

CAA consultation on its approach to airports price reviews

In December 2005 the CAA published its first major consultation paper on its policy for the reviews of airport price controls at BAA's Heathrow, Gatwick and Stansted airports, and at Manchester Airport.

The CAA is inviting views on its proposals:

- to continue to regulate each of BAA's designated airports on a 'stand-alone' basis;
- to continue to set airport price controls using the 'single till' approach; and
- for the scrutiny of BAA's airport costs and revenues, which includes a combination of joint airport-airline working – principally through Constructive Engagement – and work led or undertaken by the CAA.

Against the background of continuing strong passenger growth, and tightening capacity, the CAA is also considering how, within a context of stand-alone regulation, the price control framework needs to be modified in order to encourage investment in time to satisfy anticipated demand whilst furthering users' reasonable interests.

purpose

The CAA's December 2005 document sets out for consultation its proposed approach to the economic regulation of Heathrow, Gatwick and Stansted airports, all of which are owned by BAA plc, for the period 2008 - 2013.

The CAA will also be reviewing the economic regulation of Manchester Airport, owned by Manchester Airports Group plc, for the period 2009 - 2014. This process is due to start with the publication of a consultation document in November 2006. But interested parties are invited to respond to the consultation on BAA's review, as some of the issues are common to all four designated airports.

why set a price cap?

The CAA has a legal obligation to set a price cap on any airports designated by the Secretary of State for Transport. There are currently four designated airports in the UK: BAA's three London airports – Heathrow, Gatwick and Stansted – and Manchester Airport.

The price cap sets a maximum level for the airport charges that are levied on airlines, and must be set to meet the CAA's legal obligations (as detailed on the back page).

These obligations mean that when setting these caps, the CAA seeks to ensure that

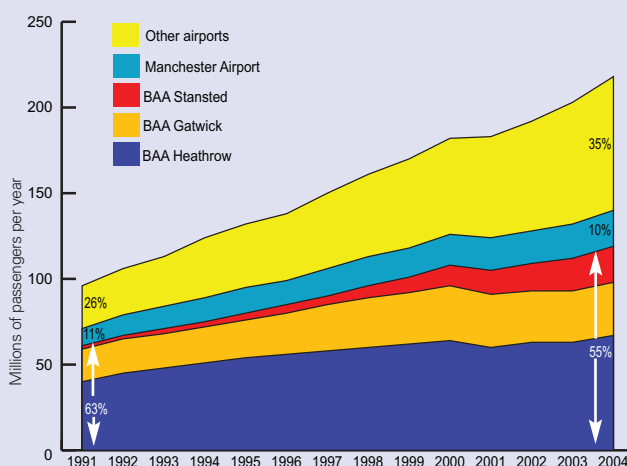


Chart 1: Passengers at UK airports

timetable

- October 2005
CAA sets out the process for the review
- December 2005
CAA consults on policy issues for the review
- May 2006
CAA summarises the consultation responses and publishes its developing thinking on the policy issues for the review
- June 2006
Price control business plans published with input from Constructive Engagement process
- September 2006
CAA consults on initial price control proposals
- January 2007
CAA conducts oral hearings
- February 2007
CAA makes references to the Competition Commission (CC)
- August 2007
The CC reports to the CAA
- October 2007
CAA publishes the CC's report and firm price cap and any public interest proposals
- January 2008
CAA conducts oral hearings
- February 2008
CAA publishes its decision
- April 2008
New price cap and any public interest conditions take effect

Note: this timetable covers the review of BAA's designated airports. The times for the Manchester Airport review will run 6 to 9 months later.

passengers and airlines are asked to pay charges and receive levels of service that are reasonable.

The CAA must also make sure that the airports can earn an appropriate return and can invest in new and improved facilities, whilst limiting its regulation to where it is necessary.

Other UK airports are not subject to price regulation. Less capacity constrained, these airports have on average grown faster than those that are price-regulated over recent years, as Chart 1 shows.

why is this important to airlines and passengers?

