



The Competition Commission's Market Investigation of BAA Ltd

The Civil Aviation Authority's response to the Emerging Thinking

May 2008

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Summary

1. The CAA welcomes the opportunity to respond to the Competition Commission's (CC's) emerging thinking on its market investigation into BAA Ltd (BAA). The CAA's comments are set out below in respect of:
 - the approach taken by the CC;
 - common ownership;
 - capacity constraints; and
 - economic regulation.

Approach

2. In general terms, the CAA supports the approach adopted by the CC. However, the CAA would encourage the CC to recognise that economic regulation is a response to a lack of sufficiently effective competition. It exists as a result – and seeks to address the potential consequences – of a high degree of market power, including the market power that results from BAA's common ownership of airports. Economic regulation serves to mitigate, rather than generate, adverse effects on competition. This suggests that in looking at whether economic regulation has had an adverse effect on competition, the CC should seek to compare observed outcomes with those that might reasonably have been expected in the absence of economic regulation.
3. The CAA would also encourage the CC, in its analysis, to ensure that performance outcomes (including past, current and prospective) are judged against those that would be expected in a well-functioning market and are considered from the perspective of the end-user or consumer of airport services, rather than focusing on the interaction between airports and airlines, unless this interaction has an impact on consumers and/or competition.

Common ownership

4. The CAA agrees that common ownership of the SE airports is likely to have had an adverse effect on competition between airports, and that this effect could continue in future.
5. The CAA reaches this position on the basis that:
 - airports can and do compete across the UK, and there is potential for such competition between the major SE airports, as shown in the CC's analysis and in evidence the CAA has submitted;

- observed outcomes on service quality are unlikely to have matched those that a well-functioning market would have generated, notwithstanding the overall positive impact of economic regulation; and
 - it is likely that there may be other adverse effects arising from common ownership (even after these have, in part, been addressed by economic regulation), which will tend to be less tangible and measurable, and relate to issues such as less innovation and product differentiation.
6. The CAA also notes that there do not appear to be any significant benefits from the common ownership of neighbouring airports.

Capacity constraints

7. The CAA does not view the existence of capacity constraints as a feature that necessarily has adverse effects on competition, as many well-functioning markets, including those in capital intensive industries, at times operate with relative scarcity of capacity. It is important, therefore, to distinguish between 'natural' and 'artificial' capacity constraints.
8. The CAA agrees that the planning process has the potential to have adverse effects on competition, as a result of the impact of the processes involved, delaying and potentially inhibiting investment in airport capacity, e.g. the planning inquiry into Terminal Five at Heathrow. However, planning processes are a feature of infrastructure markets, and clearly play an important role in ensuring that the wider social and environmental impacts of airport expansion are fully considered. In this respect, the CAA supports the objective of clarifying the framework for airport infrastructure projects, in order to remove unnecessary delays to individual planning applications, and notes that the Government is currently pursuing reforms to the planning system intended to have this effect.
9. In this context, while it is important to remember that the 2003 White Paper was designed to address undesirable delays in the planning process by setting out the location, order and timing of airport development in the SE in a relatively prescriptive way, the 2003 White Paper has the potential adversely to affect competition. However, the CAA recognises that there is inevitably a balance to be struck between leaving competing airports to determine their investment plans and the benefits of Government indicating support for airport expansion. What is important, therefore, is that this trade-off is explicitly considered, and that Government in setting the overall framework, and planning authorities in applying it, give full consideration to the impact that their decisions have on competition between airports and between airlines.

Economic regulation

10. Economic regulation of the SE airports has brought significant benefits to both passengers and airlines using these airports. It has prevented airport charges from being set at an excessive level, provided strong incentives to invest and to make best use of the available airport capacity, and ensured that gains in operating efficiency have been made and passed back to airport users through reductions in airport charges.
11. That said, economic regulation is not – and in fact can never be – a perfect solution to the existence of high degrees of market power and cannot be reasonably expected to result in outcomes that match those that would be expected in a well-functioning competitive market. Indeed, there are likely to be a number of unintended (and largely unavoidable) side-effects from economic regulation, which – when viewed in isolation – might have the effect of adversely affecting outcomes, including that: regulation can distort investment incentives and decisions, particularly between designated and non-designated airports; and could reduce the incentives on the airport to innovate. However, the overall effects of economic regulation are likely to have been positive when viewed against the likely outcome of common ownership without regulation. The CAA considers that this is the appropriate comparison.
12. Moreover, the CAA would encourage the CC to recognise that the CAA has a strong record of discharging its regulatory functions in a way that has full regard to the impacts of regulation on competition and the importance of ensuring that competition can develop, thereby minimising the scope for any adverse effects on competition to arise from the way that regulation is applied. For example, in recent price control reviews the CAA:
 - decided in 2003 that BAA's SE airports should be regulated on a stand-alone basis – prohibiting anti-competitive cross-subsidies between BAA's airports – contrary to the advice of the Competition Commission, and the preference of BAA and the Government;
 - decided in 2003 to set a 'looser' price cap at Manchester than that proposed by the Competition Commission, in recognition of the need to ensure that the emergence of competition was not stifled – a decision vindicated by the continued development of competition, leading to the recent deregulation of the airport; and
 - included within its recent April 2008 reference to the Competition Commission a range of options for price controlling Stansted's airport charges, including proposals for safeguard caps, that seek to address the risk that the application of a standard building block approach could distort competition between airports.
13. The CAA has, therefore, discharged its regulatory function having full regard to the potential for economic regulation to have adverse effects on

competition, as it considers that this is consistent with furthering the reasonable interests of users of all UK airports and encouraging the economic and efficient operation of, and timely investment at, these airports. As a result, the CAA does not accept that the system or operation of economic regulation (i.e. how the CAA has applied regulation within the current framework) has had an adverse effect on competition, or either reinforces or exacerbates other adverse effects.

14. The CAA has also considered the arguments presented in the emerging thinking that aspects of economic regulation have had adverse effects. In this respect, the CAA presents material that demonstrates that:
 - its regulatory approach has not been unduly 'light touch'; rather, the CAA has exercised its functions proportionately, in accordance with the regulatory framework set out in the Airports Act;
 - the constructive engagement initiative has compensated for the tendency for economic regulation to 'crowd-out' airport-airline dialogue, has introduced greater commercial negotiation into the price control process and has demonstrably been an improvement on the regulator-led, more adversarial, approach that it replaced; and
 - the CAA carried out an appropriate regulatory process, and in doing so it acted lawfully and reached lawful decisions, in respect of the Heathrow and Gatwick price controls.
15. In respect of the broader statutory framework that applies to UK airports, the CAA has already identified in its May 2007 and February 2008 submissions that there is a strong case for reform. This reform should focus on improving the clarity of the framework and afford the CAA more flexibility to tailor its regulation of airports, so as to ensure that any adverse effects on competition would be kept to an absolute minimum. The CAA also looks forward to participating in the Government's recently announced review of the regulatory framework.

1. Introduction

Purpose

- 1.1 The CAA welcomes the opportunity to respond to the Competition Commission's (CC's) emerging thinking on its market investigation into BAA Ltd (BAA).
- 1.2 The CAA has reviewed the CC's report carefully and, in this document, provides its views and/or evidence on the analysis carried out to date. The focus of the CAA's response is on BAA's South East (SE) airports, reflecting the CAA's role as economic regulator with responsibility for setting price caps on the three largest airports in the SE.

Background

- 1.3 This response should be read in conjunction with other written and oral evidence that the CAA has provided earlier in the market investigation, including:
 - the CAA's response to the CC's initial consultation (May 2007);
 - the CAA's initial oral evidence (June 2007);
 - the CAA's response to the CC's Statement of Issues (September 2007); and
 - the CAA's supplementary oral evidence (March 2008).
- 1.4 In considering the relationship between BAA's performance and economic regulation, the CC should also have regard to the analysis underlying the CAA's proposals for the reform of the regulation framework, which it submitted to the CC and published in March 2008.

Responses to specific issues raised by the CC

- 1.5 The CAA notes that the CC has asked for evidence and views on a number of specific issues, including:
 - how the performance of BAA's airports could be improved under separate ownership;
 - the effectiveness of competition between other UK airports and overseas; and
 - whether continued regulation of BAA's London airports would itself reduce the scope of competition between them.
- 1.6 The CAA is currently considering these specific issues, including in light of the recently published CC working papers, and will submit its views on them

shortly. The CAA will also consider the CC's Emerging Thinking on BAA's airports in Scotland, including the recently published working paper, and revert to the CC in due course.

Structure of the document

1.7 The CAA's response is structured as follows:

- the CAA's comments on the approach adopted by the CC are set out in Chapter 2;
- this is followed by the CAA's views on the CC's analysis of BAA's main SE airports (i.e. Heathrow, Gatwick and Stansted) following the broad structure adopted by the CC:
 - the case for describing common ownership as an adverse effect on competition (Chapter 3);
 - the case for describing capacity constraints as an adverse effect on competition (Chapter 4); and
 - the case for describing economic regulation as an adverse effect on competition (Chapter 5).

1.8 Annex A contains a response to a range of criticisms of the way that economic regulation has been applied that are contained in the emerging thinking report.

Contact details

1.9 If there are any questions on any of the material contained in this response, please contact Chris Hemsley (on 020 74536237 or chris.hemsley@caa.co.uk) or Isabell Kohten (020 74536234 or isabell.kohten@caa.co.uk) in the first instance.

2. Approach

- 2.1 Analysing the airport market in the SE of England is a complex task. Outcomes for consumers – in terms of airfares paid and the range and quality of service received – are the result of the interactions between many different players and many different factors. The approach taken by the CC to unpacking the various causes and effects is therefore crucial to ensuring that well-informed and balanced conclusions are reached.
- 2.2 In general terms, the CAA agrees with the approach adopted by the CC. In particular, the CAA supports the CC's decision to consider, first, the evidence on performance, and then, second, the potential causes of shortcomings in performance that have been identified with a view to establishing what feature (or combination of features) represents the underlying cause(s) of the outcomes.
- 2.3 However, the CAA believes that the CC, in forming provisional findings, should develop its approach in two significant ways:
- first, the assessment as to whether there have been adverse effects on competition should be made by comparing the outcomes for consumers (e.g. in terms of price and service) with those that they might expect to experience in a well-functioning competitive market; and
 - second, rather than treating common ownership and economic regulation as two independent features of the market both of which have the potential to give rise to an adverse effect on competition, the CC should recognise that the main purpose of economic regulation is to address the adverse effects of market power, including the effects of common ownership.

