

Airports review – policy issues
Consultation paper

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Executive summary

Introduction

1. The Civil Aviation Authority (CAA) has begun the quinquennial reviews of the four airports designated under the Airports Act. In 2008, the CAA will set the price controls for BAA's designated airports (Heathrow, Gatwick, and Stansted) for 2008-09 to 2012-13 (the fifth quinquennium, or Q5), and by 2009 for Manchester Airport for 2009-10 to 2013-14. This paper explains the CAA's approach to this task, focusing in particular on the reviews of BAA's airports, and including discussion of regulatory policy which is also likely to be relevant to the Manchester review.
2. This paper is designed to inform airports, airlines and other stakeholders of the CAA's statutory duties and functions; the market and policy context relevant to the reviews; and its provisional assessment of the regulatory policies it might adopt in setting airport price controls. This is a consultation, from which the CAA is seeking to improve its understanding of the evidence which should inform its decisions, and the implications for airports and their users of its regulatory approach.
3. The CAA invites views on the issues set out in this document in the coming three months from all stakeholders. **Chapter 1** describes the process and timetables for the reviews of BAA's airports and Manchester Airport¹.

Context for the review

4. At the last price control review, the CAA highlighted the challenge to regulation posed by fast growing demand for air travel, in relation to available airport capacity in the South East of England. Rising demand is a continuing theme of this review, which will also need to consider the changing nature of demand at and between some airports, and the implications of this for future investment in capacity at airports. This review starts some two years after the Government's Air Transport White Paper, which provided a strategic framework for the growth in UK airport capacity within which airport operators could plan future investments. Responding to this, a number of airport operators in the South East of England have recently brought forward expansion plans, for consultation, including BAA's proposals for a second runway at Stansted, and Luton Airport's plans for a new full-length runway. **Chapter 2** provides a market context for the review, describing trends in UK air travel which are likely to affect demand for BAA's designated airports in 2008-13 and beyond, and highlighting proposed developments in capacity at these and other airports in the South East of England.
5. A striking feature of the UK market in recent years has been the rapid growth in absolute and market share terms of so-called 'no frills' carriers, airlines which supply a more basic point-to-point service with fewer of the elements of passenger service

¹ The CAA also invites views from those with an interest in the regulatory policy implications of this document for the subsequent review of Manchester Airport: they are invited to comment now, but will also have a further opportunity during the separate, later consultation on the Manchester Airport review.

supplied by traditional 'hub' carriers, while operating from a lower cost base. Passengers have shown a strong appetite for this new form of air travel. In turn, this has led to intensifying competition in the airline market, with resulting pressure from airlines to reduce their input costs, including those for infrastructure supplied by airports. As the growth in air travel fills up more of the available airport capacity, however, further growth may require additional investment in capacity, with implications for infrastructure costs. The CAA will need to take full account in the price reviews of both the commercial objectives of airlines to bear down on airport costs and the impact of rising demand on the need for investment in new capacity.

6. The CAA will also take into account the impact on air travel demand and on airport capacity growth of UK and European policy measures to mitigate the environmental impacts of aviation. Local environmental impacts of airports are controlled via European Directives and Governmental air quality and noise regulations and through conditions on airport operation imposed via the planning process. Broader environmental impacts of air travel on climate change may in future be reflected in the regulation within Europe of aviation emissions. While the CAA has no specific duty to consider the wider environmental impacts of aviation in the specific context of setting price controls, to the extent that environmental controls impose costs on airports, airlines or passengers, or constrain growth, then the CAA would embody these factors in its assessments of future traffic volumes and costs.
7. **Chapter 2** also sets out the regulatory context for the next price control period Q5 by reviewing the performance to date of BAA's designated airports during the current quinquennium against the forecasts made when setting the price controls. It highlights the implications of trends in Q4 for airport charges in Q5. At Heathrow, capital expenditure is now forecast to total some £5 billion during this quinquennium² (very largely due to Terminal 5). This is higher than the Q4 capital forecast, which was the main driver in the permitted rise in airport charges at an annual rate of 6.5% above inflation during the current control period. At the last review, the CAA anticipated that prices would need to continue to rise at the same rate during Q5. Higher capital expenditure, and traffic below forecast, together provide strong upward pressures on prices for the next control period, leaving aside for the time being any other influences on the price cap.
8. At Gatwick and Stansted, the positions are less clear at this stage. Gatwick has not undertaken any major expansion projects in the recent past, nor is it currently proposing any in the near future. As a result, its future price limits are much less dependent on the effects of recent capital expenditure. At Stansted, future prices will be significantly influenced by the proposal for a second runway and associated infrastructure, in particular the timing and level of investment in relation to the forecasts of demand for the new capacity it will provide.

