

**Price control review – consultation on the framework
and options for the economic regulation of Stansted
Airport**

January 2008

**Civil Aviation Authority
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Executive summary

1. The Airports Act 1986 obliges the CAA to set a maximum limit on airport charges – a price cap – for UK airports designated for price control by the Secretary of State. Following a review during 2007, the Secretary of State decided on 15 January 2008 that Stansted Airport would retain its status as a designated airport.
2. The CAA is now required to refer Stansted to the Competition Commission (CC) and, following receipt of its advice, propose and subsequently implement price caps for the airport to take effect on 1 April 2009. The Airports Act does not allow the CAA to delay the implementation of new price caps beyond this date or to exercise any discretion and not apply a price cap. In response to this timetable, the CAA undertook a certain amount of preparatory work during 2007 to identify alternative approaches to setting price caps for Stansted.

The task faced by the CAA

3. The task faced by the CAA is to apply a price cap to Stansted Airport that best meets the CAA's statutory duties, taking account of the available evidence of the current and likely future circumstances of the airport. This includes the likely competitive position of the airport and its plans to develop a second runway and associated infrastructure, the design and cost of which the current airline customers do not support.
4. Stansted Airport has not historically enjoyed a very strong market position: it has been unable to set its charges up to the level of the price cap and has, instead, set them at a level that has been lower than most other major UK airports. Further, the CAA's analysis, supported by more recent market evidence, indicates that Stansted Airport does not currently enjoy a sufficiently strong market position (i.e. of substantial market power) that would normally be a necessary precondition for applying price caps. Indeed, the Secretary of State's decision to leave Stansted designated acknowledged that "...on balance, it is probably the case that Stansted airport alone does not currently have substantial market power" and that "...[i]n relation to BAA's common ownership of other airports in addition to Stansted airport, the exercise of market power at Heathrow and Gatwick airports is separately addressed through the CAA setting price caps for these two airports".¹
5. In respect of the future market position of Stansted, there is no certainty about the degree of market power that the airport might acquire. For example, the Secretary of State's decision stated that "...it is more likely than not that Stansted airport alone will acquire substantial market power in the future, although this conclusion is finely balanced". Moreover, the CAA's analysis indicates that were Stansted Airport's market position to strengthen to such a degree that it became dominant then competition law would provide

¹ 'Decision on the regulatory status of Stansted Airport', DfT, January 2008

an important constraint on the airport's conduct – as it does in other sectors of the economy and has, in practice, in a number of airports markets – and mitigate the risk that users of the airport would be subject to anti-competitive behaviour.

6. Against this background, this document sets out the CAA's proposed approach to identifying an appropriate price control framework for Stansted and the options for setting the Stansted price cap for the next five years. Consistent with the CAA's statutory duties – including its duty to impose the minimum conditions necessary – the CAA will need to ensure that the price cap proposals reflect all of the evidence available about the current and likely future market circumstances faced by the airport over the relevant five-year period and that the wider approach to the price control provides a suitable framework for the regulation of the airport over the longer-term. To this end, whilst the DfT set out some of the results of its analysis in its decision document, the CAA has requested that it now shares its detailed analysis of Stansted's market circumstances with the CAA.
7. In considering the issue of the appropriate price control framework going forward it is important to recognise that, historically, the CAA's price cap regulation of Stansted has not had any significant impact on the operation of, or charges set by, the airport. Instead, normal commercial and competitive pressures have provided the principal protection for users of the airport and stimulus for the airport to invest in capacity and service quality. The question faced by the CAA can, therefore, be viewed as whether Stansted's circumstances are such that the airport should *now* be subject to a building-block price cap or whether there are more appropriate ways of setting the price cap, including approaches that continue to place more reliance on normal competitive pressure to protect airport users.
8. This task is further complicated by the possibility that applying such additional regulation in the form of a 'standard' building-block price cap may have a number of adverse consequences, including leading to distortions to investment and undermine the development of a competitive airports market. So consideration of the appropriate price cap will depend upon analysis of a number of complex issues, not least the extent to which reliance can continue to be placed on normal commercial pressures and, therefore, the degree of protection that airport users might reasonably require from the price cap.
9. For this reason this document explains the potential consequences of applying a 'standard' price cap to Stansted in its present circumstances and sets out in this document five broad alternative options for setting the price cap. One of these approaches supplements the 'standard' model with extensive regulatory involvement in investment decisions. The other options, to a greater or lesser degree, seek to rely upon market-based processes to guide investment decisions. The CAA has sought to identify a broad set of options for consideration and, consequently, many of these approaches are

to some degree novel and all have both advantages and disadvantages. Accordingly, the CAA welcomes comments on both the applicability of these approaches and how they might be refined further. It is also open to interested parties to propose other options for consideration by the CC and CAA.