Airport charges are a key source of income for BAA's airports...

Airport charges form an important part of the revenues earned by BAA's airports: revenues that are used to meet the costs of running, maintaining and investing in the airport's facilities. Chart 2 shows the split of revenues at BAA's three price-controlled airports.

... and are an important element of airline costs

Airport charges are also a significant cost to airlines, which are ultimately met from the fares paid by passengers. In 2004/05, the average cost of airport charges was around £7 per passenger (one-way) at Heathrow, around £4.40 at Gatwick, and around £2.60 at Stansted.

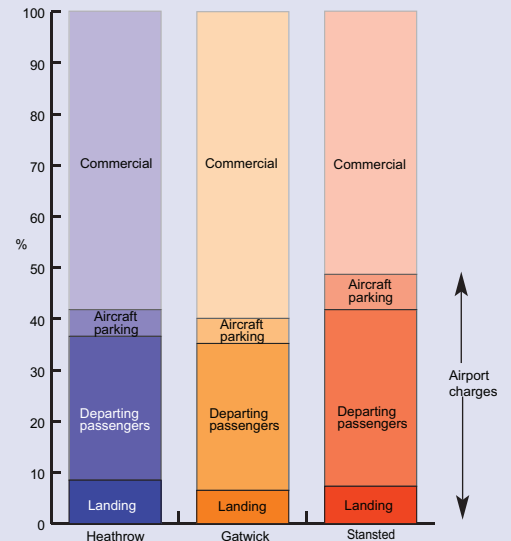


Chart 2: Composition of airport revenues at BAA's designated airports

what are the big challenges for the CAA?

Growing demand and the changing needs of passengers...

Over recent years the airline market has become increasingly diverse and competitive. There has been rapid growth in 'no frills' carriers, offering services to a growing number of destinations. Passenger numbers at Stansted airport have grown by over 400% in the last ten years.

Growth in passenger numbers generally is likely to continue – reflecting higher income and changing demographics. But the destinations that passengers will choose, and the airports that they will want to travel from, are less certain.

Change is also being driven by airlines – with the development of the largest ever passenger aircraft, the Airbus A380, and the growing use of internet bookings and automatic check-in.

Increasing liberalisation in aviation will also prompt changes in the market. A number of long-haul routes have recently been opened up to more competition, including some UK-India routes.

This liberalisation of long-haul air travel is likely to continue, increasing competition and growth in this sector of the market.

... may signal the need for airports to invest in new or better facilities...

Responding to the growing demand for airport capacity, the Government published its aviation White Paper in 2003, *The Future of Air Transport*, which analysed the case for airport expansion throughout the UK. This White Paper stated that, in relation to the South East:

- best use should be made of existing capacity;
- the Government supported the development of two additional runways in the South East; and
- the first additional runway in the South East should be at Stansted, with the second being at Heathrow if environmental issues can be resolved.

But the Government added that it did not build airports or add runways, stating that that was down to those who own and operate Britain's airports.

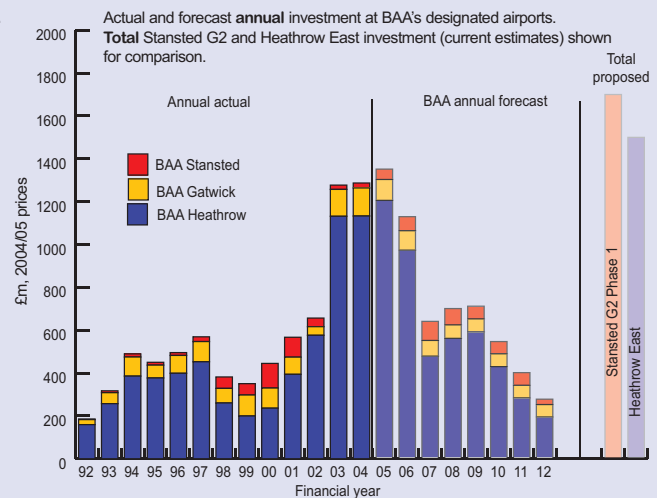


Chart 3: Capital expenditure at BAA's designated airports

All of the major London airports – Heathrow, Gatwick, Stansted and Luton – have now published draft plans, outlining how the airports might expand capacity in the future.