² 2004/05 prices

Legal framework

9. The CAA is required under the Airports Act to carry out its statutory function, the setting of five-yearly price controls on designated airports, having regard to its statutory duties, which describe the factors it must weigh up when reaching its decisions. This is the principal legal framework guiding the CAA's actions in its price control task, which is described in **Chapter 3**, along with other elements of the legal and policy framework.
10. Section 39 of the Airports Act specifies that the CAA must perform its regulatory functions including setting price caps, in the manner which it considers best calculated:
 - to further the reasonable interest of users of airports within the UK;
 - to promote the efficient, economic and profitable operation of such airports;
 - to encourage investment in new facilities at airports in time to satisfy anticipated demands by the users of such airports; and
 - to impose the minimum restrictions that are consistent with the performance by the CAA of these functions.
11. **Chapter 3** discusses these statutory duties, identifying the factors which are likely to be most relevant in judging how best to fulfil the duties. The Airports Act does not, however, provide guidance on how the CAA should weigh the various statutory duties it has been given, including that of imposing the minimum restrictions, for example in circumstances where they might conflict. Where two or more of its statutory duties may pull in different directions, the CAA proposes to consider each situation on the relevant evidence. It will base its decisions in the price control reviews on its *overall* assessment of how the *combination* of regulatory policy decisions are *together* best calculated to meet its statutory duties taken as a whole.
12. The CAA also discusses the inter-relationship between its own statutory duties and the Government's policies. The Government's 2003 White Paper set out a strategic framework against which the industry could plan for the future. It was based on evidence then available and the Government's own analysis of it (using different criteria from those contained in the Airports Act 1986). Importantly, the White Paper stopped short of mandating (or even authorising) particular developments, or precluding others. It would be for industry to decide whether particular developments were economically viable and whether they should be built.
13. To the extent that there is any conflict between exercising its function to set price controls in accordance with the Act, and the Government's policy objectives in the White Paper, the CAA has no choice but to proceed in accordance with the Act. That said, the CAA would be expected to take into account the evidence and analysis carried out by the Government. Moreover, the CAA would also expect to take into account in its deliberations the importance of Government support for major infrastructure developments, i.e. the fact that Government support for capacity growth at a particular airport is likely to be a necessary, if not sufficient, condition for such proposed developments to secure planning permission.

Regulatory approach

14. **Chapter 4** sets out the CAA's regulatory approach to conducting the price control reviews for BAA's designated airports, within the legal framework and market and policy context described previously. It first identifies a range of factors which may be relevant to any Government decision to designate (or de-designate) an airport for price control under the Airports Act. It also highlights the CAA's approach to analysing the markets within which each of the designated airports operates, in order to inform the design of the price control. In summary, until any future Government decision on designation or de-designation, the CAA proposes and is obliged to set price caps for the four designated airports.
15. The CAA then identifies two issues associated with the economics of airport operation and investment which are likely to be particularly pertinent to these price control reviews, given the scale of investments on the horizon, and discusses a number of regulatory options for managing these implications. First, notwithstanding the likely strong underlying growth in demand for airport capacity across the South East of England, there may be some uncertainties around the future rate of growth in demand at particular airports, especially Stansted, with possible implications for the precise timing of investment at that airport. It is therefore important to ascertain when there is sufficient demand to warrant the construction of additional capacity. Against this background, the CAA considers that there may be advantage in setting price controls at Stansted in a way that allows BAA some scope to test the sensitivity of demand for increased capacity to changes in airport charges (e.g. through progressively raising prices, and/or differentiating further between prices for peak and off-peak use) and thereby better inform the decision on the timing of investment in new runway capacity, and associated infrastructure.
16. Second, although much investment at airports can be incremental, tied closely to current demand, periodically larger investments may be 'lumpy', and have lead times which span more than one regulatory period. In these circumstances, the challenge for the CAA is to set the incentive framework to encourage BAA to implement such lumpy investments where it is economic to do so. For these purposes, the CAA proposes to consider a number of approaches:
- the continuation of 'stand-alone' regulation (discussed below);
 - continued emphasis on BAA consulting its current airline users – and other interested parties where appropriate – on the investments it proposes to undertake; and
 - where necessary, commissioning independent assessments of the capital efficiency of the investments contemplated.
17. The CAA would also be prepared to consider some price profiling, or revenue advancement (on the lines of that adopted for Heathrow T5 in Q4), in order to ensure that the overall price control proposal is consistent with the need to offer credible incentives to invest. This relates in particular to the third of the CAA's statutory duties.

