Section IV: Stansted

(page left intentionally blank)

21. Regulation of Stansted airport: background

Introduction

21.1 As explained in chapter 4, the regulatory challenges presented by Stansted are quite distinct from those presented at Heathrow and Gatwick. At Stansted not only is there clear evidence of material competitive constraints, but the airport operator is also contemplating major incremental investment in new runway capacity and associated infrastructure (known as the Stansted G2 phase 1 project, or 'SG2'), with projected costs included in BAA's public consultation on the second runway development for Phase 1 of the Stansted Generation 2 project[1] of around £1.7 billion compared to Stansted airport's current RAB of around £0.9 billion[2]. Discussions between Stansted airport and its users also contrast with those at Heathrow and Gatwick. Constructive engagement has not proven effective at Stansted, compared to reasonably good progress at Heathrow and Gatwick. Taken together, in the context of the CAA's statutory duties, these factors suggest the need for a different regulatory approach at Stansted: one designed to provide, against a background of generally rising demand, the best chance of the right level and type of investment, delivered at the right time. Section IV of this document describes the CAA's progress towards developing such an approach.

21.2 Section IV is organised into five separate chapters:

- chapter 21 sets out the background to the review of airport charges at Stansted. More details of analysis carried out by the CAA on Stansted airport is contained in Annex F;
- the analysis the CAA has carried out of the market within which Stansted operates is summarised in chapter 22. Full details of the CAA's analysis are contained in Supporting Paper II;
- chapter 23 describes some of the interaction between the airport operator and the users at Stansted, and goes on to analyse them in order to develop a better understanding of the underlying causes of the issues arising at the airport;
- against the background of the analysis of the market and the behaviours of the key stakeholders, chapter 24 identifies and evaluates alternative options for the future regulation of Stansted; and
- finally, chapter 25 considers whether the issues arising at Stansted might not better be dealt with via a more deregulatory approach.

21.3 This chapter sets out background to the review of airport charges at Stansted, including a summary of the issues raised on the Stansted price control in the CAA's December 2005 and May 2006 consultation documents. It also reports on the position that the CAA reached in respect of the regulatory treatment of preliminary expenditure on new runway capacity in March 2006. The chapter goes on to describe the analysis that has been carried out during 2006 by various parties on a

[1] Stansted Generation 2: December 2005 consultation, BAA Stansted, 9 December 2006
[2] Based on BAA's regulatory submission.

number of aspects of the airport operation, including: traffic forecasting; capital expenditure efficiency and operating efficiency, and the status of that work. Finally, it describes how BAA treated the issues raised at Stansted in its September 2006 regulatory submission, and the latest position on BAA's consultation on Stansted Generation 2.

Review of airport charges at Stansted

December 2005 consultation document

21.4 In its December 2005 consultation document, the CAA identified two issues of particular relevance to the review:

- notwithstanding the likely strong underlying growth in demand for airport capacity across the South East of England, there may be greater uncertainty about the future rate of growth in demand at some airports, especially Stansted, than there is at others, with possible implications for the precise timing of investment; and
- in order to meet rising demand, or to replace ageing infrastructure, it is – sooner or later – likely to be efficient for airports to undertake substantial investment in new capacity, which by its nature can be 'lumpy'.

21.5 The CAA also identified the need to develop a regulatory framework that would provide the best chance of the right level and type of investment, delivered at the right time, given the anticipated demand by airport users and constraints, uncertainties and opportunities that exist.

21.6 To give effect to this approach, the CAA proposed a number of possible measures:

- separate regulation of BAA's designated airports;
- a proposal to allow the under-recovery from one control period to be added to future price controls, giving the airport the prospect of recovering the allowed revenue in subsequent periods;
- a proposal to link the returns allowed within airport charges to the actual investment undertaken by BAA, rather than that projected; and
- a degree of Net Present Value (NPV) neutral revenue advancement in order (a) to provide additional pricing flexibility to help alleviate demand uncertainty, and (b) to offer credible incentives to efficient investment.

Responses

21.7 In response to the document, airlines expressed concern that the measures proposed indicated that the CAA had placed a disproportionate emphasis on encouraging investment, at the expense of furthering the reasonable interests of users. Others – for example, the Stop Stansted Expansion campaign – endorsed the principle that the regulatory framework should not create false incentives to invest. BAA broadly welcomed measures to improve investment incentives, but sought more specific regulatory endorsement for the SG2 project.

21.8 Very few comments were made about the first three measures set out above. However, many airlines, and airline representative groups, were broadly opposed to revenue advancement.

Policy update, May 2006

21.9 Taking heed of the arguments put forward on this particular measure, the CAA indicated that the case for revenue advancement would depend, *inter alia*, on:

- the case for further investment;
- the extent to which – in view of the analysis of the case for investment – the scale and lumpiness of investment would imply the need for significant price increases, and which in turn would argue for advancing revenues in order to smooth the profile of prices over time;
- the extent to which additional price flexibility would indeed help alleviate demand uncertainty; and
- the degree to which any revenue advancement would amount to the imposition of an unreasonable burden on Q5 users.

21.10 In summary, the CAA indicated that it expected to evaluate these issues over the course of summer 2006 in the light of the evidence being collected, with a view to consulting on a balanced package of measures, taking full account of its statutory duties. In the event, however, BAA did not provide the CAA with a business case for the SG2 phase 1 project, and therefore the CAA has not been able to evaluate it, as had been planned.

Regulatory treatment of preliminary expenditure on the development of new runway capacity at Stansted airport

21.11 In July 2005, the CAA consulted on the regulatory treatment of preliminary expenditure on the development of new runway capacity at Stansted airport.[3] Having received substantial representations on the issues raised in that consultation, the CAA published a document in March 2006 stating that it would not consult further on the issue at that stage.[4] This document went on to explain that the treatment of preliminary expenditure would be a matter for the CAA to decide in concluding its price control review, having taken into account the responses of interested parties and having regard to the recommendations of the Competition Commission.

Analysis of Stansted airport 'building blocks'

21.12 A number of separate strands of work relating to Stansted have been taken forward during the course of 2006. In particular, analysis has been undertaken of:

- alternative approaches to long term traffic forecasting;
- capital expenditure efficiency; and
- operating efficiency.

21.13 Progress against these workstreams is summarised in Annex F.

[3] Further consultation on the regulatory treatment of preliminary expenditure on new runway capacity – a CAA consultation document, CAA, July 2005.
[4] Regulatory treatment of preliminary expenditure on new runway capacity – a CAA follow up document, CAA March 2006.

BAA's regulatory submission

21.14 In its regulatory submission – and in a number of submissions made to consultants assisting the CAA in its analysis of BAA's operating and capital expenditure efficiency – BAA has presented a broad range of information on Stansted airport. In particular, BAA submitted:

- traffic forecasts;
- projected operating costs;
- projected capital expenditure; and
- projected revenues

for the airport as a whole.

21.15 However, whilst submitting various pieces of evidence and analysis relevant to the case for Stansted G2, BAA stopped short of providing a business case[5] for the development, stating that the position of the CAA with respect to this investment would be key to the project's viability. In its regulatory submission, however, BAA adopted an assumption that Stansted G2 would open in April 2015, and that the opening price in 2015/16 would be £8 per passenger (in 2006/07 prices).

21.16 BAA did not provide a view as to the future cost of capital at Stansted in its September 2006 regulatory submission, instead pointing out that its assumptions about the opening date and price resulted in a rate of return of just over 8% pre-tax real over Q5 and Q6. However, BAA subsequently wrote to the CAA indicating that in its current view the cost of capital at Stansted (on a pre-tax, real basis) was 8.79%.

21.17 In summary, BAA proposed price caps at Stansted over Q5 and Q6 of RPI+4.45% until 2015/16 and RPI+0% thereafter.

BAA's Stansted Generation 2 public consultation

21.18 BAA is also continuing to have discussions with airlines and other users of the airport about points made in response to BAA's public consultation about the second runway development[6]. As a result, BAA recently confirmed[7] that an announcement on the outcome of its public consultation about the second runway development – which is expected to include information on the location of the proposed second runway, together with details of the associated on-airport development within an extended airport boundary – would not now be made until January 2007.