Any expansion of airports is subject to the consent of the appropriate planning authorities. The CAA has no role in taking these decisions but has a role in encouraging BAA to invest in time to satisfy anticipated demand.

But all of the money for this additional capacity must come from the airport charges levied by the airport's owner on airlines and passengers and from commercial revenues. It is the CAA's role to set the maximum level of these airport charges.

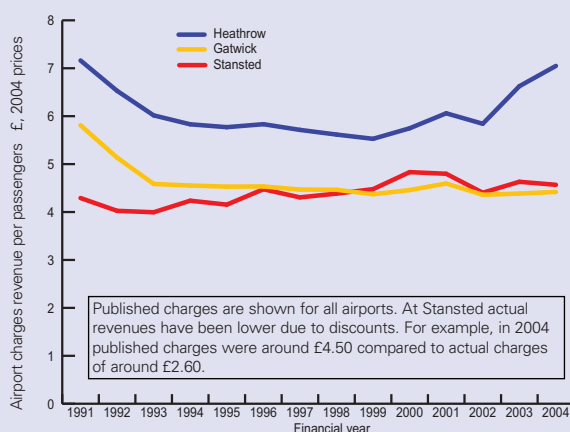


Chart 4: Trends in published airport charges

... but the costs are ultimately met by airlines and passengers

Between 1990 and 2000, airport charges at Heathrow and Gatwick fell in real terms, with improved efficiency, growing passenger numbers and rising commercial revenues. Also, increased passenger throughput was achieved by better use of capacity, and incremental investment.

But in order to provide extra capacity airports eventually need a step change in investment. And the efficiently incurred costs of these major investments need to be recovered from airport users. For example, BAA has invested £4.5bn in Heathrow's Terminal 5, which has increased total capital expenditure significantly, as shown in Chart 3. This increase in expenditure has led to rising airport charges at Heathrow, as shown in Chart 4.

how is the CAA meeting these challenges?

Identifying the future needs of airlines and passengers

In normal markets suppliers and customers interact commercially to determine the appropriate level of service, the costs that should be incurred and the investment that should be undertaken. But these processes do not occur naturally in price-regulated markets.

In order – as far as possible – to replicate this interaction at the designated airports, the CAA has established a framework called Constructive Engagement. This process is designed to give airport operators and their principal customers (airlines) an opportunity at an early stage to discuss and, where possible, agree: traffic projections; capacity requirements and investment; and service quality. This can reduce the need for the CAA to undertake its own detailed and costly analysis. Normal commercial interaction can thereby replace the need for some regulatory scrutiny.

The CAA recognised that Constructive Engagement would not be possible for all aspects of the price control and might not be possible at every designated airport.

Progress has been good at Heathrow and Gatwick but no substantive progress has been made at Stansted. This means that the CAA will now take the lead in scrutinising Stansted Airport's plans, though drawing on information provided by the airport operator and users, and taking account of any agreements that may in the event be reached by them.

The CAA will also continue with its analysis and research into the airline and airport markets – such as its recent survey of regional air transport and its analysis of the sensitivity of leisure passengers to price changes.

Facilitating the delivery of appropriate investment in new facilities

The first phase of major investment contemplated by BAA at Stansted would increase maximum capacity from 35 to 50 million passengers per year, and would remain in use for several decades. The potential investment to deliver 'Heathrow East' - the redevelopment of Terminals 1 and 2 at Heathrow - would be of similar magnitude and longevity. The impact of these projects on BAA's investment plans is shown in Chart 5.