To the extent that meeting the challenges posed by uncertain demand and lumpy investment would mean allowing higher airport revenues in Q5 than would otherwise be the case, it would be important to ensure that compensating adjustments were made to revenues in Q6 and beyond.

18. The CAA's proposed approach, both in respect of dealing with demand uncertainties and lumpy investment, could involve putting prices in Q5 onto a path towards a level that would meet investment costs. But precisely how this approach would translate into prices would depend on detailed consideration of the costs of existing facilities and any new investment, passenger volumes and commercial revenues. It would also depend on a judgement as to the degree of price profiling best calculated to meet the CAA's statutory duties, taking into account the evidence available at that time.

Separate regulation of airports

19. A stand-alone approach to the regulation of BAA's designated airports sets price caps at each airport by reference to the costs, assets and market conditions of each airport individually. In contrast, the approach of recovering revenues across all of BAA's designated airports, based on the costs, assets and market conditions of all of the airports combined, is referred to as 'system' regulation. Under a system approach, at any given time, users at one airport may be meeting some of the costs of providing capacity to users at another airport (even though each airport may be subject to its own separate price cap). **Chapter 5** sets out the CAA's approach to this issue at the last price control review, and its starting point for this review.

20. In its February 2003 decision on the price controls for BAA's designated airports³, the CAA decided to apply price caps on a stand-alone⁴ basis on the grounds that it would:

- provide for a level playing field between Stansted and non-BAA airports in the South East;
- remove a potential distortion whereby Stansted investments may be undertaken even though Stansted users do not value them sufficiently to pay for the life cycle costs at that stage; and
- improve the transparency of regulation for each airport.

21. The CAA is not at this stage aware of any additional arguments or evidence that was not considered as part of its February 2003 decision that would suggest that the stand-alone approach to price regulation should be reconsidered. Further, the CAA considers that the requirements of UK and European competition law are more likely to be met through a policy of stand-alone regulation.

22. Any proposals for a 'public interest levy'⁵, or similar mechanism to subsidise investment at Stansted, would need to be presented with detailed evidence on the benefits of these

³ Economic regulation of BAA London Airports (Heathrow, Gatwick, Stansted), 2003-2008, CAA Decision, February 2003

⁴ A stand-alone approach sets price caps by reference to the costs, assets and market conditions of each airport individually, but does not imply treating each airport as a separate company in its own right.

proposals and of their compliance with relevant legal requirements. The CAA would consider any evidence put forward that indicated that the adoption of a 'levy' or other 'system' approach might be consistent with its statutory duties. However, based on the evidence currently available, the CAA considers that BAA's designated airports should continue to be regulated on a stand-alone basis for the forthcoming price control review and in subsequent control periods. The CAA identifies in this consultation paper a number of potential adaptations to the regulatory framework to maintain incentives to invest, which would make use of flexibilities across *time* in covering the costs of investment, rather than flexibilities across *airports* as implied by the system approach.

Scope of regulation

23. When setting caps on regulated airport charges, the CAA must consider the appropriate scope of the price control. **Chapter 6** sets out the proposed definition of regulated airport charges; the scope of the airport business (costs and revenues) to which the CAA should have regard when assessing the appropriate maximum level for those charges; and the treatment of changes to the regulatory till within control periods.
24. With regard to the definition of airport charges, the CAA does not consider that there is a strong justification for seeking to amend the approach that has been consistently adopted in the past. The CAA is therefore minded to retain the current narrow interpretation.
25. With regard to the definition of the regulated business (the regulatory till), in the light of the CAA's evolutionary approach to this review, the extensive discussion and analysis of this issue at the last review and the resulting conclusions, the CAA does not intend to re-open the debate over the introduction of a dual till⁶ for this review. It is therefore proposing that price caps for airport charges in Q5 are set on the basis of a single till⁷ calculation. This has two main implications: first, that projected commercial revenues are used to offset the costs of providing aeronautical services; and second, that non-aeronautical costs (for example, relevant costs of road and rail access to the airport) are included within the total cost base of the airport against which airport charges are set.
26. The inclusion of surface access costs within the single till raises an important secondary question relating to the appropriate proportion of surface access costs to include. In answering this question, the CAA will need to ensure that its regulatory policy fully recognises the wider planning and public finance context within which surface access projects associated with airport development are specified and funded. It will also need to meet its own statutory duties, including the reasonable interests of users. **Chapter 6** sets out the CAA's proposed criteria against which it would expect to assess evidence from airport operators in support of any proposal to allow surface access costs

⁵ Whereby airport charges would be higher than otherwise at Heathrow and Gatwick in order to finance investment in new runway capacity at Stansted.