[5] For the avoidance of doubt, the term business case in this context is intended to refer to an assessment of the incremental benefits associated with the new runway compared to the incremental costs.
[6] Stansted Generation 2: December 2005 consultation, BAA Stansted, 9 December 2005.
[7] Second runway announcement planned for New Year, BAA, 15 November 2006.

22. Analysis of the market in which Stansted airport operates

Introduction

22.1 At its best, economic regulation is both targeted and proportionate. By targeting regulation it can be focused on the problem – in this case potential misuse of market power – and minimise the side effects. By making regulation proportionate, it can be designed to be appropriate to the problem (or risks) that it aims to address. This is consistent with the CAA's duty to impose the minimum restrictions that are consistent with the performance of its functions.

22.2 In considering how best to perform its statutory function, the CAA sees merit in analysing in some detail the circumstances that apply at Stansted in order to understand the problems that such maximum limits are intended to address. In particular:

- the extent of the risk that Stansted either has – or can be expected to enjoy – a position of market power that gives rise to a significant risk that it will exploit that position through charging unreasonably high prices and that cannot be effectively dealt with through existing UK and EU competition law; and
- the behaviours exhibited by the airport operator and its users, and what lies behind those behaviours.

22.3 The CAA has therefore sought to analyse the extent to which Stansted airport has, currently and prospectively, significant market power. The CAA's full analysis is contained in Supporting Paper II. In this chapter, the CAA:

- summarises the approach taken to the analysis;
- describes the key evidence identified; and
- summarises the findings.

22.4 The next chapter considers the behaviours of the airport operator and its users.

Approach to the analysis

The basic approach

22.5 The basic analytical question addressed is whether an operator of Stansted has, or can be expected at some point in the future to have, the ability and incentive to raise prices, for an extended or non-transitory period, to levels that are significantly in excess of those likely to be observed in a reasonably competitive market[8].

22.6 In order to answer this question the CAA has sought to apply an analytical approach that is commonly adopted by UK Competition Authorities, which first uses the available evidence to arrive at an appropriate working definition of the market (or 'relevant market'), on the basis of which evidence can be marshalled in order to reach a view on the market power of an undertaking.

Differences with other analyses

22.7 The focus of the CAA's analysis differs somewhat from that typically undertaken by a Competition Authority for the purposes of Article 82 or Chapter II investigations. A

[8] Or to reduce quality of service to below the levels that might reasonably be expected in a competitive market.

key reason for this is that the CAA's analysis is concerned with assessing the likely future market position of the airport[9].

22.8 Certain features of the CAA's analysis may also differ from the analysis carried out by the OFT as part of its recent market study. This is a reflection of the fact that the OFT has considered a different question from that being considered by the CAA. The OFT has set out that the main focus of its study is to 'examine the scope for benefits to arise from enhanced competition between airports … or from enhanced competition within airports…'[10]. In relation to the South East of England, this inevitably involves consideration of the impact of BAA's ownership of three of the four major London airports on the effective operation of the market and the resulting outcomes for consumers. The nature and impact of economic regulation would also be relevant to this assessment.

22.9 By contrast, the CAA's analysis is based on a scenario of the continued common ownership of Heathrow, Gatwick and Stansted and of cost-based price regulation of Heathrow and Gatwick airports. Against this background, the CAA has considered whether Stansted airport could raise prices for an extended period to levels that are significantly in excess of those likely to be observed in a reasonably competitive market.

22.10 A practical consequence of this is that the CAA focuses its analysis on understanding the competitive constraints relevant to the operation of Stansted airport, rather than those that might impact upon the operation of the wider group of BAA airports in the southeast. Due to the location and characteristics of this airport and its users, this leads to the adoption of a different market definition.

Two key observations

22.11 In terms of the CAA's analysis, there are two key observations upon which much of the subsequent analysis relies. These are summarised below.

22.12 First, the CAA has observed that there are a number of practical (including legal) obstacles that can serve to limit the extent of potential price discrimination by an airport operator. For example, it appears to the CAA that an airport cannot – in practice – differentiate its charges between those passengers originating locally from those travelling to/from the airport from further afield. As a consequence, it is difficult for an airport operator to offer lower charges to, for example, passengers that are closer to one of its competitors, whilst increasing its charges to passengers that are somewhat nearer to its own operation.

22.13 Second, the economics of airport businesses means that a relatively small change in passenger numbers has the potential to have a relatively large impact on profitability. This is a consequence of a significant proportion of costs being fixed in nature, coupled with the leveraging effect on revenues that is created by retail activities. That is, a fall in passenger numbers and/or aircraft movements will reduce net revenues from retailing activities as well as from airport charges made to airlines. In consequence, an airport operator's incentive to raise prices to supra-

[9] Merger assessments and market studies are more likely to adopt a similar, forward-looking approach.
[10] UK Airports, OFT, June 2006

competitive levels is somewhat dampened (at least compared with a situation in which there is significantly greater variability in costs). Put another way, it may require only the prospect of passengers and/or airlines choosing to switch a modest fraction of their custom away from an airport to deter a contemplated price increase.

Evidence on the relevant market

Initial focus on leisure passengers

22.14 In 2005, over 80 per cent of passengers using Stansted airport were travelling for leisure purposes, with the vast majority going to short-haul destinations on a scheduled service. In order to understand the competitive constraints faced by Stansted airport, a logical starting point is to consider how these leisure passengers, and the airlines that serve them, respond to changes in charges at Stansted.

22.15 To gauge the extent of the market within which Stansted operates, the CAA has therefore examined:

- the range of airports from which such leisure passengers (and the airlines which they use) can be expected to choose; and
- leisure passengers' (and airlines') propensity to switch airports in response to changes in charges.

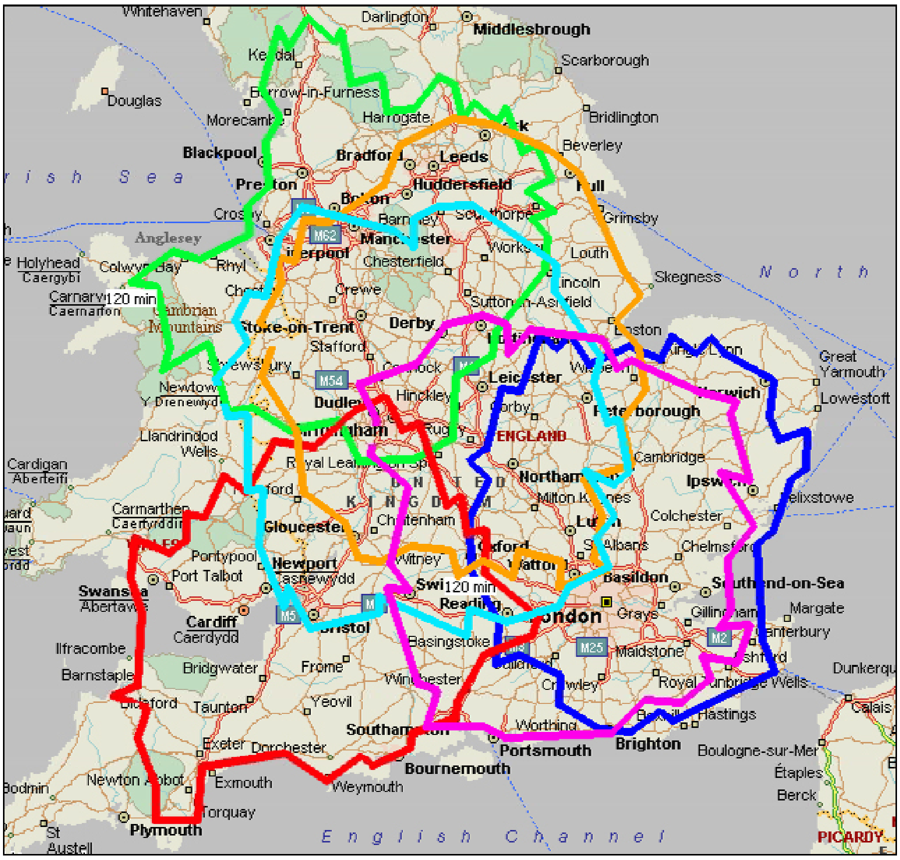
Range of airports

22.16 In considering the likely range of airports from which leisure passengers using Stansted can choose, the CAA has considered a range of evidence, including the journey times (to and from the airport) which passengers undertake. This is used to establish a 'benchmark' journey time that passengers are likely to be prepared to undertake. This benchmark can then be applied to assess the strength of overlaps between the catchment areas around airports and thereby indicate which airports significant numbers of passengers might view as being reasonable alternatives.