These issues are discussed in turn below.

- 2.4 In addition to these issues of principle, the CAA is concerned that in any assessment of the performance and effect of economic regulation, the CC has not fully acknowledged the commercial context within which criticisms of economic regulation have been made, or the statutory framework within which economic regulation has been applied. The CAA would therefore encourage the CC to:
- ensure that it has taken fully into account the particular commercial interests of both airports and airlines, and seeks objective evidence to corroborate views and opinions;
 - give full regard to the constraints that the current regulatory framework places on the way that the CAA regulates airports, in particular that it provides the CAA with the principal function, of setting a price cap,

which affords the CAA significantly less flexibility than other economic regulators enjoy; and

- acknowledge the important role of the CC in the economic regulation of BAA's SE airports and, in particular, the two main economic regulation functions ascribed under the Airports Act 1986 – setting maximum limits on airport charges and addressing whether such airports have operated against the public interest – the CC is solely responsible for determining whether BAA's airports have acted against the public interest (after which point the CAA must apply remedies).

The CAA's detailed response to material presented in the emerging thinking on the current framework of economic regulation – and its operation – is contained in Annex A.

Analysing outcomes appropriately

2.5 The CAA would encourage the CC to focus its analysis in two ways:

- by setting out the appropriate comparator, or 'counterfactual', against which conduct is being assessed; and
- by assessing effects by reference to their impact on outcomes for consumers.

2.6 In respect of the first, the CAA considers that it is important to compare BAA's conduct to that which might be expected in a well-functioning airport market. This implies that BAA's conduct should not be compared against some notion of 'ideal' conduct or, necessarily, against the stated expectations of airlines.

2.7 It follows, therefore, that in assessing whether BAA's responsiveness to airlines amounts to evidence that there are adverse effects on competition, the relevant benchmark should be that of the expected airport-airline interaction in a well-functioning competitive market, and not, for example, 'best practice' consultation undertaken by public authorities.

2.8 In respect of the second – focusing on the impact on consumers – the CC considers whether BAA's airports have adverse effects on competition in any market, including effects on:

- competition between airports;
- competition between airlines; and
- competition in other markets in the aviation supply chain.

2.9 Effects in all of these markets can generally be expected to flow through to the price and/or service quality experienced by the end-user or consumer. In order to capture all of these effects, the CC should therefore assess

outcomes from the perspective of the end-user or consumer of airport services and not focus unduly on the nature and outcome of negotiations between airports and airlines, which may reflect commercial bargaining.

- 2.10 To do so would entail considering the range and quality of service experienced by consumers compared with the service that they might expect to experience in a well-functioning competitive airports market, on which the CC has already collected evidence. It would also entail considering how the contribution to airport charges made by consumers (in the past and future) compares to that which they could expect to make in a well-functioning market. This, in turn, may require carrying out analysis of the fares paid by consumers, and the extent to which airport charges flow through to consumers.
- 2.11 As the CC is aware, there is a strong possibility that in certain parts of the market fares are set by reference to consumers' willingness to pay rather than on the basis of airlines' costs¹. As a consequence, in these circumstances, increases in airport charges would effectively be absorbed by airlines, rather than consumers, which would need to be taken into account in such analysis. Indeed, if airport charges are held below the competitive price level, an increase in such charges would not, necessarily, have any significant affect on airfares or the range of services offered to consumers.
- 2.12 Analysing outcomes from the perspective of the consumer also implies that the CC should place less emphasis on reviewing the day-to-day interaction between the SE airports and airlines, particularly as the nature of these interactions is likely to be a consequence of regulation. In particular, economic regulation tends to 'crowd-out' normal airport-airline negotiation and commercial arrangements, replacing it with necessarily formal regulatory processes – although the CAA would note that its constructive engagement initiative sought to address this effect.

Common ownership and economic regulation

- 2.13 Perhaps the most significant challenge in this market investigation lies in unpacking the separate effects of common ownership and economic regulation.
- 2.14 As a matter of principle – and assuming that they would compete against each other were they to be separately owned – the common ownership of BAA's SE airports would naturally be expected to lead to outcomes that are materially worse than would result from a well-functioning competitive market. For example, it might reasonably be expected that the limitations on competition would lead to slower growth, poorer service quality, less

¹ This would be the case if there were binding capacity constraints on the supply of air travel which, on the airport level, could be caused by insufficient investment or pricing airport capacity below its scarcity value and thus creating excess demand.

investment, higher charges, higher profits, less efficiency and less innovation than in a competitive environment.

- 2.15 However, while there is some evidence of these outcomes – for example, service quality at Heathrow and Gatwick airports has probably fallen below the standard that might be expected in a competitive market – there is limited unambiguous and measurable evidence in the observed outcomes over the past five years or so to confirm the hypothesis that BAA's common ownership has had the adverse effects arising from a lack of competition as identified above. In particular, traffic growth has been strong, investment substantial, and prices held at levels reflecting historical costs, whilst the development of the commercial businesses at the airports has been significant. Further, evidence from the consultancy studies commissioned by the CAA to inform the price caps for Heathrow and Gatwick suggests scope for continued incremental improvement rather than for a step change in BAA's operating cost efficiency.
- 2.16 It would, however, be a mistake to conclude from the relatively limited amount of unambiguous, measurable evidence that common ownership has not had a significantly adverse impact on outcomes for consumers or that its effects are relatively minor. This is because the observed outcomes naturally reflect what can actually be seen in the market, and are the result of common ownership *after* economic regulation has addressed the major adverse impacts. By its nature, economic regulation will be able to remedy the most obvious and observable forms of abuse and address adverse effects that are easily identified and measured. For example, the CAA's commissioning of a number of detailed studies of BAA's operating performance during the recent Heathrow and Gatwick price control review, which identified scope for improvement, resulted in adjustments to the relevant price caps. But it is likely that there may be other adverse effects arising from common ownership (even after these have, in part, been addressed by economic regulation), which will tend to be less tangible and measurable, and relate to issues such as less innovation and product differentiation.
- 2.17 It is also illustrative to unpack the factors that result in the *combined* effect of BAA's common ownership of airports in the South East and the application of economic regulation into:
- (a) the adverse effects that would arise from common ownership and, in particular, the abuse of BAA's market power;
 - (b) the impact of economic regulation in reducing the adverse effects of BAA's market power; and
 - (c) any unintended consequences (i.e. negative side-effects) of the application of economic regulation.
- 2.18 Analysing the problem in this way should put into context many of the criticisms of economic regulation. In particular, any negative side-effects of

economic regulation should be seen in the context of the benefits that economic regulation has brought. In terms of the analysis above, this means that the overall impact of economic regulation should be considered by taking into account both (b) and (c) above. Further, to the extent that the unintended consequences (i.e. the effects in (c)) are considered to be material, then these should be primarily considered as the indirect consequences of common ownership.

- 2.19 In summary, in looking at whether economic regulation has had an adverse effect on competition, the CC should seek to compare observed outcomes with those that might reasonably have been expected in the absence of economic regulation.

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3. Common ownership

Introduction

3.1 This chapter summarises the CAA's views on the extent to which common ownership amounts to an adverse effect on competition.

3.2 The CAA has considered:

- the CC's market analysis – together with the CAA's previous analysis – which is strongly suggestive of the potential for competition between BAA's SE airports;
- the evidence on BAA's performance, including:
 - the lack of responsiveness to interests of airline users on capital expenditure;
 - a failure to ensure operating excellence;
 - quality of service deficiencies in the London airports, indicative of a lack of responsiveness to customers;
 - a financial structure with a dependence on a single group parent balance sheet; and
 - a lack of engagement with users, and of ambition in the development of Southampton.

Market analysis

3.3 As the CC notes in its Emerging Thinking, BAA has a 91 per cent share of passenger traffic over a relatively broad area of the South East of the UK and a 60 per cent share of passengers using all UK airports. On most definitions of a relevant market, BAA's South East airports have a very strong market position. Unless each of these airports is a monopoly in its own right, this evidence alone provides a strong *a priori* case that there is potential for more competition.

3.4 The CAA has previously considered whether airports could reasonably be described as having the characteristics of natural monopoly businesses, concluding that they do not.² In addition, the CAA referred to the evidence from the UK's regional airport market(s) that clearly demonstrates how airports can compete and do so (largely free from detailed economic regulation) in a way that delivers benefits to consumers.³

² See, in particular, the CAA's May 2007 submission to the Competition Commission.

³ See, for example, 'Air Services at UK Regional Airports', CAA, November 2007.

- 3.5 This implies that it is important to consider whether there is evidence to suggest that BAA's South East airports could compete with each other, either in the short-term, by improving their price-service offering, or in the longer-term, by investing in service quality improvement and/or capacity expansion.⁴
- 3.6 In respect of competition in the short-term, the CAA has previously considered whether there is evidence of interactions between BAA's London airports and competition between these airports and non-designated airports, notably Luton Airport. For example, in December 2006⁵ the CAA summarised the results of analysis undertaken by NERA (for BAA) that highlighted the strength of interactions between BAA's London airports, and presented its own evidence on the degree to which passengers at Heathrow, Gatwick, Stansted and Luton saw a range of airports as potential substitutes. The CAA also considered evidence of passengers' willingness to travel to reach an individual airport – drawn from catchment area analysis – in order to consider the potential for passengers to switch between airports, if offered a suitable alternative airline service. This evidence supports the view that airports in London have the potential to compete for passenger and airline business.
- 3.7 In respect of the longer term forms of competition – such as competition for capacity expansion – it seems that there is evidence supporting the view that there is scope for such competition. For example:
- BAA's approach to forecasting passenger numbers includes a range of assumptions about how passenger demand might "spill" between its airports, in response to underlying demand growth and capacity expansion at the airports, implying that they are, to a greater or lesser degree, substitutes for each other;
 - [redacted]⁶; and
 - the DfT's passenger forecasts and modelling of capacity expansion implies a degree of interdependence between capacity provided at one of BAA's airports and passenger demand at other BAA airports, suggesting that these airports are, to some degree, substitutes over the longer-term.
- 3.8 The CAA also notes the analysis published by the CC on the potential for competition between BAA's South East airports and on the analysis of airline yield data, which supports the view that airports can compete for passenger and airline business.