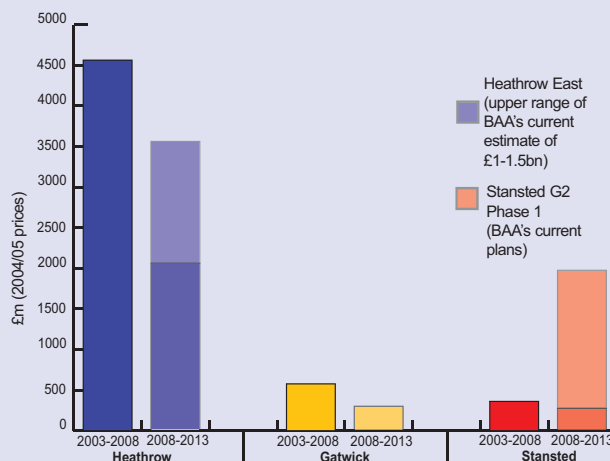


Chart 5: Forecast and potential capital spend at BAA's designated airports

Constructive Engagement, and other forms of consultation between airlines and airports, can help to ensure that any investment by BAA

delivers capacity and service at an efficient cost. For example, at Heathrow and Gatwick, the airlines are undertaking their own scrutiny of capital investment efficiency, where they are best placed – as airport customers – to judge BAA's performance.

The CAA's **regulatory policy** also plays an important part, through:

● **Stand-alone regulation**

Investment should only occur when users place sufficient value on the new facilities and should be undertaken in a cost-effective way. Stand-alone regulation – whereby airports are regulated on the basis of their individual costs, revenues and market conditions – encourages each airport to act in this way. It is also more likely to deliver a level playing field between the airports owned by BAA and those owned by its competitors, which should help to further the reasonable interests of users.

● **Price control flexibility**

Uncertainties around future demand and the 'lumpy' nature of investment have led the CAA to consider how the flexibility of price controls can be enhanced, so as to encourage efficient investment in time to satisfy anticipated demand.

Delivering value to users

Higher levels of investment to deliver extra capacity and better service quality will increase the total level of costs that must be paid for by airlines and passengers. This makes it important to encourage BAA to find more efficient ways of operating and to deliver value to its customers.

The CAA proposes a number of approaches to meeting this challenge, including:

● **Continuation of RPI-X regulation**

In line with its statutory obligations, the CAA proposes to apply RPI-X price caps which provide incentives on airport operators to bear down on costs.

● **Continuation of the single till**

The CAA proposes to set caps on airport charges for 2008-13 using a 'single till' approach so that users benefit from commercial revenues at the airport.

● **CAA-airline-airport joint working**

The CAA has already started working with airlines and airport operators to examine BAA's operating efficiency, using a practical approach to benchmarking costs and efficiency studies.

● **CAA-led scrutiny**

The CAA will be scrutinising BAA's operating cost and revenue projections as part of establishing the level at which to set caps on airport charges.

The CAA will also consider the amount that BAA will be allowed to earn on investment at each airport. The CAA intends to apply regulatory best practice to ensure that BAA receives a reasonable return that covers its **cost of capital**.

The CAA is the UK's independent aviation regulator, with responsibility for all civil aviation regulatory functions: economic regulation; airspace policy; safety regulation; and consumer protection.

The CAA's statutory duties: The CAA must set BAA's price control in a manner which it considers is best calculated:

- “(a) to further the reasonable interests of users of airports within the UK;
- (b) to promote the efficient, economic and profitable operation of such airports;
- (c) to encourage investment in new facilities at airports in time to satisfy anticipated demands by the users of such airports; and
- (d) to impose the minimum restrictions that are consistent with the performance by the CAA of its functions...”

for more information or to comment

Any comments on the CAA's proposed approach should be sent, if possible by e-mail, to airportsreview@caaerg.org.uk by 20 March 2006. Alternatively, they may be posted to: Susie Talbot, Economic Regulation Group, 4th floor, CAA House, 45-59 Kingsway, London WC2B 6TE. The CAA will publish all responses, except any material marked as confidential.