22.17 The available evidence suggests that a significant number of leisure passengers are in general prepared to tolerate a journey time of up to around two hours to reach their chosen airport. Whilst business passengers are usually prepared to tolerate shorter journeys the evidence suggests that those using Stansted are also prepared to travel reasonable distances.

22.18 On this basis, there appear to be strong overlaps between the catchment area of Stansted and other airports in the London area, with all of the London airports able to attract passengers from the large (and densely populated) London area. Moreover, there are significant direct overlaps between the area from which Stansted can be expected to attract passengers and the equivalent catchment areas of Luton, Birmingham and East Midlands airports. In other words, there are likely to be a significant proportion of leisure passengers who are able to choose between Stansted, Luton, Birmingham and East Midlands airports. Figure 22-1 illustrates the strength of some of these overlaps.

Figure 22-1 Two-hour approximate drive times around selected airports



Source: CAA analysis using Microsoft Mappoint

Key: ***STN, LTN, BRS, BHX, EMA, MAN***

22.19 It is also possible that, in addition to the direct interactions, competitive constraints might arise beyond these airports due to there being a 'chain' of competing airports[11]. This could link Stansted not only with the three airports identified above but also to their neighbouring competitors, as well as other, smaller, regional airports.

Propensity to switch

22.20 Analysis of the likely conduct of international UK leisure passengers suggests that a significant proportion of them would seek to respond to a change in their airfares by switching to an alternative airport, and that these passengers are likely to have a credible alternative airport from which to travel, in part due to the growing strength of route overlaps between Stansted and its neighbouring airports.

22.21 Furthermore, the evidence indicates that, as a matter of fact, airlines have found it advantageous to relocate existing services between airports and to locate new services at airports away from their principal, existing centres of activity. Like passengers, therefore, airlines, appear to have both an incentive and an ability to respond to any significant change in the charges that they pay at Stansted.

[11] For example, if Birmingham and Manchester compete for passengers and/or airlines and the same can be said of Birmingham and Luton then it would be reasonable to conclude that Manchester and Luton are indirectly linked by the common competition with Birmingham airport.

The CAA's proposed view of the relevant market

22.22 On the basis of the available market evidence, the CAA therefore proposes that the analysis of Stansted airport should be undertaken against a background of a geographic market that is broader than the London area and is likely to include the East Anglia region. There is also strong evidence that supports the inclusion of Birmingham and East Midlands airports within this market. Further, there is some basis for considering the inclusion of Southampton and Bristol airports and that indirect competitive constraints might also arise beyond these, due to the possibility of a chain of substitution. However, the degree to which any particular airport serves as a competitive constraint on Stansted will, other things being equal, tend to be lower the more distant the potential competitor is from Stansted.

Evidence on current and future market power

22.23 Using this relatively broad definition of the market as a frame of reference, the CAA has gone on to gather and evaluate the evidence on the current and future market power of Stansted.

The current position

22.24 Over the last 15 years, Stansted airport has not generated sufficient revenues for it to be able to earn a reasonable return on its capital employed. The airport has consistently set its charges below the maximum level permitted by the price cap and has had recourse to extensive discounting of charges below the published tariff. As a consequence, the revenues generated from each passenger at the airport have been comparatively low by both UK and international standards. This evidence alone provides a strong basis upon which to conclude that the airport has not had a position of substantial market power or dominance in a relevant market.

22.25 More recently, BAA has indicated that it wishes to increase the level of *published* charges significantly from the current level of around £4.80 per passenger to £5.50 in 2007/08 (all prices expressed in nominal terms). This compares to the outturn average level of aeronautical charges in 2005/06, after allowing for discounts, of £2.95 per passenger[12]. However, this still leaves charges at a level that is below the maximum allowed charge of £6.44 per passenger and at a level that is comparatively low when compared to the charges levied at other airports operating in the same market (e.g. Birmingham and East Midlands Airports). Accordingly, even the potentially substantial airport charge increases being contemplated by Stansted airport do not in themselves provide evidence that Stansted currently enjoys a position of significant market power.

22.26 This conclusion concerning the market position of Stansted should not be confused with possible conclusions concerning the wider position of Stansted's owner, BAA. The CAA is <u>not</u> saying that the evidence suggests that BAA as a whole does not have market power. For this reason it is necessary to identify the factors that explain why BAA's high market shares in a relevant market do not necessarily

[12] Source: Stansted regulatory accounts, year ended 31 March 2006. £2.95 is the actual yield per passenger from aeronautical charges on passenger aircraft. It is calculated by dividing the revenue from aeronautical charges levied on passenger aircraft, net of any discounts, (£65.7m) by the number of terminal passengers (22.237mppa).

translate into a position of significant or substantial market power at Stansted.

22.27 The most important point here is that the joint ownership of the major London airports does not afford much financial protection to BAA from loss of business at Stansted. If Stansted prices were raised substantially, the ability of passengers and airlines to switch to Heathrow or Gatwick would be severely limited by airport capacity constraints at those airports, whilst BAA's ability to raise charges at Heathrow and Gatwick (in response to the increased demand for use of those airports) would be restricted by the presence of binding price caps at these airports. It can be expected, therefore, that, for the most part, the loss of revenue caused when business switches from Stansted would not be offset by increased profitability of Heathrow or Gatwick airports. In such circumstances, the impact on the airport owner of passengers either being lost to the market or switching to a non-BAA airport is likely to be increased.

The future position

22.28 As indicated, the past and current charges set by BAA at Stansted provide strong indicators of the strength of the competitive constraints at this airport. However, the CAA needs also to consider whether Stansted airport is likely to face continued competitive pressure in the future and, in particular, whether it might reasonably be expected that the airport will acquire a position of substantial market power or dominance in the future. Inevitably, forward-looking analysis will not be able to reach a definitive conclusion as to what <u>will</u> happen: outcomes are necessarily uncertain. Nevertheless, by focusing analysis on questions such as whether the factors driving airport competition can be expected to change materially, it is possible to make a broad assessment of relative likelihoods and to reach a view on what might be expected.

22.29 In this context, the balance between the demand for and supply of available airport capacity is a potentially important influence on future inter-airport competition, although care needs to be taken when assessing how this potential effect operates. A tightening of the supply-demand balance in any competitive market can be expected to put upward pressure on prices. The airport market is no different. Such a response may provide a signal of the need for investment in additional capacity and is not necessarily a sign that the market suffers from some form of dysfunction. Therefore, it is important to distinguish between conduct by an airport that *artificially* restricts the availability of airport capacity in the market, and raises prices, from the impact of planning (or similar external constraints) that act to limit the expansion of airport capacity.

22.30 The CAA, of course, entirely accepts that the supply-demand balance is likely to affect the degree of market power held by an airport. Broadly speaking, in a market facing significant airport capacity constraints, passengers and/or airlines wishing to switch airports in response to higher prices or lower quality of service are more likely to find that such a switch will prompt a significant increase in charges at potential alternative airports, reducing the incentive to switch, than would be the case in a market with greater available supply.

22.31 However, given the conclusion that the market within which Stansted operates is not limited to the London-area airports, there exist competitive constraints on Stansted emanating from a number of airports with significant amounts of under-used runway capacity. These airports might, over the relevant timescales, be expected to respond to any lack of airport expansion at the London airports by growing their businesses, and therefore to continue to provide competitive constraints on Stansted that will be sustainable over an extended period. Indeed, survey evidence of passengers' preferences indicated that a significant number of passengers using the major London airports expressed a strong preference for a regional airport. This evidence is consistent with data on passenger origins that suggests that almost three million passengers travel for over two hours to reach Stansted.