⁴ This is, of course, a rather stylised way to distinguish between different periods and how inter-airport competition might take place in practice. The reality will, inevitably, be more complex than is suggested by such short-term/long-term distinctions.

⁵ See, in particular, pages 68 to 75 of Supporting Paper II of 'Initial price control proposals for Heathrow, Gatwick and Stansted airports', CAA, December 2006, and paragraphs 18 to 23 of Supporting Paper I of the same document.

⁶ Material provided to the Competition Commission but excised on grounds of commercial confidentiality.

- 3.9 More generally, however, it is important to recognise that any analysis of the current market circumstances, and of current expectations of market developments, is likely to understate the potential for competition. Indeed, this has been recognised by the CC in its report. By its nature, competition between suppliers is likely to stimulate innovation, reveal information and encourage efficiency improvements in ways that cannot be anticipated fully in advance. Recent commercial ventures undertaken by airlines highlight this point, such as the expansion of business-only long-haul at Luton Airport and BA's stated intention to launch similar services from London City Airport, as well as the cost per seat achieved, and range of destinations served, by no-frills airlines.

BAA's performance

- 3.10 The CAA notes the material included in the CC's Emerging Thinking assessing BAA's performance. The CAA considers that it is important to view this material as the result of the combined effect of common ownership and the application of economic regulation (including both the direct, beneficial effects of economic regulation and its indirect side-effects).
- 3.11 The CAA's view is that some of the evidence presented on BAA's performance does not directly support the case that common ownership adversely affects competition, although – taken together with the evidence discussed in the previous section – the CAA agrees with the CC that common ownership is likely to have had an adverse effect on competition, and that this effect could continue in future. This is discussed in more detail below.

Lack of responsiveness to interests of airline users on capital expenditure

- 3.12 In paragraph 83(a), the CC states that at its south-east airports, BAA shows a lack of responsiveness to the interests of its users on capital expenditure that would not be expected of a business competing in a well functioning market. According to the CC, this lack of responsiveness is evidenced by:
- “the absence of a planning system ... to enable BAA to understand and take into account ... the reasonable requirements of the airlines in planning and implementing new investment;
 - “the asymmetry of information between BAA and the airlines ...;
 - “the scope for BAA to take advantage of the differing requirements of individual airlines and effectively to play one airline off against each other;
 - “control by BAA over the timing of the release of information to the airlines ...;

- “the absence of any dispute resolution procedure under Constructive Engagement ...;
 - “control by BAA over the timing of the release of information to the CAA ...; and
 - “unwillingness to consider options of separate terminal development, co-investment or longer-term contracts.”
- 3.13 For the reasons set out above⁷, we do not share the CC’s view that the apparent lack of responsiveness to the interests of airline users on capital expenditure is necessarily indicative of an adverse effect on competition.
- 3.14 The shortcomings in BAA’s performance identified by airlines (and described here) are examples of BAA’s performance falling short of airline views of what an effective consultation process should involve. However, as noted in chapter 2, there are two reasons why this is not necessarily the relevant test. First, the nature of airline-airport interaction does not necessarily have an adverse impact on outcomes (in terms of fares paid or service quality) experienced by consumers. Whilst the interests of airlines are likely to align to varying degrees with consumers’ interests vis-à-vis airports, their interests may well diverge, for example where investment in capacity would facilitate entry by competing airlines.
- 3.15 Second, even if airlines’ interests and views were closely aligned with those of consumers, it is not clear that performance should be measured against what might, for example, constitute an appropriate consultation process for a public authority. Instead, the appropriate benchmark should be the nature of airport/airline interaction expected in well-functioning airport markets, which usually do not feature a public consultation process at all and instead rely on less formal – and often private – consultations and negotiations.

Failure to ensure operating excellence

- 3.16 In paragraph 83(b), the CC states that BAA fails to ensure ‘operating excellence’ that has also led to an increased likelihood of higher costs than would be expected in a more competitive environment.
- 3.17 The CAA recognises that the efficiency incentives that economic regulation provides can be uneven in their effectiveness, with arguably greater efficiency incentives on operating (rather than capital) expenditure and stronger incentives to achieve efficiency at the beginning rather than at the end of five-year price control periods. Nevertheless, the incentives provided by economic regulation (combined with the natural pressures for efficiency from capital markets) have provided incentives on BAA to improve operating efficiency. For example, the evidence from the consultancy studies commissioned by the CAA to inform the price caps for Heathrow and Gatwick

⁷ See paragraphs 2.6 to 2.7.

suggested scope for continued incremental improvement rather than a step change in BAA's operating cost efficiency.

- 3.18 So while it is probably accurate to say that BAA's SE airports have failed to ensure 'operating excellence' and have fallen short of passengers' and airlines expectations, care needs to be taken when assessing the observed performance of BAA's SE airports. As discussed in chapter 2, this performance should be compared (or contrasted) with the degree of efficiency that might be expected in a well-functioning competitive market. Accordingly, it should recognise that in such markets, whilst companies strive to deliver market-leading performance, outcomes sometimes do fall short of this aspiration. Against this benchmark, the evidence is less clear-cut.

Quality of service deficiencies

- 3.19 In paragraph 83(c), the CC states that "quality of service deficiencies in [BAA's] London airports [are] indicative of [BAA's] lack of responsiveness to customers."
- 3.20 In practice – even though economic regulation has served to remedy many of these detrimental consequences of a high degree of market power, and has done so in a way that minimises the adverse effects on competition – the outcomes for consumers of SE airport services in terms of quality of service appear to be below those which one might expect in a well-functioning market.
- 3.21 There have been, for example, instances where the service quality performance of Heathrow and Gatwick has fallen below the level that would reasonably be expected in a well-functioning airport market, particularly in respect of security clearance. Supporting evidence for this position is contained in the ASQ data for UK airports, which shows BAA's SE airports are perceived to have been outperformed by regional, non-regulated, UK airports.⁸

Dependence on a single group parent balance sheet

- 3.22 In paragraph 83(d), the CC states that BAA's dependence on a single group parent balance sheet "could constrain the ability of the airports adequately to invest or to maintain service standards".
- 3.23 The CAA considers that the best regulatory approach to protecting users from the risks associated with high leverage is that which it has adopted in the regulation of Heathrow and Gatwick airports, i.e. to protect users through the approach taken to regulating price, service and investment, including: not adjusting the price cap to reflect the airports' financial structure; and introducing the prospect of ex post reviews to claw-back revenues in the event that financial stringency results in under-investment.

⁸ ASQ (Airport Service Quality) survey conducted by Airports Council International (ACI) at about 100 airports around the world.

- 3.24 That said, the CAA accepts that there are natural constraints to the extent to which regulation can result in the adoption of the most appropriate financial structures. This is because any regulatory approach relies on potentially imperfect judgements about:
- the appropriate division of risk between the regulated company and its users;
 - the most efficient – yet robust – means of financing the regulated company (and the proportion of risk that it bears), including the proportion of debt, and the extent to which the management of the company should agree to constraints in the way it operates (in the form of ring-fences and/or other undertakings made to lenders); and
 - the investment performance of the regulated company, and the reasons for any under-investment.
- 3.25 Overall, therefore, the CAA considers that dependence on a single group parent balance sheet – and the relatively high leverage observed in BAA's financial arrangements – could amount to supporting evidence that common ownership has led to outcomes (in terms of users' risk exposure) that are inconsistent with those that one might expect to observe in a well-functioning competitive market. In such markets, diversity of financial structures and competition can be expected better to protect consumers from the consequences of the financial structure adopted by any single supplier.
- 3.26 It is not clear whether the financial arrangements have resulted directly from common ownership or – as seems more likely – from perceptions at the time of acquisition about the treatment of high leverage by the regulatory regime, in which case these arrangements would only be indirectly attributable to common ownership. However, it is not clear that it is necessary to make such a distinction, as the likely underlying cause is the high degree of market power associated with common ownership.

Lack of engagement with users, and of ambition, in the development of Southampton

- 3.27 In paragraph 83(e), the CC states that BAA shows “a lack of engagement with users, and of ambition in the development of Southampton”.
- 3.28 The CAA has not undertaken detailed analysis of the market power enjoyed by Southampton Airport, or considered how the airport's market position would be affected by any change in the common ownership of the London airports or any changes to the economic regulation of these airports.
- 3.29 However, given the relative proximity of Southampton to Heathrow and Gatwick airports there might be potential for greater competitive interaction between these airports. Whilst it is possible that common ownership with Heathrow and Gatwick might have the effect of materially reducing the strength of competition faced by Southampton, the reverse appears much

less likely due to the relative size of the two airports, albeit that the acquisition of the airport could be viewed as consistent with a long-term strategy to consolidate its position in the South East against potential competitors.