The potential consequences of 'standard' price cap regulation

10. The 'standard' approach to setting price caps is typically applied where competition is not possible or where it is still developing. This approach involves basing the price cap on the historical costs incurred by the airport and a forecast of the costs likely to be incurred over the next five-year period, including investment costs. In principle, this requires establishing an investment programme and setting a cost allowance to match the projects that will be delivered.
11. In common with other regulators, the CAA has, in practice, augmented this 'standard' approach with additional regulatory safeguards to cover investment decision-making. For example, at Heathrow and Gatwick the process of constructive engagement – joint airport-airline working – has provided many of the important inputs into the CAA's price control proposals. In this way, a degree of commercial negotiation has reduced the need for intrusive, regulator-led processes.
12. However, the circumstances at Stansted are somewhat different. The combination of rising demand, with the potential for significant expansion of the airport, and a Regulatory Asset Base that does not appear to reflect the current cost of airport assets results in a significant risk that major investment decisions may be distorted. In particular, the airport operator is likely to face incentives to increase capital expenditure in order to increase the price cap and, therefore, the revenue that the airport is allowed to earn, whilst the incumbent airlines might face incentives to oppose efficient expansion due to the impact that it might have on the airport charges they pay. Indeed, this combination of incentives provides one possible explanation for the failure of constructive engagement at Stansted.
13. In principle, this effect might have been evident in previous price control reviews. However, the CAA has not previously placed sole reliance on a building-block calculation when setting the price cap and, in practice, the CAA's price cap regulation of Stansted has not had a significant impact on the operation of, or charges set by, the airport. Instead, normal commercial and competitive pressure has provided the principal protection for users of the airport and stimulus for the airport to invest in incremental capacity and in service quality.
14. Having considered the circumstances faced by Stansted, the CAA considers that the 'standard' approach to price cap regulation is unlikely to meet its statutory duties. At a minimum, it will be necessary to establish some form of 'augmentation', in the form of extensive capital scrutiny, to address the risk

that the 'standard' building-block approach distorts investment decisions, with the consequent impact on the development of a competitive UK airport market and on the interests of airport users generally, at present and in the future.

The tools available to the CAA

15. In developing a suitable response to the circumstances at Stansted, the CAA is provided by the Airports Act with a single statutory power – it applies a price cap on airport charges covering a five-year period. However, the Act allows the CAA some discretion in the way in which this price cap is established. The Act does not, for example, oblige the CAA to apply a per-passenger price cap, adopt RPI-X regulation, or base the price cap on costs incurred. It is, therefore, open to the CAA to adapt its approach to setting price caps for Stansted, in order to ensure that its proposals best meet its statutory duties.
16. In addition to setting a price cap for the next five-year period, the CAA can also provide guidance as to how it might set the price cap in future periods. Given the long-lived nature of airport assets and, therefore, the importance of investment incentives, this guidance (set out in a Regulatory Policy Statement) can be an important element of the overall price control settlement, albeit that such guidance cannot bind subsequent CAA decisions.

The options

17. In December 2006, the CAA set out for consultation its initial views on the options for setting a price cap for Stansted. The CAA has continued to develop its thinking on the potential ways in which the Stansted price cap could be set, has considered whether there is any useful regulatory precedent, and has met with a number of the Stansted airlines to discuss their ideas.
18. This document invites views on whether the 'standard' approach to setting price controls is appropriate and sets out, for consultation, the following five options:
 - Option 1 – Augmented Building Block
 - Option 2 – Legacy Price Cap
 - Option 3 – Terminal Development Tendering
 - Option 4 – Market-led price cap
 - Option 5 – Precautionary price cap

It is, however, open to interested parties to propose additional or alternative options, or refinements of these.