22.32 In addition, whilst airline switching of services relies on available capacity at suitable airports, competition for passengers can derive from airlines expanding their supply of seat capacity at alternative airports. This competition for passengers can, therefore, be facilitated by the deployment of larger aircraft or take the form of increases in average load factors and does not rely on spare runway capacity.

22.33 Against a background of continuing demand growth, it appears to the CAA that if there are no material additions to airport (runway) capacity in the South East of England then, under most forecast demand scenarios, Stansted could acquire substantial market power or become dominant in a relevant airport market. However, it is precisely in the high demand-growth outcomes associated with this risk of evolving market power that there would be greatest incentives and pressure for capacity expansion. If strong demand growth persists, therefore, the CAA does not expect the 'no investment' scenario to be the most likely outcome, particularly given the Government's support for appropriate airport development, the range of plans proposed by the relevant airport owners, and the fact that rising charges at one or more of these airports would increase the profitability of investment at competing airports.

22.34 Set against any 'downside' risk to competition from a very tight demand/capacity balance, analysis of other factors indicates some developments can be expected to increase competitive pressures. For example, it seems reasonable to conclude that competition in the airline market will continue to develop and that liberalisation of the long-haul market could significantly improve the prospects for competition not only between airlines but also between airports. In addition, as regional airports grow, it seems probable that the number and significance of route overlaps between these airports and Stansted will increase, adding to the levels of competitive interaction. Indeed, analysis of these overlaps indicates that there is considerable potential for such direct route competition: 39 of the largest 50 routes operated out of Stansted, accounting for 55 per cent of Stansted's passengers, are currently available from Luton, East Midlands or Birmingham airports

Summary of findings

22.35 The key findings from this analysis are:

- that Stansted airport does <u>not</u> currently hold a position of significant market power;

- that the market position of Stansted is, starting from a relatively weak base, likely to strengthen over time, but that market power is, on balance, highly unlikely to reach potentially problematic levels (e.g. dominance) in the short- to medium-term; and
- over the longer-term the outlook is inevitably less certain. However, for the airport to acquire such a position, it would require the probably unlikely combination of strong passenger growth, which would increase the returns to investment in additional capacity, and limited levels of investment in capacity at Stansted and at a number of airports located over a relatively broad geographic area. Additional growth and investment at relevant regional airports could, therefore, help to sustain competitive constraints on Stansted.

22.36 On balance, therefore, the CAA concludes that, whilst there is some risk that Stansted might come to enjoy a position of substantial market power at some point in the longer term, there is no evidential basis for a finding that such an outcome could reasonably be expected.

23. Analysis of airport operator and user conduct

Introduction

23.1 Building on the analysis summarised in the previous chapter, and in order to develop a better understanding of the issues arising at Stansted, the CAA has considered carefully the conduct of the airport operator and the users at Stansted. This consideration is relevant to the consideration by the CAA of its statutory duties in relation to setting the future price control at Stansted.

23.2 This chapter sets out:

- a brief description of some of the observed conduct at Stansted airport; and
- an analysis the underlying causes of that conduct.

Description of observed conduct of airport operator and users

23.3 Over the past two to three years, the CAA has observed generally poor – and deteriorating – relationships between the airport operator and its users. Meetings between the Stansted ACC and the airport operator have been characterised by disagreements over the capital investment programme, particularly over the scale, nature and rationale for the Stansted G2 project, and associated preliminary expenditure.

23.4 The airport operator has sought to promote the development of a second runway and associated infrastructure at Stansted. Moreover, it has sought to do so as soon as possible, in line with its interpretation of Government policy as set out in the Government's December 2003 White Paper[13], and on the basis that extra capacity at Stansted (assuming it will get permission to grow to 35 mppa), together with extra capacity planned by Luton London City airports, will soon be absorbed by increasing demand. However, while the airport operator has promoted the Stansted G2 development, it has not presented either the CAA, or its users, with a business case for the development. [14]

23.5 Airlines currently operating at Stansted, on the other hand, have consistently voiced opposition to the airport operator's proposals. In particular, the Stansted ACC has expressed concern that current airline users will be required effectively to underwrite what <u>they</u> believe to be: unexplained traffic forecasts; over-specified facilities; excessive land-take; misrepresented project costs; and unjustified preliminary expenditure on Stansted G2. The Stansted ACC, nevertheless, consistently emphasises that it supports the expansion of Stansted airport in principle. A central concern, however, is the fear that a RAB based regulatory system will generate artificially inflated price caps from artificially inflated forecasts.

23.6 These tensions between the airport operator and its users were clearly identified in a report prepared for the CAA by a former senior member of the CAA's Economic

[13] The Future of Air Transport, Department for Transport, 16 December 2003.
[14] Again, for the avoidance of doubt, the term business case in this context is refers to an assessment of the incremental benefits associated with the new runway compared to the incremental costs.

Regulation Group, Mr R. Cotterill ('the Cotterill Review').[15] In particular, Cotterill identified that:

'Certainly there is a significant potential source of tension between BAA's proposals on the nature and timing of new runway and associated infrastructure (flowing from the conclusions reached in the Government's White Paper and reflecting, inter alia, the Government's view of the overall needs of the South East) and the commercial priorities of the two low cost airlines – Ryanair and EasyJet – which currently account for the majority of Stansted's passengers. In these circumstances, securing agreement between BAA, with its need to reach a workable solution and to steer matters through the statutory planning processes, and the low cost airlines, which depend for their continued prosperity on keeping their costs and fares as low as possible, was always likely to be challenging.'

Analysis of the underlying of airport operator and airline user tension at Stansted

23.7 To some extent, a degree of tension is to be expected between a typical regulated company and its customers. This is because the circumstances in which regulation normally applies involve the supply of essential services by natural monopoly suppliers to captive customers, where the interests of supplier and customer can be sharply divergent.

23.8 However – as discussed in the previous chapter – such market circumstances do not appear to apply at Stansted, or at least not to the same extent that they would be expected to apply in other regulated sectors of the economy where price controls apply. In these circumstances, it seems appropriate to examine whether it is the fundamental market circumstances that are creating the tension at Stansted, or whether there is some other explanation of the conduct being observed.

23.9 The CAA's preliminary analysis suggests that a key contributory factor to the issues arising at Stansted is the regulatory framework itself. Evidence for this is contained in:

- the conduct of the airport operator and users; and
- an analysis of the incentives that the standard RAB-based building block approach appears to create.

These are examined, in turn, below.

Analysis of airport and users' conduct

23.10 Evidence of the conduct of the airport operator, and its users, is can be adduced from observation of Stansted ACC meetings[16]. Unlike any normal commercial negotiation in which commercial counter-parties would discuss terms with each other and either agree (or disagree) and move on, at Stansted significant resources over a prolonged period of time have been devoted to safeguarding their positions in respect of the regulatory process, including the expected forthcoming Competition Commission investigation. For example, the airport operator has tended to focus on

[15] See Supporting Paper IX, Review of BAA's Compliance With Annex 4 of CAA's Decision of February 2003, Mr Robert Cotterill, December 2006.

[16] A CAA representative attends Stansted ACC meetings in an observer capacity.

the need for regulatory support for airport expansion, more than its commercial merits. The Stansted ACC, with equal force and commitment, has sought to highlight what it believes to be serious shortcomings in the case for a second runway, providing detailed critiques of costings and traffic forecasting techniques. In this way, the parties' appeals to the regulatory process appear to have replaced the normal process of commercial negotiation between a supplier and its customers.

Analysis of the RAB-based building block approach

23.11 The CAA's own technical analysis of the standard building block (or RAB-based) approach to setting price controls supports to the possibility that it is regulation itself which distorts dialogues and conduct of Stansted airport and its users.

23.12 Under a RAB-based approach, the level at which price caps are set reflects the level of investment undertaken, and expected to be undertaken. In other words, the greater the level of investment, the higher the likely level of price caps in future.