Benefits of common ownership

- 3.30 In May 2007, the CAA set out its view that airports are likely to face increasing average costs as they expand, rather than the falling average costs typically experienced in natural monopoly industries. A consequence of this observation is that common ownership of airports is unlikely to generate significant scale economies.
- 3.31 Further, even if it was the case that common ownership of airports could give rise to scale economies, the CAA has not identified any reason why these scale economies could not be achieved through the common ownership of multiple airports that are not each others' closest competitors.
- 3.32 The CAA notes BAA's arguments that common ownership removes the risk that "... separate owners ... work against each other in the delivery of new capacity"⁹. However, to the extent that there is a need for some form of coordination of investment plans, the CAA does not consider that this role should be given to BAA, not least as it is a commercial airport operator that is in direct competition with other commercial airport operators. In short, if there is a need for a coordination role between competing investment propositions, this role should be reserved for a public authority, and not granted to a private company with interests in the market.
- 3.33 The implication of this is that there is no reasonable expectation that a well-functioning market would result in common ownership of neighbouring airports. The CC is right, therefore, to compare the outcomes that would be expected to arise under common ownership of neighbouring airports with a counterfactual in which these airports are not jointly owned.¹⁰

Summary

- 3.34 In summary, there is strong evidence that airports can, and do, compete for passengers and airline business. Further, there is evidence that supports the view that BAA's SE airports could compete, both in the short- and long-term.
- 3.35 Service quality outcomes appear likely to be below those that one might expect in a well-functioning competitive market. Furthermore, as discussed in chapter 2, it is likely that there may be other adverse effects arising from common ownership (even after these have, in part, been addressed by economic regulation), which will tend to be less tangible and measurable, and relate to issues such as less innovation and product differentiation.

⁹ Paragraph 4.11 of "BAA Limited – initial submission", BAA, May 2007.

¹⁰ Albeit that these airports might reasonably be expected to be held in common ownership with other (non-neighbouring) UK and/or international airports.

However, the CAA considers that the strength and relevance of evidence on engagement with airlines and operating efficiency is less clear cut.

- 3.36 Overall, the CAA agrees that common ownership of the SE airports is likely to have had an adverse effect on competition between airports, and that this effect could continue in future.

4. Capacity constraints

- 4.1 This chapter considers whether capacity constraints amount to a feature of the market that adversely affects competition. The first section considers the nature of capacity constraints, and their underlying causes. The second section sets out the CAA's current views on the extent to which the planning regime and the 2003 White Paper can be said to have an adverse effect on competition.

Distinguishing between natural and artificial capacity constraints

- 4.2 In considering whether capacity constraints have an adverse effect on competition, it is important to be clear about the different types of capacity constraint, and their underlying causes. In particular, we would encourage the CC to distinguish between natural and artificial capacity constraints.
- 4.3 Natural capacity constraints are, at times, likely to be a feature of any capital intensive market, in which capacity increases through relatively 'lumpy' investment.¹¹ This is because supply (which increases in 'lumps') cannot perfectly match demand (which increases more smoothly). It follows that before additional capacity is supplied in a 'lump' (such as a new runway) capacity is likely to be constrained, and afterwards there is likely to be spare capacity. But such capacity constraints (and spare capacity) are natural features of the market, which occur as a result of the fundamental nature of airports. Any associated increases (and decreases) in market price are equally natural, and to be expected in a well-functioning competitive airport market.
- 4.4 Artificial capacity constraints – on the other hand – are those over and above the natural capacity constraints. These include capacity constraints caused by market abuse, for example, as a result of a dominant supplier restricting the supply of airport capacity. Artificial capacity constraints are likely to have a detrimental effect on outcomes for consumers, compared to consumer outcomes in a well-functioning competitive market.
- 4.5 Certain constraints on capacity – such as those flowing out of the planning regime – could be either natural or artificial. If the planning regime simply serves to have the effect of reflecting the broader social and environmental impacts of airport expansion (such as noise and air pollution), then there is no reason to suppose that it would lead to an artificial capacity constraint. On the other hand, if the planning regime were to go further than necessary to deal with the relevant externalities, such constraints could be artificial, and thereby liable to have an adverse effect on competition.

¹¹ More generally, some degree of scarcity is experienced in all markets.

Analysis

Planning regime

- 4.6 It follows from the above discussion that, purely as a matter of principle, the planning process has the *potential* to have adverse effects on competition. But in order to conclude that the planning process has *actually* had an adverse effect on competition, it would not be sufficient simply to point to evidence that the planning system has restricted the expansion of airports. Where there are broader social and environmental impacts of capacity expansion that are not fully reflected in the costs faced by an airport operator, it may well be reasonable for capacity expansion to be restricted. It follows that restrictions on capacity expansion that are proportionate to (or warranted by) the external costs such expansion would create can reasonably be regarded as a feature of a well-functioning competitive market.
- 4.7 However, it appears to the CAA that the planning system has, in the past, acted to restrict investment in capacity and service quality improvements beyond this point. For example, the planning processes had the effect of significantly delaying Terminal Five at Heathrow, meaning that this facility was brought to market late, with consequent impacts on service quality outcomes for consumers.
- 4.8 In this respect, the CAA notes that – in addition to the 2003 White Paper – the Government has brought forward plans for reform of the planning processes that apply to major UK airports. The CAA is looking forward to engaging further with the CC on this issue on the basis of the CC's working paper on the impacts of the planning regime on competition¹².

2003 White Paper

- 4.9 The Government's stated rationale for its 2003 White Paper was that the scale of challenges facing the UK, and particularly the South East, was so great and the impacts so wide-ranging that only the Government could take the strategic view necessary in setting the policy framework within which specific proposals from the private sector would be taken forward. If Government did not take the lead, airport development would be piecemeal and uncoordinated. The CAA supported the Government lending its support to airport developments, so as to hasten the relevant planning process.
- 4.10 The relevant question, however, is whether the Government's policy went further than it needed to. In particular, by setting out the location, order and timing of runway development in the SE, did the Government act in a manner that had an adverse effect on competition?
- 4.11 The answer to this question partly depends on the view that is taken about the degree to which Government policy effectively prescribes the location,

¹² As discussed by the CC in paragraph 193 of the emerging thinking.

order and timing of SE airport development. BAA has consistently taken the view that the White Paper does prescribe the location, order and timing. Others – on the other hand – have taken the view that Government policy supports development, but does not mandate it.

4.12 The CAA's view is that there is room for doubt. The Government set out that the first new runway in the SE should be built at Stansted and that it should be built as soon as possible (around 2011/12). However, on the other hand, the Government at the same time made it clear that nothing in the White Paper either authorised or precluded any particular development. Moreover, in the White Paper¹³ and the December 2006 progress report¹⁴ the Government stated that the timing and nature of development was a commercial matter for the airport operator.

4.13 On balance, the CAA's view is that by setting out its preferred location, order and timing of airport developments in the SE of England, the Government's White Paper was relatively prescriptive. However, whether being so prescriptive has had an adverse effect on competition between airports depends on:

- whether Government policy had the effect of artificially encouraging airport development at Stansted and/or discouraging development elsewhere; and
- if it did, whether the extent to which prescribing the location, order and timing of development was a necessary step.

4.14 It is not clear to the CAA how far, in practice, the White Paper could be said to have adversely affected airport development and outcomes for consumers. After all, the prescriptive timings have not proved to be binding. Even if Government had wanted to insist on development at a particular location, or time, it did not have – and made clear it did not have – the legal power to do so.

4.15 As to whether the degree of prescription was necessary, we would suggest that the CC, in considering this question, considers the extent to which it was necessary to prescribe developments so as to keep costs – such as blight costs – to a minimum. On the other hand, examples from other sectors (such as energy generation, and ports) show that the Government did not consider it necessary to prescribe the location of new development in those sectors.¹⁵ Then again, there are potentially good reasons why airport development in

¹³ Paragraph 12.2, 'The Future of Air Transport, White Paper', DfT, December 2003.

¹⁴ Paragraph 5.14, 'The Future of Air Transport, White Paper: Progress Report', DfT, December 2007.

¹⁵ For example, in its January 2008 White Paper on Nuclear Power, the Government concluded "it would be in the public interest to allow energy companies the option of investing in new nuclear power stations; and that the Government should take active steps to open up the way to the construction of new nuclear power stations. It will be for energy companies to fund, develop and build new nuclear power stations in the UK, including meeting the full costs of decommissioning and their full share of waste management costs."

the SE should be treated differently, for example, owing to the scale of disruption to the local population.

- 4.16 Whatever the appropriate balance between reliance on competition to drive investment and on Government support, it seems to the CAA that it is important that the planning process explicitly considers the impact of decisions, and the nature of Government support, on competition between airports and between airlines. This implies that Impact Assessments should include detailed competition assessments, so as to ensure that any adverse effects arising from Government's planning role are minimised.
- 4.17 Overall, while it is important to remember that the 2003 White Paper was designed to address undesirable delays in the planning process by setting out the location, order and timing of airport development in the SE in a relatively prescriptive way, the 2003 White Paper has the potential adversely to affect competition. However, the CAA recognises that there is inevitably a balance to be struck between leaving competing airports to determine their investment plans and the benefits of Government indicating support for airport expansion. What is important, therefore, is that this trade-off is explicitly considered, and that Government in setting the overall framework, and planning authorities in applying it, give full consideration to the impact that their decisions have on competition between airports and between airlines.

5. Economic regulation

5.1 This chapter sets out the CAA's views on:

- whether economic regulation can be said to have had an adverse effect on competition; and
- a description of how the CAA has sought to exercise its functions under Airports Act 1986 so as to minimise the impact on competition.

5.2 The CAA has also considered the arguments presented in the emerging thinking that aspects of economic regulation have had adverse effects. In this respect, the CAA has included material in Annex A that demonstrates that:

- its regulatory approach has not been unduly 'light touch'; rather, the CAA has exercised its function proportionately, in accordance with the regulatory framework set out in the Airports Act;
- the constructive engagement initiative has compensated for the tendency for economic regulation to 'crowd-out' airport-airline dialogue and has introduced greater commercial negotiation into the price control processes and has demonstrably been an improvement on the regulator-led, more adversarial, approach that it replaced; and
- the CAA carried out an appropriate regulatory process, and in doing so it acted lawfully and reached lawful decisions, in respect of the Heathrow and Gatwick price controls.

Does economic regulation have an adverse effect on competition?

5.3 As noted in chapter 2, the CAA considers that in looking at whether economic regulation has had an adverse effect on competition, that the CC should compare observed outcomes with those that might reasonably be expected from BAA's joint ownership of airports in the SE in the absence of economic regulation.