⁶ Under which airport charges would be calculated with reference to the costs and revenues associated with providing aeronautical activities alone, removing the scope for commercial revenues to reduce airport charges below the costs associated with the provision of these activities.

⁷ Under which the revenues from all aeronautical and commercial activities, undertaken by the airport company, are set against operating costs and capital charges for the purposes of calculating the revenue required to be raised through regulated airport charges.

associated with airport development to form part of the regulatory cost base on which price caps are set.

Competition and regulation within airports

27. Regulation is designed to deliver benefits to users of designated airports in circumstances where competition in the market *between* airports is, on its own, judged insufficient to do so. Airports provide a bundle of services to passengers and airlines, and *within* most designated airports there is already competition *for* or *in* the market for some of these services (for example, baggage handling, retail outlets). In principle, greater competition *within* an airport could deliver benefits directly to users, reducing the required scope and / or intensity of regulation at the airport level. There may, however, be offsetting costs of coordination, operational and planning inefficiencies, and more intrusive regulation, which would militate against the CAA proposing further competition within an airport. To date, these costs have, in the CAA's view, outweighed potential benefits.
28. **Chapter 7** sets out the CAA's current thinking on the potential advantages and disadvantages of regulating to introduce competition *within* a designated airport. It builds on the analysis and consultation conducted by the CAA on this topic in 2001 for the previous quinquennial review, updated in light of developments since the Q4 price control decision. It sets out the CAA's current analysis of the legal options available, were it to favour measures to promote competition within airports. In considering the issue of intra-airport competition, the CAA plans to assess evidence and any suggestions for the introduction of competition against a set of proposed criteria related to the potential benefits and drawbacks of measures to promote intra-airport competition.

Regulatory building blocks: compiling the evidence

29. The RPI-X price control regime can provide powerful ongoing incentives to efficiency. To enable it to do so effectively requires the CAA to calibrate the price control using evidence on each designated airport's current cost base, its projected operating and investment costs against forecast outputs, and the scope for future efficiency savings. Under a single till approach, the CAA also needs evidence on the future path of commercial revenues which offset costs in determining the revenue required from airport charges. In this review, the CAA has created a framework for 'constructive engagement' between the airports and airlines, with the aim of significantly contributing to this evidence, with the CAA initially focussing its scrutiny on other aspects of airports' costs and efficiencies. **Chapter 8** sets out how the CAA proposes to compile evidence from its own studies and from constructive engagement between airports and airlines.
30. With regard to constructive engagement, the CAA has recently reviewed the progress at each of BAA's designated airports towards the goal of each airport and airlines submitting evidence jointly by June 2006 to the CAA in the form of a price control business plan. This would set out evidence from each side, and agreements where relevant, on topics assigned to airport-airline discussion relating to: traffic volumes and service quality, implications for capacity requirements and capital investment,

opportunities for capital and operating efficiencies, and prospects for non-regulated charges which airports place on airlines. The purpose of the progress review was to aid the CAA in gauging the potential of the constructive engagement discussions to deliver results material to the analysis and decisions that the CAA will undertake in determining the price controls. The CAA stated that where, in its view, constructive engagement appeared unlikely to deliver results material to the price control review at a particular airport, then it would revert to a more typical regulatory review process for that airport.

31. At **Heathrow and Gatwick**, the CAA has concluded that good progress has been made in establishing the structures for engagement and the core issues for discussion. There remains a lot of work to do but the CAA is sufficiently confident of the prospects for constructive engagement delivering by June 2006 material inputs to the price control review that it is content to rely on constructive engagement as planned.
32. At **Stansted**, the CAA has concluded that no substantive progress has been made in establishing the processes, structures and core issues for constructive engagement in the six months to date. Against this background, the CAA believes that there is a significant risk that the process will fail to provide the CAA with information material to the Q5 review in the six months that are left until the required submission of the Price Control Business Plan. In the absence of any substantive progress to date and the resulting balance of risk, it would be irresponsible of the CAA not to commence, early in 2006, its own scrutiny of the price control building blocks currently identified for constructive engagement. The CAA therefore concludes that the issues currently identified for constructive engagement at Stansted should revert to scrutiny by the CAA under a more traditional regulator-led process. In the course of that scrutiny, the CAA would be open to receipt of evidence from all parties, and to the possibility that dialogue between the airport and airlines in the first half of 2006 on topics identified for constructive engagement may lead to a more substantive exchange of views, which could deliver evidence which could be taken into account by the CAA.
33. The CAA intends to publish the evidence from its own scrutiny studies to complement constructive engagement at Heathrow and Gatwick, and in place of it at Stansted, in autumn 2006, as part of the evidence on which its proposed reference to the Competition Commission of BAA's designated airports will be based. This will provide a further opportunity for airlines and others to contribute their views on airports' costs to help inform the CAA's reference to the Competition Commission in spring 2007. In the meantime, the CAA will remain open to the receipt of evidence from airlines and others on the issues discussed in this chapter and the implications for the operating costs, capital costs and commercial revenues of BAA's designated airports.