23.13 The existence of a link between investment, the RAB and price caps is normally regarded as a desirable feature of price control regimes. This is because it simultaneously provides comfort to the regulated company that the regulator will allow efficient and economic capital expenditure to be recouped, whilst at the same time giving users comfort that they will pay no more than the costs of service. What is efficient and/or economic is typically determined through a process overseen by regulation. Such processes can include forward-looking auctions of capacity (which, for example, inform Ofgem whether investments in gas transmission capacity are likely to be economic) or administrative processes (such as constructive engagement, in which airport operators and airlines have participated in structured discussions to determine the efficiency and/or desirability of capital expenditure programmes). The way such processes have operated at Heathrow and Gatwick shows how such processes can work reasonably effectively.

23.14 However, considered from the perspective of the long-term interests of users, it is conceivable that the link between investment, the RAB and price caps might not always be benign[17]. In particular, where future investments are substantial relative to the size of the existing RAB, there is a risk that *specific* investment decisions could be significantly influenced by the effect of an increase on the RAB on the *general* level of the price cap. For example, a RAB-based approach could give a regulated company an enhanced incentive to build *new* facilities if the act of investing gives rise to a loosening of the RAB-based price cap, and thereby permits the company to raise prices to its *existing* users compared to the level it would otherwise be permitted to charge. Such a weakening of the link between investment and the anticipated demands of users does not appear to be in the reasonable interests of users; nor does it enhance the economic, efficient and profitable operation of the airport.

23.15 It is relatively easy to see how such circumstances could arise at Stansted. At Stansted, the current RAB is around £0.9 billion[18], compared to Stansted airport's

[17] In situations where price caps are expected to constrain the airport in at least some relevant future periods, even if price caps are not binding now or in the relatively near future.
[18] Based on BAA's regulatory submission.

estimate of projected costs included in BAA's public consultation on the second runway development for Phase 1 of the Stansted Generation 2 project[19] of £1.7 billion for the investment in Stansted G2. The level of any RAB-based price cap at Stansted is therefore very different according to whether allowance is made for the Stansted G2 project, or not. It follows that – as long as Stansted airport continued to be designated for price control purposes and a RAB-based approach adopted – BAA's assessment of the case for significant new investment may partly be based on additional revenues from use of existing facilities rather than flowing from the use – and benefits – of new facilities. In this way, a RAB-based approach to regulation could, in certain circumstances, lead to investment taking place on a greater a scale, or too soon, compared to the scale, or timing, that would result if such investments were promoted solely on the basis of the incremental benefits of the development versus the incremental costs.

23.16 Against this background, there appears to be a clear risk that RAB-based regulation could – in the circumstances that apply at Stansted – artificially distort the incentives on the airport operator. The corollary is that RAB-based regulation could also distort the incentives of the airport users. The mechanical link involved in the RAB-based approach means that new investment tends to increase price caps – perhaps significantly – whereas in more normal commercial circumstances pricing would be determined by market circumstances and commercial negotiation. As a result airlines' understandable desire to restrain increases in airport pricing becomes focussed on delaying or opposing investment which might, against a background of different incentives, be seen as benefiting airlines and their customers.

Summary

23.17 In summary, there is tension between Stansted airport and its users. More specifically, there appears to be a clear risk that RAB-based regulation could – in the circumstances that apply at Stansted – artificially distort the incentives on Stansted airport and its users.

[19] Stansted Generation 2: December 2005 consultation, BAA Stansted, 9 December 2005

24. Proposals for future regulation of Stansted airport

Introduction

24.1 Against the background of the market analysis (as summarised in chapter 22), and the analysis of the risks associated with applying RAB based regulation given the particular circumstances arising at Stansted (as set out in chapter 23), the CAA has considered how it could set maximum limits on charges at Stansted airport in a manner best calculated to meet its statutory duties under section 39 of the Airports Act 1986, and also having regard to the five principles of better regulation[20]. This chapter therefore identifies and evaluates alternative options for setting future caps on airport charges at Stansted.

Alternative approaches to setting price caps at Stansted

24.2 Taking into account the analysis of the circumstances that exist at Stansted, and the market within which the airport operates, the CAA has identified two alternative options for setting price caps at this airport:

- Option 1 – despite the issues identified in the previous chapter, retain the standard RAB-based building block approach but augment it with a mechanism that would link any increase in the price control to cover SG2 investment costs to regulatory approval of the project including its scope, scale, specification, timing and costing; and
- Option 2 – set a price cap at a level unrelated to the level of investment undertaken by BAA, but at a level high enough to avoid disincentivising investment (either by Stansted or other airports) though not so high as to compromise the reasonable interests of users.

These options are described more fully and evaluated below.

Option 1 – An augmented RAB-based price control

Description of Option 1

24.3 Under this option, rather than leave the airport operator to determine precisely what investment is undertaken and when (within the standard RAB-based framework), a supplementary test (or series of tests) would be applied by the CAA to check that the Stansted G2 investment would be economic and efficient. Only if the test were met would price caps at Stansted be set in Q5 (and beyond) at a level which reflected the investment costs.

24.4 Clearly any such test would require the CAA to satisfy itself on a number of issues:

- first, as part of ensuring it was ‘efficient’, the CAA would need to satisfy itself that the investment proposition was appropriately designed in terms of its scale and specification to meet the anticipated demands of users over time;
- second, and also as part of ensuring it was ‘efficient’, the CAA would need to satisfy itself that it was efficiently costed; and

[20] The Legislative & Regulatory Reform Act received Royal Assent in November 2006. This will place a statutory obligation on the CAA, when and if its functions are designated by a Minister of the Crown, to have regard to five principles of good regulation. These principles promote proportionate, transparent, accountable, consistent and targeted regulation.

- third, in order to ensure the investment was economic, it would need to evaluate whether the present value of future streams of benefits generated by the project exceeded the costs of the investment, including a risk-based cost of capital.

24.5 When the test would be carried out would probably depend on when the airport operator had a worked up proposition to make. In principle, therefore, it could be carried out as part of the current airport price control review or – alternatively – by means of a review during the next price control period, perhaps on application by the airport operator to re-open the price control.

Analysis of Option 1

24.6 At first sight, Option 1 appears to have a number of benefits. The CAA's analysis demonstrates that although any RAB-based price control regulation can, in principle, distort investment decisions, it is the magnitude of the Stansted G2 project relative to the existing Stansted airport RAB which gives rise to the material risk that too much investment is made too soon. By augmenting the regime with a regulatory-led test, therefore, the substantive risk to users is reduced or potentially removed.

24.7 However, it seems very likely that the continued operation of a RAB-based price control – even with a supplementary regulatory-led test – would not address the counter-productive incentives flowing out of the RAB-based regime, as described in the previous chapter. On the contrary, maintaining a RAB-based approach to regulation could perpetuate them. Indeed, both Stansted airport and its users could see their respective interests best served by taking ever more extreme views of the Stansted G2 proposition, in the hope that this would lead to a regulatory settlement in their favour. As a consequence, Option 1 would appear to undermine the potential for a normal commercial resolution to the questions of efficiency and timing of investment. Accordingly, it would mitigate against dialogue which – given the market circumstances – could be expected to lead to broadly the right level and type of investment, delivered at the right time.

24.8 Such a consequence would be undesirable in the context of monopoly regulation, and rests uneasily beside the CAA's statutory duties, although it could be accepted as a necessary evil if no other options were available. But in circumstances in which the regulated company faces material competitive constraints – as described in chapter 22 – the side-effect of augmenting regulation in the way described under Option 1 looks to be not only undesirable, but also unnecessary.

24.9 Equally, as this option would be applied in circumstances in which the regulated company might not have significant market power, there would be material risks associated with the application of the test set out in paragraph 24.4 to the Stansted G2 investment case. Indeed, the competitive circumstances in which Stansted would operates would increase both:

- the risk of getting the assessment wrong. For example, other things being equal, a competitive environment would imply that there is much greater uncertainty around traffic forecasts, than would be the case for a business that enjoyed a position of substantial market power. This is because it is necessary to factor into projections how rival airports will act (and react) to developing circumstances; and

- the impact of getting the assessment wrong. For example, any regulatory decision that implied that Stansted G2 should proceed in advance of the date on which a commercial operator would proceed could be detrimental to the long term interests of rival airports – such as Luton airport – and therefore adversely affect competition between airports to the long term detriment of users.