5.4 As also noted in chapter 2, while a high degree of market power might typically be expected to lead to a number of undesirable effects (e.g. on price and service quality), relatively limited unambiguous and measurable evidence exists of the outcomes that might normally be expected from a high degree of market power.

5.5 In the CAA's view, a key reason for better outcomes than might be expected in the context of a high degree of market power (i.e. common ownership) is economic regulation. In particular, economic regulation of BAA's SE airports, through the design of the price cap, has provided:

- strong incentives to make the best use of the available runway and terminal capacity, e.g. while Heathrow facilities, prior to the development of T5, were designed for around 45 million¹⁶ passengers per annum (mppa), the airport served well over 60mppa;
- strong incentives to invest, including recently strengthened incentives on investment (in the form of capex triggers and the potential for *ex post* clawback of revenues in the event of under-investment), e.g. since 2003 the Heathrow regulated asset base has roughly doubled in size, and is expected to grow to just over £12 billion (in 2007/8 prices) by March 2013. Much of this investment has been informed by the results of the negotiation between the airport and airlines, under the guise of constructive engagement;
- limits on airport charges prevented BAA from setting excessive prices to airlines;
- stand-alone regulation of BAA's SE airports, which, since 2003, has prevented anti-competitive cross-subsidies between these airports, e.g. it prevented BAA from proceeding with its suggestion (made in May 2005) that a second runway at Stansted, and associated infrastructure, should be subsidised by users at Heathrow and Gatwick [§<]17, which could have significantly distorted competition between airports¹⁸;
- significant – and strengthening – financial incentives and penalties around service quality standards, e.g. Heathrow and Gatwick airports now stand to lose up to 7% of their revenues should service levels fall below pre-defined targets; and
- strong incentives on operating efficiency and incentives to grow the commercial airport operations, the benefits of which are then passed through to airlines in the form of reductions to the price cap on airport charges.

5.6 This is not to say that economic regulation has led to outcomes that are ideal or that exactly match those that would be expected in a well-functioning competitive market. No regulatory system can be expected to operate as a perfect substitute for competition. Indeed, the CAA accepts that there are a number of unavoidable and unintended side-effects from economic regulation, which – when viewed in isolation – might have an adverse effect. However, the appropriate way to assess the impact of economic regulation is to consider these adverse side-effects in the context of the benefits that also accrue from economic regulation. These side-effects include:

¹⁶ See 'Heathrow's Terminal 5 to open six months from today', BAA, 27 September 2007.

¹⁷ Material provided to the Competition Commission but excised on grounds of commercial confidentiality.

¹⁸ The CAA recently built on this policy and undertook a review of the allocation of central costs between BAA's airports. This review concluded that a number of the central cost allocations were not appropriate, and adjusted the price caps applied to Heathrow and Gatwick airport accordingly.

- the strong incentives on the airport to serve the maximum number of passengers, given short term capacity constraints, might have served to exacerbate congestion, with a consequential detrimental impact on service quality, and had implications for the resilience of the airports to unexpected events such as the tightening of security clearance procedures in August 2006;
- while regulation can provide price controlled airports with a strong incentive to invest, it is difficult in practice for an airport regulator to know precisely what investment (or combination of investments) are most highly valued by consumers, and therefore which should take priority. In these circumstances, although processes such as constructive engagement can assist, it is difficult in practice for regulators to provide differentiated incentives for airport owners to invest in different projects according to the value they create. All projects therefore tend to attract an equal return. It follows that price controlled airports may generally have an incentive to pursue low risk – or less controversial – projects even though these may not be the projects of most value to consumers;
- while regulation can encourage investment at price-controlled airports, limiting prices at these airports to historical costs could, in principle, dampen investment incentives at other airports. Indeed, this effect would be greater, the more caps constrain prices relative to the competitive level. The consequences of any dampening of investment incentives could include artificially limiting airport capacity across the SE market, with a detrimental impact on the range and quality of service experienced by airport consumers. The CAA has drawn attention to this risk in its reference of the Stansted Airport price control to the Competition Commission;
- while regulation has held airport charges to levels broadly in line with historical costs, it is not clear that all end-users (or consumers) of BAA's SE airports have shared in these benefits as in certain parts of the airline market (including parts of the long-haul market) fares are set by reference to what the market is prepared to pay, not according to the level of input costs. Indeed, it is possible that the price caps have served to hold airport charges below the competitive level, thus conferring a significant share of the value of the scarce airport capacity on incumbent airlines¹⁹;
- it could be argued that, despite the downward pressure that it exerts on airport charges and the value that passengers place on retail offerings²⁰, the strong incentives to grow the commercial/retail operation might have undesirable consequences for consumers, e.g. in

¹⁹ The potential size of this effect could be inferred from recent slot transactions, such as Continental Airlines' recent purchase of four pairs of Heathrow slots for just over \$200 million.

²⁰ As evidenced by the investment made by non-designated airports in their retail offerings.

reducing space and/or giving rise to incentives on the airport to slow the progress of passengers through the airport so as to encourage shopping; and

- the nature of regulation can also serve to subdue the degree of innovation, as the five-yearly cycle of regulatory reviews and formal consultation processes introduce inflexibility that sits awkwardly with the nature of commercial decision-making and the ability to take greater risks in order to earn higher returns.

5.7 But, notwithstanding the potential for these effects to flow through into the service experienced by airport consumers, the overall net benefits of regulation are likely to have been positive when viewed against the likely outcome of common ownership/market power without regulation, which is the appropriate comparison. It follows that, in the CAA's view, economic regulation overall has not had an adverse effect on competition.

How the CAA has applied economic regulation

5.8 The CAA also considers that the CC's emerging thinking does not sufficiently recognise that the CAA has consistently and actively sought to ensure that economic regulation does not have an adverse effect on competition. In this respect, the CAA has a strong record of discharging its regulatory functions in a way that has full regard to the impacts of regulation on competition and the importance of ensuring that competition can develop, thereby minimising the scope for any adverse effects on competition to arise from the way that regulation is applied. For example, in recent price control reviews the CAA:

- decided in 2003 that BAA's SE airports should be regulated on a stand-alone basis – prohibiting anti-competitive cross-subsidies between BAA's airports – contrary to the advice of the Competition Commission, and the preference of BAA and the Government;
- decided in 2003 to set a 'looser' price cap at Manchester than that proposed by the Competition Commission, in recognition of the need to ensure that the emergence of competition was not stifled – a decision vindicated by the continued development of competition, leading to the recent deregulation of the airport; and
- included within its recent April 2008 reference to the Competition Commission a range of options for price controlling Stansted's airport charges, including proposals for safeguard caps, that seek to address the risk that the application of a standard building block approach could distort competition between airports.

5.9 The CAA has, therefore, discharged its regulatory function having full regard to the potential for economic regulation to have adverse effects on competition, as it considers that this is consistent with furthering the

reasonable interests of users of all UK airports and encouraging the economic and efficient operation of, and timely investment at, these airports.

- 5.10 In respect of the broader statutory framework that applies to UK airports, the CAA has already identified in its May 2007 and February 2008²¹ submissions that there is a strong case for reform. This reform should focus on improving the clarity of the framework and afford the CAA more flexibility to tailor its regulation of airports, so as to ensure that any adverse effects on competition would be kept to an absolute minimum. The CAA looks forward to participating in the Government's recently announced review of the regulatory framework.

Summary

- 5.11 Economic regulation of the SE airports has brought significant benefits to both passengers and airlines using these airports. It has prevented airport charges from being set at an excessive level, provided strong incentives to invest and to make best use of the available airport capacity, and ensured that gains in operating efficiency have been made and passed back to airport users through reductions in airport charges.
- 5.12 Further, the CAA has a strong record of discharging its regulatory functions having full regard to the potential for economic regulation to have adverse effects on competition, as it considers that this is consistent with furthering the reasonable interests of users of all UK airports and encouraging the economic and efficient operation of, and timely investment at, these airports.
- 5.13 As a result, the CAA does not accept that the system or operation of economic regulation (i.e. how the CAA has applied regulation within the current framework) has had an adverse effect on competition, or either reinforces or exacerbates other adverse effects.

²¹ This submission was published by the CAA on 17 March 2008, and is available from the CAA's website: www.caa.co.uk.

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Annex A Comments on economic regulation

A.1 This annex provides comments on some of the detailed points on economic regulation set out in the Competition Commission's Emerging Thinking report.

Introduction

A.2 In general, the Emerging Thinking report presents a number of statements made by parties that appear to be statements of opinion rather than necessarily ones of fact. It is not clear to the CAA what reliance has been placed on these opinions or the extent to which they have been corroborated by other evidence or analysis.

A.3 Further, it is not always clear how these statements relate to the task faced by the CC: to decide whether there are features of the market that have an adverse effect on competition (AEC). For example, the dissatisfaction of some airlines with the process of constructive engagement does not appear to be evidence of an AEC. Similarly, disagreement over the appropriate way to expand Stansted Airport does not, in itself, suggest that there is an AEC.

A.4 The CAA also notes that in summarising the views of some airlines on the CAA's price control decisions for Heathrow and Gatwick the CC does not give sufficient weight to the range of views expressed or to the material published by the CAA setting out its rationale for these decisions.

A.5 The CAA has not sought to provide detailed comments on all of the views and issues set out by the CC. Rather, the CAA has focused on three particular issues raised in the Emerging Thinking:

- the CC's interpretation of some of CAA's actions and decisions as a 'light-touch' approach to regulation;
- the perceived failure of constructive engagement; and
- the regulatory processes of the fifth quinquennial price control review (Q5) for Heathrow and Gatwick following the CC's recommendations in September 2007 until the final decision by the CAA in March 2008.

These issues are discussed in turn below.