The cost of capital and regulatory finance

34. The cost of capital is the level of expected return required by the financial markets to provide capital to a company for a given level of risk. It is often a central issue in the regulation of capital-intensive utilities as small changes in the cost of capital can have a major impact on the price cap. This is the case for airports. **Chapter 9** outlines the approach the CAA intends to adopt in making this assessment, providing a review of the financial framework established during Q4; an outline of the CAA's proposed

approach; and an introduction to some key issues that are likely to contribute to the CAA's determination of the financial framework for Q5.

35. In coming to its cost of capital judgement, the CAA intends to use the traditional capital asset pricing model approach (supplemented where appropriate by additional models), and to have particular regard to the analysis of the Competition Commission on the generic factors within this model. The CAA has also identified a number of significant issues that will need to be assessed over the course of the review, namely the implications of stand-alone regulation, the incentives for investment, gearing assumptions and allowances for taxation. The CAA will undertake further analysis on these issues and consult further as its position develops. The CAA intends to maintain the position adopted at the last review to set price caps on the basis of regulatory fundamentals and not in order to accommodate any particular financing arrangement adopted by BAA.

Regulatory incentives to efficiency, service and investment

36. The design of the price controls and the associated regulatory policy statement, as encapsulated in the CAA's February 2003 decision, provide the current regulatory incentive framework for each of BAA's designated airports towards efficiency, service and investment. **Chapter 10** describes the evolution of the price control design over previous reviews, and sets out the CAA's preliminary views on the criteria for making any changes at this review, focusing on setting the right incentives for investment and on rectifying any aspects of the current regime which may not be contributing to meeting the CAA's statutory objectives. It identifies, and invites views on, a range of price control design elements which might be considered candidates for reform, including:

- volume risk sharing, under which airline users would bear some of the traffic volume risk currently borne entirely by the airport operator;
- the correction factor which enables an airport to recover previous under-recovery of revenues per passenger, potentially both within and between price control periods;
- security costs, under which 75% of any additional unanticipated costs over a minimum threshold are passed through the price control directly to users;
- triggers which adjust the price caps according to the achievement of specified capital investment milestones;
- the service quality regime of standards and rebates, especially in light of the outcomes of airports-airlines discussions under constructive engagement;
- capital investment incentives, to cater for changing demands for investment between five-yearly price control reviews and the airport's incentives to meet these demands flexibly and efficiently; and

- operating expenditure roll-over incentive mechanisms, which might strengthen incentives for operating efficiencies at any point during a price control period by enabling the airport operator to benefit from the savings in later control periods.

Public interest issues

37. As part of the references to the Competition Commission, the CAA has to ask the Commission whether the airport operator has acted against the public interest since the last references. Where the Commission finds that an airport has acted against the public interest, the CAA has to impose conditions as it considers appropriate to remedy or prevent the adverse effects to the public interest. At each review so far, the Commission has found that at least one designated airport has acted against the public interest. There are, therefore, a number of existing conditions on the designated airports and the CAA will wish to consider whether, with the passage of time, they should remain, be amended, or can be removed. **Chapter 11** describes the roles of the Competition Commission and the CAA with respect to public interest matters. It sets out how the CAA proposes to compile and assess evidence on new matters of public interest which may have arisen since the last review before submitting any proposals to the Competition Commission. It also summarises the existing public interest conditions, and sets out how the CAA proposes to review these.

Conclusion

38. The CAA welcomes views from all interested parties on the contents of this document. It plans to assess the responses to this consultation in March and April 2006, and then to publish a policy paper in May 2006, providing a summary of the responses to this document and an updated statement of the CAA's regulatory approach in light of the consultation and other evidence received by then. The publication by the CAA of its initial proposals for price controls at Heathrow, Gatwick and Stansted will follow in September 2006.