Option 1 – Augmented Building Block

19. This approach would involve setting the level of the price cap using the 'standard' building-block price cap calculation, based on historical costs incurred and a forecast of costs to be incurred over the next five-year period.
20. As described above, such an approach runs the risk of distorting both airport and airline incentives and behaviour. It would, therefore, be necessary to supplement the price cap with additional regulatory processes, in order to mitigate the risk of investment decisions being distorted. In principle, these regulatory processes could place reliance on airport-airline consultation and discussion in order to establish agreement over key aspects of the airport's investment programme. However, given the incentives on the parties, and the experience of poor airport-airline relations at Stansted, it appears likely that the airport and airlines will not reach substantive agreement on any capital investment plan. It is, therefore, probable that the CAA will be required to determine a number of major elements of the investment plan, potentially extending to decisions on the detailed design of the facilities.
21. The CAA would also need to establish whether any investment plan was consistent with its duties in respect of users – including prospective airlines and passengers – of other airports, whether designated or not. The CAA would expect to consider, amongst other things, whether: the incremental benefits of expansion of Stansted to its users exceed the incremental costs borne by users; the costs of the proposed development are no greater than necessary; and whether the impact of investment at Stansted unreasonably prejudices feasible investments by rival UK airports, and the development of competition within the UK airport market.
22. Such scrutiny is a feature of price controls at Heathrow and Gatwick including through constructive engagement. However, the fact that the incentives of the airport and airlines are likely to be distorted, by the impact of the price control on their profits, complicates the CAA's task: it reduces the reliance that can be placed on their views, in part as their interests might not be aligned with those of passengers and/or future airport users. A consequence of this is that the degree of necessary regulatory scrutiny is likely to be more extensive than might be expected for an equivalent project that had received broad airline and airport support under constructive engagement.
23. This approach would, therefore, represent a considerable extension of regulatory oversight, with its associated costs, that might be inconsistent with the CAA's duty to impose the minimum restrictions necessary. Such an increase in regulation might also be expected to 'crowd out' normal commercial dialogue and negotiation between the airport operator and its users, and risk introducing a disjunction between the business of taking forward a project in response to commercial pressures, within the general planning framework, and regulatory decision-making processes, with their necessary formality and consequent loss of flexibility and greater risk of dispute and delay. Further, notwithstanding the regulatory processes put in

place to mitigate the potential for competition between airports to be distorted, some residual risk of such distortions would probably remain.

Option 2 – Legacy Price Cap

24. The key feature of a Legacy Price Cap approach is that a price cap is applied to the existing (i.e. legacy) airport assets – based on the ‘standard’ building-block approach – but incremental investment in capacity and/or improved service quality would fall outside of this price cap and be free to earn a more commercial return².
25. This approach would, in principle, allow investment in capacity or service quality to be driven by demand for its use, with the airport either entering into contracts with airlines or undertaking more speculative investment at its own risk. As the price cap on the existing assets would not be adjusted to reflect any expenditure relating to the incremental capacity this would reduce the risk that the price cap unduly distorts investment decisions.
26. This approach would appear to continue to afford the existing users the protection of a price cap, mitigating any risk of exploitation arising from any inability on their part to switch away from the airport. New capacity would be treated much like a new airport, and allowed to earn a return free from such regulation.
27. However, it appears to the CAA that such an approach would be difficult to implement in practice and would carry the risk of unintended consequences. For example, airports with two runways would be expected to operate them in a coordinated way and to deliver improved resilience as a result. In practice, therefore, the ‘legacy’ airlines would either benefit from the new assets without contributing to the cost, or it would be necessary to establish an appropriate additional charge. The former is clearly inappropriate, whilst the latter would be very complicated and contentious. Further, the differential treatment of existing and new airport users risks distorting airline competition and of providing existing users with an incentive to oppose efficient investments.
28. Furthermore, there is potential for this approach either to encourage or require BAA to adopt discriminatory pricing practices that could raise legal issues in light of the EC Treaty, UK competition law and/or the UK’s international obligations.