'Light-touch' approach to regulation*CC's emerging thinking*

A.6 In the section on economic regulation, the CC appears to endorse some of the airlines' criticisms about the CAA's approach to economic regulation and refers to the CAA's 'philosophy of a light touch approach to the regulation of BAA' (paragraph 267) and, in particular, that the CAA has:

- an 'inclination' to put particular emphasis on the fourth of its objectives (to impose the minimum restrictions necessary);
- a wider philosophy of a light touch approach to the regulation of BAA;
- a reluctance to address the consequences of the courses of conduct by BAA in respect of the planning of capital expenditure; and
- a reluctance to become involved in dispute resolution in constructive engagement, or to ensure the appropriate content and timeliness of information flow from BAA.

CAA's views

A.7 An important first step when considering the regulatory regime and how it is applied is to consider the nature of the Airports Act 1986 and the regulatory functions that it sets out. Unlike other UK economic regulators, which have considerable discretion and flexibility as to the scope and intensity of regulation in their respective sectors, the CAA has somewhat more limited and prescribed powers under the Airports Act 1986 in respect of the economic regulation of designated airports.

A.8 There are two broad economic regulation functions set out in the Airports Act in relation to designated airports:

- In respect of the price cap:
 - the CC is required to make recommendations to the CAA on the level of the price cap; and
 - the CAA then, after having regard to these recommendations, must set the price cap.
- In respect of public interest findings:
 - the CC is required to consider whether an airport has operated against the public interest and to propose remedies; and
 - the CAA must implement the CC's public interest findings, having regard to the proposed remedies.

- A.9 In respect of the price cap, the CAA's decisions on price caps have generally been close (in terms of quantitative limits on airport charge revenues) to those recommended by the CC, albeit that in recent reviews there have been some important differences in our respective approaches:
- **Q5 review for Heathrow and Gatwick:** The CAA's Q5 decision for Heathrow and Gatwick included a number of additional costs, including those the CC explicitly left the CAA to consider further (this is discussed in more detail in the third section of this annex).
 - **Q4 review of Manchester Airport:** The CAA's Q4 decision included an upward adjustment to airport charge price caps from the CC's recommendations in order to ensure that any adverse impacts on competition between airports in the North West was minimised.
 - **Q4 review of Heathrow, Gatwick and Stansted:** Whilst the CAA's price cap decisions were close to those proposed by the CC, the CAA set the price caps on a 'stand-alone' basis, whereas the CC recommended a 'system' approach. This stand-alone approach removed the potential for anti-competitive cross-subsidisation between airports and, as a result, significantly reduced the potential for adverse impact on competition²².
- A.10 In respect of the public interest findings, the CAA has implemented the CC's public interest findings in full, as it is required to do under the Airports Act.
- A.11 The CAA does not, therefore, consider that economic regulation of UK airports – and the potential for it to have an AEC – can be assessed simply by reference to the CAA's role and statutory functions. The CC has also played a central role in shaping the regulatory regime in the past two decades, notably through the CC's power to extend the scope of regulation, through public interest findings made at each quinquennial price control review. An example of this is the finding by the CC at the 2002 review in relation to service quality at Heathrow and Gatwick which had not previously been subject to direct regulation.
- A.12 Turning to the detail of the Emerging Thinking document, the CAA does not consider that the CC has adequately summarised the CAA's approach to airport regulation, given full consideration to the constraints imposed on the CAA by the Airports Act 1986, or fully reflected the role given to the CC in the regulatory framework. These issues are discussed in the following paragraphs. (The issues relating to the process of constructive engagement will be addressed separately in the second section of this annex).

²² The CC's recommendation (in its November 2002 report) was that (paragraph 1.13) 'In principle we believe that the 'system approach' to setting the maximum level of airport charges—with respect to the rate of return of the system as a whole rather than that of each airport—should be retained under current conditions.' The CAA's decision on this issue (in its February 2003 decision document) was that (paragraph 3.18) 'having heard the views of interested parties the CAA's view is that the stand-alone approach is best calculated to meet its statutory objectives'.

A.13 The CAA notes that the CC intends to explore these issues further in the coming months. The CAA considers that an important element of this should be assessment of all of the relevant and available evidence and of the incentives faced by market participants – airlines as well as airports – and the degree to which these are influenced by the regulatory framework.

Emphasis on the CAA's fourth statutory duty

A.14 The CAA has a statutory function to set a price cap that is best calculated to meet four statutory duties. It does not hold an 'inclination' towards the fourth of these duties and does not consider that the CC presents any evidence – to support the opinions of some airlines – to justify such a claim.

A.15 Further, the CAA notes that the issue of the appropriate regulatory approach flows from each of its statutory duties. An approach involving more regulation does not imply that users' reasonable interests are better protected or that outcomes for users are necessarily improved. For example, a more intrusive approach based on *ex ante* approval of all pricing and capital investment decisions would have consequences for users, as the approval of investment costs would have the effect of passing risk from the airport to users. In contrast, an incentive-based approach (adopted by the CAA and all other UK economic regulators) is more likely to result in the airport taking ownership of its decisions and bearing risk, to the benefit of users over time.

A.16 The CAA emphasises that it is committed to the principles of better regulation (consistent with meeting its statutory duties) and, with that, considers that there is a need to ensure that regulation is targeted and proportionate.

A 'light touch' approach

A.17 The CAA rejects any inference that it is in some way disinclined to regulate BAA. Such a view is not supported by evidence.

A.18 For example, in discharging its functions under the Airports Act to set price caps and to remedy adverse public interest findings, in recent years the CAA has:

- proposed and implemented **stand-alone regulation** of BAA's London Airports – and limited the potential for anti-competitive cross-subsidies between BAA's airports that it facilitated – in the face of opposition from BAA, contrary recommendations from the CC, and scepticism amongst many stakeholders that the CAA would be able to maintain such a position²³;

²³ It should also be noted that during the Q5 review the CAA undertook a review of the allocation of central costs and inter-company charges, to ensure that the stand-alone principle was being applied in practice. The CAA identified a number of inappropriate allocations of costs (principally where Stansted costs were being met by Heathrow and Gatwick users), which it disallowed from its Heathrow and Gatwick price control decisions.

- proposed a very significant **reduction in the allowed cost of capital** for Heathrow and Gatwick which, whilst justified by the evidence, was strongly criticised by BAA;
- ensured that **airport users are not exposed to the consequences of BAA's financial structure**, making clear that the CAA would not 'bail out' any purchaser of BAA's designated airports. The CAA's approach has been recently vindicated by the fact that it is BAA's owners – and not airport users – that have had to provide £400 million of additional financing to the company; and
- **doubled the potential adverse impact on airport profitability of failure to meet service standards.**

A.19 The CAA would also observe that these four examples have each had (or potentially have) a very significant impact on outcomes for airport users. Indeed, it is worth highlighting that the implementation of stand-alone regulation removed the potential for the biggest single source of an AEC arising from the way that economic regulation is applied.

A.20 The CC refers to the auditing of non-regulated charges as evidence of a 'less intrusive regulatory regime' than that advocated by the CC, explaining that the CAA's approach resulted from its duty to impose 'minimum restrictions necessary'. The CAA considers that paragraph 251(g) may have misinterpreted the CAA's position, which is set out at paragraph 7.14 of its November 2007 proposals document for Heathrow and Gatwick. In summary, the CAA did not agree that the CC's suggestion, to appoint jointly – with BAA and the airlines at each airport – a firm of accountants to consider the appropriate basis for allocating costs and to conduct an annual audit of cost allocation, would be justified against the CAA's statutory duties. In particular, the CAA considered that users' reasonable interests would be better served through ongoing consultation with BAA on the cost basis of non-regulated charges and through the transparent and audited statements which BAA would provide to users. The CAA did, though, adopt two suggestions made by airlines to strengthen protection for users against any abuse by BAA in setting non-regulated charges.

Addressing BAA's courses of conduct

A.21 The CAA disagrees with any view that it is reluctant to regulate BAA's conduct in respect of the planning of capital investment, and does not consider that evidence has been presented that would support such a view.

A.22 Indeed, the CAA developed the process of constructive engagement so as to improve the price control process, including the way that BAA's capital investment programme is developed and assessed. The CAA also

introduced more stringent consultation requirements on BAA²⁴ as one of the two-pronged tests for capital investment to be allowed into the regulatory asset base; tests that were carried out in the recent Q5 Heathrow and Gatwick reviews and were endorsed by the CC.

- A.23 However, the CAA's involvement in capital investment processes should be set in context. The CAA has a statutory function to discharge, which it does every five years. The CAA's overall approach is to apply incentive-based regulation, within the broad RPI-X framework – in common with other UK regulators. Under this approach, the regulator does not get involved in the day-to-day approval of the capital investment programme, as to do so would undermine the incentives for the airport to improve its efficiency. In short, the implication of more detailed involvement in investment planning would move the regulatory approach away from RPI-X regulation, towards a more cost pass-through approach.
- A.24 Further, the CC correctly refers to the limitations that the Airports Act 1986 places on the way in which the CAA regulates BAA and the function that it must discharge (i.e. to set a price cap at designated airports). The CAA has not been given wide-ranging powers to assess and intervene in the conduct of BAA. Rather, such powers as there are have been reserved to the CC, to exercise periodically in each quinquennial price control review, notably through the power to make public interest findings, which the CAA is bound to implement, and recommendations for conditions on airports. In light of this, it is somewhat strange that the CC appears to be criticising the CAA's role, when the most obvious tool for addressing potential issues is one that is held by the CC. The CAA has separately recommended that consideration should be given to reforming the regulatory framework to give the CAA the powers to address broader issues of BAA's conduct.²⁵
- A.25 A related matter is discussed in paragraph 259, where the CC suggests that the Service Quality Regime (SQR) at Heathrow and Gatwick may provide insufficient incentives for BAA to increase service quality, and leaves open the question as to whether there is a need for a tighter regime with stronger incentives. The CAA notes that it took steps to strengthen service quality incentives throughout the Q5 review, where it saw a need for it, and implemented higher maximum levels of rebates (at 7 per cent of airport charges) within the range of increased rebates proposed by the CC (5-10 per cent). However, there is also a question whether any regulation of service quality should, or indeed could, be designed to address every possible external shock, such as the changing security processes in August 2006, which are cited by the CC as an example of poor service quality which should have been addressed by tighter regulation. The CAA's view is that an SQR cannot be designed in this way and, inevitably, will focus on ranges of

²⁴ Agreement with BAA on enhanced information disclosure and consultation, Annex 4 to the CAA's February 2003 price control decisions for Heathrow, Gatwick and Stansted airports.