24.10 As noted earlier, in other industries subject to price control regulation, regulators generally tend to prefer to develop regulatory frameworks in which, so far as is possible give the constraints of statutory duties, commercial assessments and decisions based on those assessments are matters principally for companies rather than regulators. These include the auctions set up to guide investment decisions in the energy sector, and other forms of structured negotiations between regulated companies and their users (constructive engagement is one example). Although there are clearly some differences between the CAA's powers and duties, and those of other regulatory bodies, there is nothing in the Airports Act that implies the CAA should take a more interventionist approach than other regulators. Indeed, the CAA's highly circumscribed statutory powers, the emphasis placed on imposing the minimum restrictions necessary, and the impending statutory requirement on the CAA (as opposed to other economic regulators) to have regard to the five principles of better regulation, would tend to suggest that the CAA could be expected to adopt a less interventionist approach. In such circumstances, it would seem perverse for the CAA to adopt the relatively prescriptive approach to regulation implied by Option 1.

Option 2 – A market-led price control

Description of option 2

24.11 Under this option, the level of the price cap would not be derived mechanistically from calculations of costs, and would not therefore be linked to the investment costs incurred. Instead, the price cap would be set by reference to a judgement of the relative risks of setting it too high or too low, considered in the context of the CAA's statutory duties.

24.12 In terms of the risks of setting a price control too high, the CAA would have regard to evidence as to what would constitute an unreasonably high level and/or path of charges during Q5. Evidence that the CAA might take into account in reaching such a judgement would include:

- evidence of the historical costs of serving SG1 users, e.g. by reference to the costs incurred at Stansted. (It would not necessarily be appropriate simply to calculate the price cap implied by the current Stansted RAB. There is a risk in doing so that such a calculation would fail to reflect the underlying costs of the SG1 infrastructure which to an extent was subsidised through 'system' regulation over the course of the 1990s. Accordingly, therefore, if an historical measure of costs was adopted, there might need to be some form of adjustment to reflect the actual costs incurred); and

- evidence of the replacement costs of the current infrastructure. To the extent that users' reasonable interests can be equated to prices that are not excessive under competition law, it might also be possible to calculate benchmarks below which prices would not be 'excessive' using the approaches set out in competition law guidelines, and/or competition case law.

24.13 In terms of the risk of setting a price control too low, the CAA would need to have regard to the risk that the level and/or path of prices during Q5 would compromise the investment incentives of either Stansted airport itself, or other rival airports. Essentially, the CAA's judgement here would be to set a price cap at a level (or on a path towards a level) no lower than the forward-looking long run average costs of new airport capacity. In the first instance, the CAA would expect to derive evidence as to the level of long run average costs of new airport capacity from:

- estimates of the charges per passenger implied by a range of investment projects, including Stansted G2, Luton airport's plans to develop a replacement runway, and any other worked up investment plans; and
- review of the level of airport charges (or equivalent) levied by a range of UK airports; and
- review of the level of airport charges (or equivalent) levied by a range of airports overseas.

Clearly, however, it would be important to recognise in such analysis that the level of airport charges at any particular time might not reflect the underlying long run average costs. Indeed, owing to the lumpiness of airport investments, there is every reason to consider that airport charges would vary considerably around the average level. In order to avoid distorting investment decisions of airports, some consideration would need to be given to allowing charges to vary within a band around the long run average, as might be expected in an unregulated, capital-intensive industry.

24.14 Where precisely the CAA decided to pitch the level and/or path of such a price control would depend upon a judgement based on the respective risks, and also the advice of the Competition Commission. The CAA would, however, expect that the risks of setting the price cap too tight, and compromising appropriate investment incentives, would be greater than the risks associated with setting the price control too loose. One reason the risks are asymmetric is that, given the earlier market analysis, if too loose a price cap is set, there will be a range of outcomes in which it will simply not constrain the airport; by contrast, too tight a price cap would always bite, and hence cause distortions. As described in chapter 22, the market analysis tends to suggest that the terms of access offered by Stansted airport would, in any event, be conditioned by passenger and airlines choices about which airport they would like to use.

24.15 On the other hand, the CAA would need to recognise that the level at which the Stansted price control was set in Q5 would not, in itself, determine the viability of any particular investment (whether undertaken by Stansted or a rival airport). This is because, given the lead times associated with major airport investments, the vast majority of investment costs would likely fall to be recouped in Q6 and beyond, and therefore the level and/or path of the price control in Q5 would serve to indicate, rather than determine, the viability of any particular investment.

24.16 By adopting such an approach, the CAA would effectively discontinue the use of the RAB, and – in doing so – discontinue a key long term feature of the standard regulatory regime. The effect of this would be that the regulated company would not be able to rely on the implicit regulatory commitment represented by the RAB, i.e. that the regulated company can expect that expenditure rolled into the RAB to be allowed by future regulation to be remunerated.

Analysis of Option 2

24.17 The main benefit of Option 2 is that it would break the link between investment in Stansted G2 and the level of the Stansted price cap, thus removing a potentially serious distortion to Stansted airport's investment incentives. Moreover, by breaking the link between the price control and investment, the approach could remove a key underlying cause of the ongoing dispute between Stansted airport and its users. Such a move would appear to be consistent with the CAA's statutory duties in that it would facilitate an effective dialogue between the airport operator and its users as to what should be built, and by when, which in turn, given the market circumstances, could reasonably be expected to encourage broadly the right level and type of investment, delivered at the right time.

24.18 It could be argued that Option 2 – a market-led price control – would represent a significant departure from the standard regulatory model. This could be characterised as creating uncertainty around the regulatory approach adopted at Gatwick and/or Heathrow. However, as was made clear in chapter 4, the circumstances at Stansted are very different from those at BAA's other designated airports. At Heathrow, whilst investment is significant it is much less significant as a proportion of the existing RAB, the potential for competition is self-evidently much less significant, and – bearing in mind the investments undertaken at Heathrow in Q4 (notably T5) there is a strong case for regulatory continuity. At Gatwick, projected investment represents a relatively small proportion of the RAB, the prospects for competition– although significantly greater than at Heathrow – appear to be materially less promising than at Stansted by virtue of its location and mix of airlines and passengers, and again there is a strong case for continuity. Indeed, the case for continuity is reinforced by the good progress made at both Heathrow and Gatwick towards agreement of projected outputs (and associated capital expenditure) under the constructive engagement process. In addition, Stansted airlines and BAA have both separately, and publicly, recognised that Stansted represents a different regulatory challenge. On this basis, a proposal to adopt a modified approach to setting price caps at Stansted would not appear to undermine the continuation of the RAB-based approach to regulation – supplemented by constructive engagement – that appears to have worked effectively at Heathrow and Gatwick.

24.19 Perhaps the main drawback with the market-led approach would be that by discontinuing the use of the RAB as the basis for the Stansted price control, a key long term feature of the standard regulatory regime (one that delivers a degree of certainty) would be removed. The effect of this would be that the regulated company would not be able to rely on the implicit regulatory commitment represented by the RAB, i.e. that the regulated company can expect that expenditure rolled into the RAB to be allowed by future regulation to be remunerated.

24.20 Arguably, there could be a case for considering replacing the RAB by a more general qualitative regulatory statement to the effect that the CAA would expect to be reasonably well-disposed to investments that were both efficient and economic and which properly corresponded to users' interests over time. However, the CAA does not consider that such a statement would, in practice, provide any more comfort to an investor than the wording of the CAA's statutory duties already do. This is because it would neither amount to an implicit nor explicit advance endorsement of a particular capital investment programme.

24.21 It follows that regulating without regard to a RAB at Stansted could give rise to an effective increase in the discretion available to the regulatory authority at future periodic price control reviews. Accordingly, a consequence of adopting Option 2 would be that the regulated company would face a greater degree of uncertainty in relation to investment compared to the uncertainty faced by an equivalent company operating in an unregulated environment.

Assessment of alternative regulatory options

24.22 In summary, therefore, whilst Option 1 appears at first sight to address the issue at hand, it seems very likely that the continued operation of a RAB-based price control – even with a supplementary regulatory-led test – would not address the counter-productive incentives flowing out of the RAB-based regime, as described in the previous chapter. The risk around regulatory intervention to determine precisely what is built and when are also potentially very significant, with consequences extending to other airports, and their users.

