the interests of airlines. Further, the CAA notes that the airlines at Manchester Airport also, in general, opposed the de-designation of that airport. However, the Secretary of State, on this occasion, agreed with the CAA that this airport should not continue to be price controlled.
 - *“Some of the options that the CAA proposed for price controls at Stansted... were again wholly contrary to the views of the Stansted user airlines”*
The CAA identified five options – including one proposed by an airline – for the approach to the price control at Stansted. The CAA considers that it is best practice to identify a range of options and then to consider views and evidence on these options. The CAA, therefore, rejects the

Commission's implication here that the CAA erred by setting out options that airlines did not, in the event, support.

94. As is clear from the above, the Commission criticises the CAA both for making proposals that were not supported by airlines and for setting out a range of options, some of which were not supported by airlines. If the Commission's views are accepted at face value, this implies that a regulator should attempt to identify proposals that stakeholders – and in this case a subset of stakeholders – will support and only propose these options. This is clearly not best-practice regulation or consultation, and could open the CAA to charges of failing to discharge its statutory duties to promote the reasonable interests of all users.
95. The Commission also appears to fail to recognise that a central element of the Q5 price control process was the introduction of the process of CE. This policy innovation was intended to increase significantly the role of airlines in the price control process. It is, therefore, strange now to be criticised by the Commission for placing insufficient weight on the views of airlines, when there is clear, demonstrable evidence that the CAA has invested significant resource into increasing their involvement. Arguably, airlines enjoyed a greater role in the price control process than other customer groups in other regulated sectors. The fact that airlines found the CE process (and BAA's behaviour within that) frustrating at times, that agreement was not reached on all issues, and that the CAA's subsequent ruling did not uniformly favour airlines, should not detract from the facts that Heathrow and Gatwick airlines consider CE to have a substantial advance on previous regulatory practice, and that it is evident that the airlines had substantial influence on key investment and service outcomes from the Q5 price review.
96. The Commission's analysis also contains a number of inaccuracies, which call into question the validity of its overall finding in respect of the CAA's regulation. For example, the Commission states that the CAA does "not regard Ryanair and easyJet, both successful and profitable airlines, as proxies for their customers", explaining that "the CAA also appears not to accept that they wanted to grow their businesses at Stansted". This is not the CAA's position. Indeed, the transcript of the CAA's hearings with the CC make this very clear and that the CAA's concerns related to whether these incumbent airlines could be expected to want to expand their base less quickly than might be in passengers' interests: a rather more subtle point than that made by the Commission and one that a regulator with a duty to passengers (as well as to other airport users) would be expected to raise.
97. The Commission also supports its view that the CAA places insufficient weight on the views of airlines by referring to the contents of a press release issued by the CAA in response to the Commission's Emerging Thinking document, arguing that this press release focussed on passengers, rather than on airport users. The weakness of this as a piece of supporting evidence for a major regulatory finding is self-evident. However, as a matter

of fact, the CAA was not performing a function under Part IV of the Airports Act. The CAA's response was however consistent with its wider duties towards users of air transport services (i.e. passengers) set out in the Civil Aviation Act. The CAA's emphasis on the interests of passengers, therefore, appears consistent with its wider duties and – more generally – to be vindicated by the Commission's change in stance on whether the CAA in its airport regulation should have a primary duty to passengers.

Proposed remedies

98. To remedy these alleged adverse effects, the Commission makes two recommendations relating to the operation of the current regulatory system:
- that the CAA introduce annual service quality audits of the service quality incentive scheme at Heathrow; and
 - that the existing information protocol at Heathrow – which guides the airport operator's consultation and information sharing with airlines – be updated.
99. In respect of the first of these, the Commission first recommended in its Heathrow and Gatwick Q5 price control report that the CAA employ annual audits. The CAA considered this recommendation but took the view that a more proportionate approach would be initially to commission two audits – one towards the start and one near the end of the quinquennium – and to consider the case for a higher frequency when the results of the first audit were known. The Commission has therefore simply repeated – for Heathrow – its view that the frequency of service quality audits should automatically be annual. The CAA has decided to retain its existing policy that there will be two automatic audits, with the potential for this to move to annual audits once the results of the first audit are known.
100. In respect of the second, the CAA's approach is not to make automatic adjustments to the protocol but to ascertain first what is required in the current circumstances. The CAA has, therefore, recently written to the airport operator and airlines inviting them to consider what changes they might wish to make to the information protocol.
101. More generally, the disconnect between these recommendations and the wide-ranging criticisms made by the Commission of the CAA's regulation is self-evident.
102. The Commission also made a number of recommendations on reforms to the framework of economic regulation, which are discussed at length in the CAA's response to the Government's consultation.
103. The CAA notes in passing that the Commission does not appear to have considered exercising its powers under section 54 of the Airports Act to revoke or modify conditions applying at BAA airports.

Conclusion

104. The CAA does not consider that the Commission has established that the CAA's regulation of airports has had an adverse effect on competition. The Commission significantly restricts its analysis to exclude its own role and fails to reconcile its contemporaneous findings under the Airports Act with its later findings under the Enterprise Act.
105. Indeed, much of the analysis supporting the Commission's findings on the CAA's role is based on ex post assessments, benefiting from hindsight. Even with hindsight, the Commission's line of reasoning from CAA action or inaction to adverse effect on competition is obscure and/or tenuous. Such an approach cannot reasonably be used to support its criticisms of the CAA's decisions. Furthermore, on a number of occasions the Commission makes factual errors when presenting the CAA's arguments and relies upon arguments that had not been previously put to the CAA.
106. The CAA acknowledges that there will be lessons to be learnt from the past and that there should be open debate so as to improve the future regulation of airports. However, this debate should be fully informed and evidence-based.