²⁵ The Competition Commission's Market Investigation of BAA Ltd, A submission by the Civil Aviation Authority on Economic Regulation of UK airports, February 2008.

circumstances that are closer to 'business as usual'. The CAA notes that other regulators generally make provision for extraordinary events within incentive schemes.

Involvement in dispute resolution

- A.26 The CAA notes the CC's criticism that it has been reluctant to resolve disputes that have arisen in constructive engagement. The CAA does not accept, though, that this criticism is valid, nor that it bears on whether regulation has had an AEC.
- A.27 When reviewing the CAA's role in constructive engagement it is, perhaps, tempting to suggest that it should have been more actively involved, particularly when examples are cited of disagreement between BAA and the airlines. However, the CAA's role needs to be understood in its proper context. The CAA introduced constructive engagement, following consultation with airlines and BAA in 2004 and 2005, as a way of encouraging more normal commercial negotiations between regulated airports and their airline customers. Such a process relies on the CAA maintaining a role as final decision-maker in respect of the whole package of agreements.
- A.28 If the CAA were to have been drawn into individual disputes, during the process of negotiation, this would have undermined that process and risked unravelling a complex set of compromises and agreements. In short, as soon as the CAA is involved on one issue, any constructive airport-airline interaction is likely to be replaced by a regulator-led process – the very thing that constructive engagement was designed to replace.
- A.29 This is not to say that lessons cannot be learnt from the recent experiences of constructive engagement. Indeed, the CAA has developed and strengthened the requirements on BAA for timely disclosure of information to airline users and effective consultation on airport development, investment programmes and individual projects. BAA's performance against these requirements²⁶ will be assessed in 2010, as part of the CAA's mid-quinquennium capital expenditure efficiency review at Heathrow and Gatwick, and then again at the next price control review in 2012.

Constructive engagement

CC's emerging thinking

- A.30 The Emerging Thinking states (paragraph 265) that it appears to the CC:

'...that both the system or the way in which [economic regulation] is conducted may facilitate, reinforce or exacerbate some of the other characteristics of the market, most particularly the failure of constructive engagement to result in either (a) the appropriate level, specification and

²⁶ Annex G to the CAA's price control decisions for Heathrow and Gatwick airports, March 2008

timing of investment or (b) the appropriate level and quality of operational service to airlines and passengers.'

A.31 The CC appears to base this conclusion on:

- the 'CAA's reluctance to get involved in resolving disputes that arise under Constructive Engagement, particularly on issues in relation to Stansted where there has been no Constructive Engagement' (paragraph 266(f));
- the CAA being the 'obvious party' to get more involved in the dispute resolution/arbitration mechanism at relevant stages of the constructive engagement process but chose only to act as an observer, implying that it is the CC's view that the CAA should have been more actively involved in the process (paragraph 34(c));
- easyJet's announcement of its intention to seek judicial review of the CAA's determination of charges for Gatwick for Q5, commenting that this is 'indicative... of the failure of the consultation processes to enable meaningful agreement to be reached' (paragraph 39); and
- Virgin's comments that it perceived a 'marked deterioration' in the process of constructive engagement over the last few months of the Q5 review and regarded the CE now as a failure (paragraph 262).

CAA's views

A.32 The CAA does not agree with the CC's views on constructive engagement. The CAA urges the CC to assess constructive engagement against its original objective and its intended outputs for the price control process. In sum, the CAA took the initiative to introduce constructive engagement in response to airlines' requests for greater commercial engagement in the price control process. The results have been better than before, albeit not without some shortcomings. The CAA does not consider that its orchestration of constructive engagement could conceivably be viewed as an AEC.

A.33 The CAA also considers that the CC needs to take care when analysing the CAA's involvement in the process and in assessing the implications of the lack of constructive engagement at Stansted. More generally, the CAA notes that the CC refers to comments made by a number of airlines but does not present contrasting views expressed by other parties. These issues are discussed in more detail below.

Objective and outputs of constructive engagement

A.34 The CC's comments on constructive engagement appear to be based on an expectation that this process was intended to "result in" the appropriate level,

specification and timing of investment and the appropriate level and quality of operational service to airlines and passengers.²⁷

- A.35 When assessing the performance of constructive engagement it is important to have full regard to what it was intended to achieve; what it replaced; and the types of conduct that might be expected in a well-functioning airport market.
- A.36 In respect of the first, constructive engagement was intended to deliver a certain set of price control inputs – focusing on areas that were not ‘zero-sum’ (such as cost of capital) or which relied upon commercially confidential data (such as airports’ retail revenues) – rather than to cover or determine all of the aspects of airport operations. Further, the CAA did not originally anticipate that there would necessarily be agreement on all of the matters remitted to the constructive engagement process, but that even in such cases the information arising from airport-airline discussions could provide useful inputs to the price control review. The lack of agreement on some matters is, therefore, not surprising, nor does it amount to a ‘failure’ of constructive engagement.
- A.37 In respect of the second, constructive engagement was an attempt to introduce a more commercial, airport-airline focused, approach to the price control. It replaced a number of regulator-led processes that inevitably introduced inflexibility and ‘crowded out’ the potential for the airport and airlines to make compromises and reach an overall package. Instead, a regulator-led approach encourages disagreement and means that it is the regulator that must trade-off the competing objectives of users.. In this context, the CAA considers that constructive engagement was a significant improvement on the previous approach and, in particular, moved the regulatory process towards a more commercial approach – to make regulation better reflect what might be expected in a well-functioning airport market.
- A.38 Third, in the context of the CC’s current inquiry, it seems to the CAA that it is particularly important to compare the degree and form of consultation undertaken at the regulated airports with that which occurs at airports operating in well-functioning markets. In this respect, the CAA notes that it is not typical for airports to undertake detailed, set-piece, public consultations with airlines. Indeed, suppliers in other sectors do not normally undertake ‘consultations’ with their customers – rather, they enter into (typically) bilateral negotiations and strike commercial agreements.

CAA’s involvement in constructive engagement

- A.39 The CAA considers that it made it clear to all parties at the outset of constructive engagement that its role in the process was not to become

²⁷ Emerging Thinking, paragraph 33.

involved in all disputes between the airport and airlines²⁸. However, it should be noted that there was a dispute-resolution mechanism – issues would be passed back to the CAA for analysis and decision. This mechanism was, for good reason, reserved to the end of the process, thereby maximising the time and potential for negotiation and agreement. The CAA considers that, overall, the level of agreement presented in the Heathrow and Gatwick constructive engagement reports vindicates this approach. Notably, BAA and the airlines made good progress at each airport in jointly defining broader and higher service quality standards. Constructive engagement also produced a good degree of consensus on the strategic vision for the development of each airport and on the major issues of prioritisation, sequencing and timing of investment projects. Where differences remained, constructive engagement provided valuable inputs to the CAA in the form of clear evidence on reasons for differences.

- A.40 In summary, the CAA considers that a process through which it intervened during the constructive engagement process would have been more likely to have generated disputes, as all parties would have an incentive to bring issues to the regulator rather than trying to resolve them bilaterally. It would also have made it more difficult for the airport and airlines to reach compromises, as each party could have sought regulator support to strengthen its bargaining positions. Attempting to arbitrate throughout the process would have been very much like a traditional regulator-led regulatory process and would not have given sufficient space for normal commercial negotiations to develop between airlines and the airport.

Constructive engagement at Stansted

- A.41 The CC seems to assume that, had the CAA intervened as described above, the constructive engagement process would not have broken down at Stansted. The CAA has given evidence to the CC that explains its views on why constructive engagement did not succeed at Stansted, building on the material previously published by the CAA.²⁹ In its recent reference document for the Stansted price control review of April 2008, the CAA discusses throughout Part I the possible reasons behind the failure of constructive engagement at Stansted and concludes that it is partly driven by distorted incentives of both BAA and the airlines, which arise from the framework of regulation.
- A.42 In particular, the CAA has highlighted that one cause of the failure of constructive engagement at Stansted is the incentives that building-block price control regulation places on the airport and on airlines. Under this regulatory approach, approved capital expenditure increases the price cap, providing the airport with an incentive to propose over-specified investment plans whilst also giving the incumbent airlines an incentive to oppose

²⁸ Airport Regulation: The process for constructive engagement, CAA, May 2005.

²⁹ See, for example, chapter 23 of 'Initial proposals for Heathrow, Gatwick and Stansted airports', CAA, December 2006.

efficiently specified investment plans. The size of the capacity expansion contemplated at Stansted – together with the potential impact of this proposal on the price cap – and the greater degree of uncertainty about the appropriate nature of expansion at the airport exacerbate these incentive effects.

- A.43 In short, the observed airport and airline conduct at Stansted, evidenced in the experience of trying to introduce constructive engagement, should be viewed as a consequence of the (anticipated) regulatory approach (i.e. the building-block approach) rather than the CAA's design and operation of constructive engagement. The CAA has therefore identified a range of alternative options for setting price caps at Stansted which attempt to alter the incentives on the airport and its airline customers.