Option 3 – Terminal Development Tendering

29. The concept behind a Terminal Development Tendering approach was originally outlined by easyJet to the CAA in meetings in December 2007. Under the TDT approach competitive processes would be introduced into the

² In practice the Airports Act would require the CAA to apply a price cap to any incremental capacity. Consistent with the overall rationale for this approach, this price cap could be set in a similar manner to the Precautionary Price Cap proposal, set out as Option 5.

provision of terminal facilities, by putting the development of additional terminal capacity (and related facilities) out to competitive tender. In this document the CAA describes its view of one way in which this concept could be implemented, and highlights some of the detailed design features that need to be resolved.

30. One key feature of this approach is that the results of the terminal tender would be used to determine whether runway investment was permitted under the price control – with a successful terminal tender ‘triggering’ the construction of a second runway (and other core infrastructure). BAA would not be permitted to participate in this tender to provide terminal facilities but would provide the runway infrastructure.
31. The terms of the tender would be drawn up by the CAA, in consultation with the airport operator, airport users and expert engineering and financial consultants. This tender would set out the timing, nature and extent of the proposed runway and access infrastructure as well as the price at which this infrastructure would be charged to any provider of terminal facilities. The CAA would also set out the minimum standards for any terminal facilities, together with rules governing the treatment of new entrant airlines and the interface between the terminal and remainder of the airport. It might also be necessary to increase the degree of transparency over airport charges, reflecting the potential for separate charges to be levied for runway and for terminal access and that some of these charges might vary between existing and new assets.
32. However, without BAA’s consent, it is unclear whether the current legal and regulatory framework would allow this approach to be adopted, not least since it would prohibit BAA from pursuing its own terminal development plans. This option may also face a number of other practical problems, including that any planning application for a new runway will need to set out sufficient detail about the location and size of terminal buildings to enable the planning inspector to assess the likely significant environmental and other effects of the proposed development. This might reduce the degree to which competing terminal providers could bring forward alternative proposals for the development of the airport’s terminal infrastructure.
33. In addition, the proposal requires the CAA to determine a very significant part of the overall investment plan (including the timing and position of any second runway) and to set out the rules by which an independent terminal operator would interact with the provider of the airport infrastructure. This level of involvement in investment decisions appears likely to draw the CAA into operating issues on an ongoing basis. It is, therefore, unclear at this stage whether this option would yield significant benefits compared to Option 1 – which could also require the regulator to take a very active role in specifying the detail of investment projects – that would justify the apparent complexity of the TDT approach.

34. However, it is possible that alternative regulatory approaches that introduce additional competition between or within airports, such as introducing competition between terminals, could deliver benefits to users. However, these issues, which might require changes to the statutory framework, are best considered by the Competition Commission in its Market Investigation of BAA airports.

Option 4 – Market-led price cap

35. The market-led price cap (MLPC) approach places reliance on the competitive constraints faced by Stansted to protect users, and involves the CAA setting a price cap that enables airport-airline interaction to set prices, enabling the CAA to maintain a lower degree of involvement in the detailed operation and development of the airport.
36. An MLPC would be set by reference to a judgement of the relative risks of setting it too high or too low, considered in the context of the CAA's statutory duties. In particular, the price cap would be set sufficiently high so as to remove the risk of serious distortions to investment decisions and to competition, but would also have regard to the degree of risk faced by users that the airport might abuse its market position.
37. The MLPC would not seek to reflect the short-term balance between supply and demand in such a way as to "second guess" what the market price should be. Rather, the MLPC would be set for five years, based on a forward-looking assessment of the level at which the price cap would not unduly distort behaviour, in the expectation that the level of charges paid would vary below this level, in response to market circumstances – i.e. that the resulting prices paid would be market-led.
38. In practice, this would involve setting the MLPC at a level that reflects forward-looking measures of costs, such as the current cost of replacing or expanding airport capacity, and have regard to evidence of prices charged by other airports, rather than being based on the level of historical costs incurred at Stansted. As a result, the level of the price cap would not increase in response to investment, removing the distortions associated with the building-block price cap approach.
39. Overall, the CAA sees considerable merit in this approach. It makes use of the competitive constraints that apply to Stansted, ensures that investment decisions and competition are not unduly distorted and provides some protection for users against high prices, albeit additional to that already provided by competition law.
40. However, as with all of the options identified, there are possible disadvantages. In particular, the MLPC approach would require the CAA to exercise a considerable degree of judgement when setting the actual level of the price cap, introducing a degree of regulatory uncertainty.