24.23 Option 2, on the other hand, would serve to break the link between investment and price caps, and thereby remove a potentially significant distortion to Stansted airport's investment incentives, and lower what appears to be a significant barrier to effective dialogue between the airport operator and its users on the appropriate future investment programme. Though a significant departure from the standard RAB-based approach, it would not appear to undermine the approach taken to regulation at Heathrow and Gatwick. All parties broadly accept that Stansted represents a different regulatory challenge. Besides, clearly signalling an end to RAB-based regulation would squarely address a central concern of the Stansted airlines that a RAB based regulatory system would generate inflated price caps from inflated forecasts of demand and/or capital expenditure. In ceasing to regulate Stansted by reference to a RAB, however, a key long-term feature of the standard regulatory regime would be removed and – as a consequence – the airport operator would be exposed to more uncertainty about the long term regulatory regime than would otherwise be the case.

24.24 It follows from this that neither of the options set out above are without their disadvantages. However, given the difficulties associated with Option 1 in terms of the effect on the decision-making process, and the potentially adverse consequences for other airports and their users of pursuing this option, the CAA currently prefers Option 2. Given the market circumstances, such an approach could be expected better to incentivise the right level and type of investment, delivered at the right time, given the anticipated demand by airport users and constraints, uncertainties and opportunities that exist.

(page left intentionally blank)

25. Proposals for future deregulation of Stansted airport

Introduction

25.1 As noted above, the CAA recognises that there would be consequences of regulating under Option 2 for investment at Stansted. In particular, were the CAA to set a price control at Stansted without reference to a RAB, the effect would be to remove an implicit floor on the level of future price caps, thereby removing some comfort that future price caps (in Q6 and beyond) would be set at a level that allows a reasonable return on investment. While the CAA has made clear why it might do so (i.e. to avoid artificially distorting investment decisions and competition between airports), a consequence is to leave the airport operator at Stansted with more uncertainty than – for example – would face an equivalent investor with a capital programme that had been agreed in advance by its users and regulator.

25.2 In such circumstances – and recognising that it is currently the responsibility of the Secretary of State to decide whether or not an airport should be designated (or de-designated) for price control purposes – the CAA has reflected on whether there is a case for de-designation.[21]

25.3 This chapter therefore sets out for consultation some preliminary thoughts on the question of de-designation of Stansted, setting out:

- the broad criteria against which any decision might be made;
- evaluating the evidence against those criteria, drawing on the analysis and the evidence exhibited earlier in this document; and
- the views of a range of interested parties, encompassing the recent recommendations of the House of Commons Transport Select Committee and the Better Regulation Commission.

25.4 It goes on to discuss possible benefits – in terms of improved certainty for airport operators and their users – from tightening up the designation (and de-designation) criteria. It subsequently points out some of the consequences of a more deregulatory approach for Stansted airport and its users. The very last section of the chapter summarises the CAA's current thinking in relation to Stansted airport, and invites views on it.

Broad criteria for assessing the *prima facie* case for de-designating Stansted

25.5 In 1995, the DfT concluded[22] that government considered the following four criteria to be relevant to designation:

- the market position, including the extent of competition from other airports and other modes;
- *prima facie* evidence of excessive profitability or abuse of a monopoly position;

[21] Stansted Airport is designated under the Economic Regulation of Airports (Designation) Order 1986 for the purposes of Section 40 of the Airports Act 1986. Any removal of this designation would not affect designation of Stansted Airport under other statutes.
[22] Review of the Framework for the Economic Regulation of Airports, DfT, 1995.

- the scale and timing of investment, and their implications for profitability; and
- efficiency and quality of service.

25.6 These criteria are a mixture of a market-related test (which is embodied in the first criterion) and different types of evidence that bare on whether that test has been met (the second, third and fourth criteria). Moreover, the types of evidence identified are not obviously relevant in the case of an airport that is currently designated, and therefore subject to price control. The CAA would also observe that the test relates to the market position of the regulated company, and no reference is made to the potential costs and distortions associated with regulation.[23]

25.7 However, on the basis that both the risk of abuse of market power and the costs and distortions that could arise from regulation are taken into account, there appears to be a reasonable *prima facie* case for the de-designation of Stansted.

Scope for prospective exploitation of users

25.8 As set out in chapter 22 – and more fully in Supporting Paper II – the CAA has recently reviewed the market position at Stansted in some detail. The conclusion of this work is that Stansted airport does <u>not</u> currently hold a position of significant market power and that the market position of Stansted is, starting from a relatively weak base, likely to strengthen over time, but that market power is, on balance, highly unlikely to reach potentially problematic levels (e.g. dominance) in the short- to medium-term.

25.9 In other words, there are doubts about whether Stansted airport could be said to possess significant market power, let alone that it could be expected to abuse that position. This puts the market circumstances in which Stansted airport operates in sharp contrast to those typically observed in other industries in which *ex ante* price control regulation is applied. For example, in energy markets price control regulation is confined to the on-shore gas and electricity transportation networks, where there is a degree of market power that equates to monopoly, or near monopoly, and in which there is a presumption that abuse would occur unless *ex ante* price regulation were to be applied. However, large parts of the energy supply chain, including power stations, gas storage facilities and retail supply, do not operate under *ex ante* price control regulation. Instead, Ofgem relies on its powers under the competition law to investigate companies *ex post* in the event that it suspects

[23] It is now widely acknowledged that in reaching proportionate regulatory solutions, it is important to consider the costs (both administrative and policy) of regulation alongside the expected benefits, whilst taking account of the risks around both the costs and benefits. In this context, this means that while acknowledging that regulatory intervention might serve to address the distortion created by RAB-based regulation, it is also necessary to recognise the risks that the solution could carry unintended consequences. More detail on these issues is contained in Regulation – Less is More: Reducing Burdens, Improving Outcomes, Better Regulation Task Force, October 2004.

that there has been an abuse of market power.[24]

25.10 So, whilst some firms enjoy a degree of market power that would be regarded as significant, the degree of market power is not regarded as so great that it can reasonably be presumed that exploitative abuse (in the form of excessive prices) would occur if no *ex ante* price controls were applied. Instead, the view can be taken that the deterrent to firms with significant market power provided by competition law (in the form of effective *ex post* penalties for abuse) would serve to protect users' interests in a manner that was proportionate to the risks they face.

25.11 It follows that were Stansted to be de-designated for price control purposes, and it subsequently developed a position of dominance and also considered abusing that position dominance through exploitative or excessive pricing, users would enjoy the protections afforded by standard UK and European competition legislation.

Scope for prospective costs and distortions arising from regulation

25.12 On the other hand, the cost in terms of increased regulatory risk on investment at Stansted, as discussed above, could be potentially significant. In particular, Option 2 – whilst the least bad of the regulatory options examined – could expose the airport operator to more uncertainty about the long-term regulatory regime, i.e. how the CAA would discharge its functions in Q6 and beyond, than would otherwise be the case.

25.13 Moreover, experience from other industries – as described above – suggests very clearly that *ex ante* price controls are most likely to be appropriate where there is clear evidence of monopoly power.

Other views

Transport Select Committee

25.14 The House of Commons Transport Committee recently considered the question of designation and de-designation of airports.[25] The Committee recommended that the Government review the continuing need for the designation of airports subject to economic regulation by the CAA as a matter of principle, and that it publish its assessment of the relative merits of this approach, compared to the use of standard competition legislation to regulate the abuse of dominant position by airports. Moreover, the Committee specifically recommended that the Government should consider de-designating Manchester and Stansted airports as a first step.

Need for better regulation

25.15 Looking at the case for de-designation of Stansted would also be consistent

---

[24] In addition to these powers, Ofgem also has a number of behavioural licence conditions which it can seek *ex post* to enforce. In order to determine when it is appropriate to use its powers, Ofgem conducts regular market surveillance to ensure that the markets it oversees are operating according to supply and demand fundamentals. In the event that it suspects that a company is abusing its position it will take action to avoid detriment to consumers.