Airlines' views on constructive engagement

- A.44 The CAA would urge the CC not to misinterpret airlines' stated disappointment with the outcomes of constructive engagement at Heathrow and Gatwick as a reliable indicator that the process of CE was a failure. The CAA provided detailed material to the CC in April 2008 that documents the far-reaching agreements reached between airlines and BAA on capex issues at Heathrow and Gatwick. Indeed, the CC's own recommendations made extensive use of the agreements reached between the airport operators and airlines. The CAA would also note that there is, in fact, a range of airline views about the process of constructive engagement. Even where there was disappointment with the end-game there has been recognition of the benefits.³⁰
- A.45 The CAA also considers that a public disagreement of airlines with increasing charges is not necessarily an indication of failure of the constructive engagement process, as it is highly likely that they would have reacted similarly in other circumstances. These reactions should not distract from the very significant achievements of constructive engagement, that have resulted from the considerable effort of airport and airline staff to reach agreement on a number of important issues – agreements that are documented in the joint airport-airline constructive engagement reports.
- A.46 The CAA has received formal notice that easyJet has applied for judicial review of the CAA's decision in setting the price cap at Gatwick from 2008 to 2013. The CAA remains of the view that both its decision as to the maximum airport charges that may be levied by Gatwick Airport (and also by Heathrow Airport) and the process leading up to it were lawful, and will defend vigorously claims to the contrary.

³⁰ See for example, page 3 of the response from the Gatwick Airlines Consultative Committee and page 1 of the final response from the Heathrow Airport Operators' Committee to the CAA's November 2007 proposals available on the CAA's website. Also, the transcript of the oral hearing with IATA (page 199) and the Heathrow AOC (pages 251/252) held on 28 January 2008 and with British Airways held on 29 January 2008 (page 454), again available on the CAA's website.

The regulatory processes of Q5 from October 2007 until March 2008*CC's emerging thinking*

A.47 The CC expresses concerns about the regulatory process that was followed for the price control review for Heathrow and Gatwick, in both the sections on BAA's performance and on economic regulation.

A.48 In particular, the CC notes the following (paragraph 262, except where otherwise specified):

- that the final settlement for Heathrow in March 2008 was 'almost £1 billion' more than the CC's September 2007 recommendations for Heathrow, after allowing for the transfer of Airport Navigation Service charges into airport charges;
- that 'nearly all the changes to BAA's projections during and after our inquiry had the effect of substantially increasing its overall revenue requirements', arguing that 'it seems implausible that there was no scope for offsetting reductions in capital expenditure, or operating expenditure, during the review process, giving rise to strong suspicions among the airlines that BAA had 'gamed' the whole process' (paragraph 34);
- the concerns of the airlines about whether there had been adequate opportunity for the CAA to assess the increases in projected operating and capital costs and the consequences for charges;
- the concerns of the airlines about whether there had been adequate opportunity for the airlines to assess the increases in projected operating and capital costs and the consequences for charges;
- the concerns that the regulatory system had not worked properly during this review; and
- the concerns that the succession of revisions to the figures resulted from an element of 'regulatory gaming' by BAA.

A.49 To support these comments the CC refers to the views of airlines, in particular that:

- BA and bmi, for example, in their evidence on the CAA website said that this called the [regulatory] process into question;
- Star Alliance said that the CAA had not taken account of the reasonable interests of users;
- BA noted that the CAA consultation document in November 2007 was itself based on £1 billion more revenue than the proposals in March 2007;

- 'Virgin Atlantic also commented that over the last few months there had been a marked deterioration and it now regarded Constructive Engagement as a failure [with] BAA submitting an update of operating expenditure and capital expenditure forecasts without any consultation with airlines.'

A.50 The CC appears to use this material to support the view that:

'The regulatory system applied to the BAA London airports and/or the way it operates may also reinforce or exacerbate other features which adversely affect competition'. (paragraph 36)

CAA's views

A.51 It is unclear to the CAA whether the CC is simply reporting the views put to it or whether in noting this material the CC is also expressing its support for these views. As discussed previously, the views quoted by the CC are not uniformly held by all stakeholders. But, in any case, views need to be tested to assess whether they represent evidence, particularly where regulation can distort the incentives of market participants.

The final CAA settlement and the CC's recommendations

A.52 In paragraph 262 the CC notes that '...the final settlement in March 2008 was indeed almost £1 billion more than [the CC] recommended for Heathrow in September 2007, after allowing for the transfer of Airport Navigation Service charges into airport charges'. However, Table 16 of the Emerging Thinking document indicates that the CAA's final settlement for Heathrow allowed £769 million more revenue from airport charges than the CC's September 2007 recommendations.

A.53 As noted in Table 16 the CAA's revenue projections included the reclassification of ANS charges, which had no effect on overall costs to airlines. Adjusting for this reclassification of ANS costs, therefore, reduces the difference between the CAA's decision and the CC's recommendations to £519 million.

A.54 For the record, of this £519 million, the majority relates to issues which the CC explicitly requested the CAA to consider further in reaching its final decision, in particular:

- around £100 million related to costs associated with Heathrow expansion (i.e. a third runway and mixed mode operations, which might be enabled by a Government policy decision during Q5), where the CC was supportive of some provision being made to encourage timely investment;
- around £100 million for additional security related operating expenditure which was required in light of agreement between BAA and airlines to

extend the scope of the service quality regime to include measures for transfer security queuing, staff queuing and control post queuing. It was also agreed that the SQR should apply to queue lengths for the whole of the operational day rather than only apply at peak periods. The CAA's allowance (which also reflected changes in the Government's airport security requirements) was informed by detailed scrutiny of BAA's projections including extensive consultation with airlines; and

- around £150 million for additional investment costs, reflecting both capital expenditure BAA had undertaken in the final year of Q4 (which met CAA criteria for inclusion in the regulatory asset base), and additional scope of capital projects at Heathrow during Q5, which had, in the main, been agreed with airlines and which followed a risk review recommended by the CAA's own consultants.

A.55 The remaining difference is explained by other adjustments which the CAA made, following its own further assessment and consultation. These included a reduction in projections of commercial revenues and non-regulated charges and an increase in the allowance for pensions and construction price inflation. In addition, the CAA also made some off-setting reductions to operating costs, for example in relation to Terminal 5 and central costs.

A.56 The difference between the CC's recommendations and the CAA's decision can, therefore, largely be explained by the issues that the CC explicitly left for the CAA to resolve and that, following the CC's recommendations, additional costs were identified. To be clear, the additional airport charge allowance was largely associated with additional identified costs and does not amount to an increase in BAA's profit allowance. Indeed, the cost of capital – the aspect of the price control settlement that could most accurately be described as a 'profit allowance' – remained unchanged between the CC's recommendations and the CAA's decision.

A.57 The CAA does not recognise the reference made to the increased operating and capital expenditure allowances that 'it seems implausible that there was no scope for offsetting reductions'. There were a number of adjustments made to BAA's operating costs, capital expenditure allowances and commercial revenue projections. For example:

- at Heathrow, BAA agreed with the airlines in January 2008 to manage within the previously agreed capital budget for Q5 those cost pressures which were identified during autumn 2007 following scrutiny by the CAA's own capital consultants and BAA's own risk management review of the investment programme;
- at Gatwick, the CAA 'disallowed' all of BAA's proposed additional non-security related operating expenditure, and at Heathrow, the CAA made allowance only for those elements which were demonstrably

incremental since the Commission's own assessment during summer 2007;

- at each airport, the CAA allowed only what it considered to be reasonable additional security related expenditure, based on the CAA's careful assessment of efficient operational targets.

A.58 With regard to other criticisms of the price control review, the CAA rejects the following assertions:

- Inadequate opportunity for CAA scrutiny of operating and capital expenditure, following the CC's own report in September 2007: the CAA properly scrutinised operating and capital expenditure during this period. The CAA notes that the CC neither sought the CAA's detailed views on this matter nor presented any evidence to support the views set out in the Emerging Thinking. The CAA did, however, provide evidence to the contrary in April 2008 after its March 2008 hearing with the CC.
- Inadequate opportunity for airline scrutiny of operating and capital expenditure: the CAA provided to the airlines, and discussed with them, information necessary for them to make informed submissions in response to the CAA's November 2007 consultation. On security processing costs in particular, there was an intensive process of presentation and consultation between the CAA, BAA and airlines in relation to BAA's proposed increased security costs over the period November 2007 to end January 2008. The CAA consulted fully at each stage of the Q5 review, and set out its analysis and findings in full in its published documents.

A.59 With regard the CC's criticisms that the regulatory system has not worked properly, it is unclear whether the material presented by the CC refers to the suitability of the regulatory framework, or to the degree to which the CAA discharged its statutory function in accordance with its statutory duties.

A.60 In respect of the first, the CAA's views have been set out in its February 2008 submission to the CC on the Regulatory Framework. In summary, the CAA argued that the Airports Act 1986 risked not keeping pace with future changes in the UK aviation market and should be modified to bring it into line with best practice regulation. This reform should include:

- reframing the CAA's duties to place the interests of consumers first, recognising that effective competition provides the best means of protecting their interests, as it does at the majority of UK airports;
- providing the CAA with more flexibility and discretion so that it can tailor its regulation better across airports and over time, responding to the continually changing market environment. This could allow it to act more rapidly when unfair conduct is identified but also enable the CAA to

enter into longer-term commitments with airports in a way that encourages appropriate investment;

- providing the CAA with concurrent competition powers - which most other regulators hold - so that it can make use of the existing competition law regime to balance sector-specific regulation with general competition tools; and
- additional measures aimed at providing a check against unnecessary regulation, including: an improved appeals mechanism, installing the Competition Commission as the appeals body for CAA price control decisions; the use of time-limited licence conditions; and periodic reviews of the regulatory burden.

These improvements to the framework would enhance the clarity and flexibility of regulation, without extending unnecessarily the CAA's intervention in markets: the CAA considers that the vast majority of UK airports should continue to operate free of detailed economic regulation as competition, rather than regulation, provides the best way of ensuring that consumers receive the service they demand, offered at reasonable prices.

A.61 In respect of the second, the CAA notes that whilst the Emerging Thinking repeats the views of the airlines it does not present any evidence that the CAA failed in its role. The CAA considers that it carried out an appropriate regulatory process, and in doing so it acted lawfully and reached lawful decisions in respect of Heathrow and Gatwick price controls.

Regulatory gaming by BAA

A.62 While there can be speculation about the reasons behind the specific timing of BAA's release of information, the important point is that it did not lead to the allowance of any unjustified operating or capital expenditure into the final price control decision.