Option 5 – Precautionary price cap

41. The final option would also rely on competitive constraints to protect users' reasonable interests. The price cap would be focused on mitigating the risk that circumstances changed in such a way that the airport was likely to abuse its market position. This approach would, therefore, apply the price cap as a precautionary measure, in the expectation that it would not, in practice, be required to constrain prices. For this reason, the CAA has referred to this approach as the precautionary price cap (PPC).
42. Like the MLPC, the PPC would not seek to reflect the short-term balance between supply and demand in such a way as to "second guess" what the maximum permitted market price should be at any one time. Rather, the PPC would be set for five years, based on a forward-looking assessment of the level above which prices might, if sustained over a period, be viewed as excessive under general competition law.
43. The main benefit of a PPC approach is that the price cap would mitigate the risk that prices rise to an excessive level in the event that the airport acquires substantial market power. This would remove the need for users to rely on competition law to provide them with protection from being exposed to abuse in the short term. Further, this supplementary protection would correspond to the period over which users might be less able to rely upon competitive pressure and competition legislation to protect their interests, and potentially remove the need for airlines to take legal action should Stansted seek to increase prices to an excessive level.
44. The PPC shares some of the characteristics of the MLPC approach, in that the price cap is based on forward-looking measures of cost, and is not linked to the historical costs incurred by the airport. The main distinguishing feature between these two approaches is that the PPC places greater reliance on competitive constraints to protect the reasonable interests of users. This means that the PPC would be set somewhat above the level implied by the MLPC approach.
45. However, whilst the PPC approach still requires the CAA to exercise a degree of judgement in setting the level of the price cap, the underlying principle – that the price cap should be set to prevent excessive prices in the event that the airport acquires a dominant position – is somewhat simpler than that underlying the MLPC approach. As a result, it could be argued that the PPC approach is simpler, reducing the degree of regulatory uncertainty.

Transitional arrangements

46. Some of the above options could be modified to provide for a transition from the level of the current price cap. Such a transitional period could be justified on the basis that it is probably more important to establish a credible long-term framework for investment, rather than focus on the level of the price cap in the short term. Transitional arrangements would also enable airline to plan

their response to any potential changes in airport charges, whilst facilitating airport-airline commercial arrangements.

47. The CAA will consider the merits of transitional arrangements as options are developed further.

Implications for the level of the price cap

48. Under all options it is likely that the principal determinant of prices will be the competitive interaction of the airport and its airline users. In practice, therefore, the actual prices paid by airlines at Stansted may not vary significantly between each of the options identified.
49. Against this background, the CAA has, based on a number of broad assumptions, presented calculations to illustrate the different options and the price caps that might result from their application. These illustrations should not, however, be viewed as estimates of the CAA's eventual price cap proposals. Under each approach further analysis would be required in order to reach proposals for the level of the price cap.
50. Under certain scenarios relatively low price caps of £6 to £7 per passenger result. However, these either do not allow the airport to expand its capacity or only apply this lower price cap to existing – and not any new – users of the airport. The augmented building-block approach, whereby the price cap is set partly to reflect the historical cost of airport assets but also takes account of BAA's projected capital investment plan, would result in a price cap increasing from current levels to around £8.50 per passenger by the end of the Q5 period. This illustrative value is based on a number of assumptions, including the construction of a second runway and associated facilities. Changes to the timing and specification of these plans would affect these illustrative price caps.
51. By way of comparison, the market-led approach would involve price caps that reflect the forward-looking costs associated with airport expansion. To illustrate this concept, the CAA presents calculations that suggest that, if the underlying assumptions were proved to be valid, the price caps might fall in the range £8.50 to £12.50 per passenger. A precautionary price cap approach would tend to result in the cap being set towards the upper range of these illustrative numbers.

Initial views on the options

52. Historically the CAA's price cap regulation of Stansted has not had a significant impact on the operation of, or charges set by, the airport. However, the implementation of a 'standard' building-block price control at Stansted would now be likely to have a number of significant adverse effects and is, therefore, unlikely to best meet the CAA's statutory duties. In light of this, the CAA has set out five alternative options, that might better deal with the current and likely future circumstances of Stansted.