[25] The Work of the Civil Aviation Authority, Thirteenth Report of Session 2005-06, House of Commons Transport Committee, published on 8 November 2006.

with the Government's broad, public commitment to better regulation, including its acceptance in full of the first set of recommendations of the Better Regulation Commission (then the Better Regulation Task Force).[26] More recently, a report from the Better Regulation Commission[27] has urged the Government to redefine its approach to risk management in a number of ways, so that state regulation is only embarked upon where it represents the optimum solution for managing risk.

25.16 Indeed, only a matter of weeks ago, the Legislative & Regulatory Reform Act received Royal Assent. This will place a statutory obligation on the CAA, when and if its functions are designated by a Minister of the Crown, to have regard to five principles of good regulation. These principles are that regulation should be proportionate, transparent, accountable, consistent and targeted. Proportionate regulation – in line with the CAA's stautory duty to impose the minimum restrictions necessary – clearly implies fitting regulation to the circumstances at hand. This, in turn, implies a more deregulatory approach where the market circumstances permit.

Views of users and BAA

25.17 For the reasons discussed above – although Stansted ACC has not provided a formal view on the question of designation, or de-designation – full de-designation would appear clearly, and cleanly, to address many of the concerns users have about the impact of regulation on Stansted airport's incentives.

25.18 Moreover, it would be in line with BAA's request that 'as the CAA moves through [the price control review process] it should look for opportunities to lighten the regulatory burden…'. Indeed, such a move would also be fully consistent with BAA's statement that: 'It is an axiom that competition is better than regulation, and even where competition is imperfect, the costs and incentive distortion which inevitably accompany regulation may outweigh its benefits.'[28]

CAA's recommendation

25.19 Against this background, and in line with a recommendation made by the Transport Select Committee and the principles recently advocated by the Better Regulation Commission, the CAA recommends to the Government that it consider the case for the de-designation of Stansted airport

Improving the (de)designation criteria

25.20 De-designation of Stansted would not, in itself, remove all unnecessary regulatory risk from investment decisions. Stansted airport could still suffer regulatory risk albeit indirectly through the risk that it might be re-designated.

[26] See Regulation – Less is More: Reducing Burdens, Improving Outcomes, Better Regulation Task Force, October 2004.
[27] Risk, Responsibility and Regulation: Whose Risk is it Anyway?', Better Regulation Commission, October 2006.
[28] All quotations cited in paragraph 25.18 are taken from 'BAA Response to CAA Policy Issues Consultation Paper', BAA/Q5/100, BAA plc, March 2006, available on the CAA's website: www.caa.co.uk.

This suggests that – whilst recognising the possibility that airport could build up a position of significant market power that warranted re-designation – there would be merit in removing any unnecessary risk that the airport operator might face, e.g. as a result of the Government retaining an unnecessarily wide discretion as to the circumstances in which Stansted could be re-designated.

25.21 One way to achieve this would be for the Government to update its criteria for designation (and de-designation) so as to define more closely the circumstances in which price control regulation would, and would not, apply. In this vein, the CAA would make five recommendations to Government:

- in any new criteria it will be important not to conflate the test and the evidence. Of the current four designation criteria, three criteria (the second, third and fourth) describe forms of evidence, and only one (the first, which refers to 'market position') represents a test;
- second, the market position test needs to be expressed in terms of the risk of abuse of market power. This way proper account can be taken of the effect of the constraining effect of competition law;
- third, the test should consider the risk only of exploitative abuse of market power (i.e. abuse that takes the form of excessive prices, poor service, reduced investment) rather than exclusionary abuse (i.e. abuse that takes the form of restricting, distorting or preventing competition by undermining competing suppliers, such as predatory pricing). This is because exclusionary abuse is already addressed by general competition law and could not, in any event, be effectively addressed by designation, as designation simply has the effect of requiring the CAA to impose a cap on airport charges;
- fourth, the test should be focused on the risk of exploitative abuse of market power currently and in future, rather than historically, for obvious reasons; and
- fifth, the test should include some comparison with the costs and distortions associated with regulation, i.e. the risk of ‘regulatory failure’. This is necessary in order to ensure a balanced comparison is made.

25.22 The CAA therefore recommends that the Government consider updating its criteria for designation (and de-designation), in line with the suggestions made in paragraph 25.21 so as to remove unnecessary risk of designation, and thereby improving the climate for airport investment.

Some consequences for Stansted airport and its airline users

25.23 If either the CAA ultimately[29] sets price controls at Stansted by reference to the considerations set out under Option 2 above, or the Government decides to review, and ultimately, de-designate Stansted airport, much of the

[29] Under the current timetable, the CAA will not make a final decision on the price controls until early 2008.

responsibility for establishing the price and non-price terms of access to Stansted airport – including the capital expenditure programme undertaken – would revert to the airport operator and its customers.

25.24 Obviously, final decisions on these issues – whether it is a regulatory settlement, or a Government decision to de-designate Stansted – can and should only be reached after due process has been followed. However, rather than waiting for these processes to take place, there could be commercial advantage to both airport and airlines in engaging in discussions on the terms of airport use forthwith.

25.25 The CAA recognises, of course, that constructive engagement between the airport and its airlines presented such an opportunity and it failed at Stansted. But – as discussed above and in the Cotterill review – the degree of regulatory uncertainty, and the incentives caused by RAB-based regulation, contributed to this failure, and these potential causes the CAA is now expressly seeking to resolve.

25.26 Accordingly, the CAA would encourage Stansted airport and its users resume discussions with a view to reaching agreement on the future terms of use of Stansted airport bearing in mind:

- the CAA is now proposing an approach to setting a price control which is not RAB-based; and
- the parties would effectively have the freedom to negotiate all aspects of the terms of use in a combined format, rather than consideration of individual elements (such as traffic forecasts and capital expenditure) being dealt with separately.

Summary

25.27 In summary:

- there is a limited possibility that Stansted either has – or can be expected to enjoy – a position of market power that gives rise to a significant risk that it will exploit that position through charging unreasonably high prices; and
- there appears to be a clear risk that RAB-based regulation has – in the circumstances that apply at Stansted – artificially distorted the incentives on Stansted airport and its users.

25.28 As a consequence, of the two options examined, the CAA currently prefers a market-led price control. This would involve setting a price cap at Stansted airport at a level unrelated to the level of investment undertaken by BAA, but at a level high enough to avoid disincentivising investment (either by Stansted or other airports) though not so high as to compromise the reasonable interests of users. Such an approach would serve to break the link between investment and price caps, and thereby remove a potentially significant distortion to Stansted airport's investment incentives, and lower what appears to be a significant barrier to effective dialogue between the airport operator and its users on the appropriate future investment programme. Given the market circumstances, such an approach could be expected better to incentivise the right level and type of investment, delivered at the right time, given the anticipated demand by airport users and constraints, uncertainties and opportunities that exist.

25.29 Such an approach would appear to be the least bad regulatory solution to the problems that exist at Stansted. However, it would not be free of all disadvantages. In particular, by ceasing to regulate Stansted by reference to a RAB, a key long-term feature of the standard regulatory regime would be removed and – as a consequence – the airport operator would be exposed to more uncertainty about the long-term regulatory regime than would otherwise be the case.

25.30 Against this background, and recognising that:

- there is no evidence of exploitative market abuse by Stansted at present, and that the possibility that Stansted can be expected to enjoy a position of market power that gives rise to a significant risk that it will exploit that position through charging unreasonably high prices is limited;
- in any case, to the extent that Stansted airport both developed a position of dominance, and sought to abuse that position of dominance through exploitative or excessive pricing, users would enjoy the protections afforded by standard UK and European competition legislation; and
- the costs of regulation, in terms of increased regulatory risk on investment at Stansted could be potentially significant

the CAA recommends to the Government that it consider the case for the de-designation of Stansted airport, and that it considers updating the criteria for designation in line with the CAA's recommendations set out in paragraph 25.21.

25.31 In any event, and recognising that if either the CAA ultimately adopts its preferred option, or the Government decides to review, and ultimately, de-designate Stansted airport, responsibility for establishing the price and non-price terms of use would revert to the airport operator and its customers, then the CAA would recommend that Stansted airport and its users resume discussions with a view to reaching agreement on the future terms of use of Stansted airport.