53. All of these five options have some advantages and disadvantages. However, at this initial stage, the CAA considers that there are significant practical and/or legal problems associated with a number of the options. Options 2 and 3 – the Legacy Price Cap and Terminal Development Tendering – appear difficult to implement in practice and raise a number of potentially significant legal obstacles that might prevent them from being pursued.
54. Option 1 – the augmented building-block approach – applies a familiar methodology for calculating the level of the price cap and introduces additional regulatory scrutiny and intervention in response to the likely distortions to airport and airline conduct that would result from such a price cap. However, this necessary augmentation would result in a considerable extension of regulatory intervention, with its associated costs. Indeed, this level of involvement in investment decisions appears likely to draw the CAA into the detail of investment decisions which, over time, could undermine the accountability of the airport for its own performance, drawing the CAA further into the day-to-day operation of the airport. In this way, such an increase in regulation might also be expected to ‘crowd out’ normal commercial arrangements, act as a barrier to innovation, and risk distorting competition between airports, to the long-term detriment of airport users.
55. Indeed, there is strong evidence that Stansted faces material competitive constraints and that there are significant interactions between it and a number of non-designated airports. The CAA’s statutory duties require it to balance the interests of all UK airports and their users when setting price caps at Stansted and to impose the minimum restrictions necessary. This would favour approaches that set the price cap in a way that makes best use of the existing competitive constraints, supplementing them where necessary but taking care not to replace or undermine them, and does not distort investment decisions or undermine the development of a competitive airport market. Options 4 and 5 – the market-led and the precautionary price cap approaches – appear most consistent with these aims. Indeed, such approaches would provide users with a level of protection over and above that which would be provided by competition law whilst also avoiding constraining the level of prices unnecessarily and limiting the scope for commercial interactions. It could, therefore, be argued that such approaches are most consistent with the previous price controls applied to Stansted.

Way forward

56. The CAA is now inviting interested parties to comment on the issues raised in this document and, in particular, on the options presented for the framework for setting a price cap for Stansted. It is open to interested parties to propose alternative options or modifications to the options identified.
57. The CAA will publish its reference to the Competition Commission in April 2008, taking account of the responses received to this document.

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1. Introduction

1.1 This chapter sets out:

- the purpose of this document;
- the context for the CAA's proposals;
- a summary of recent market developments and the performance of Stansted Airport; and
- an outline of the remainder of the document.

Purpose of this document

1.2 The CAA is responsible under the Airports Act 1986 ('the Act') for modifying the price control conditions every five years³ at the four airports currently designated for this purpose by the Secretary of State. These airports are Heathrow, Gatwick, Stansted and Manchester⁴. The price control conditions regulate the maximum amounts that may be levied by the airport operator of each airport by way of 'airport charges', as defined in the Act.

1.3 This document seeks views on the CAA's initial proposals for the setting of new price controls at Stansted Airport for the five years from 1 April 2009 to 31 March 2014. The CAA is also inviting respondents to identify any course of conduct of a type described in the Airports Act 1986 that the airport has followed since the previous reference in February 2001 that, in their view, has operated or might be expected to operate against the public interest. This document, the responses to it, and the CAA's analysis of the responses, will help to inform the CAA's mandatory reference to the Competition Commission in respect of Stansted, which is planned for April 2008. The CC is required to report, with recommendations, back to the CAA within six months of the reference (unless an extension is granted by the CAA). Thereafter, the CAA is required to have regard to the CC's recommendations in coming to its own price control decision, following final consultation.

Document structure

1.4 The remainder of this document is structured in eleven further chapters. Chapter 2 sets out recent developments in: the regulation applied to UK airports (including the recent Government decision to leave Stansted designated for price control; the airline and airport market; and the performance of Stansted. Chapter 3 provides an overview of the legal framework that is relevant to the setting of price caps at Stansted. Chapter 4 sets out the key challenges associated with setting a price control at Stansted. Chapter 5 identifies five alternative options for setting the price

³ The five-year period can be extended by up to a maximum of twelve months, as the CAA has done for both Manchester and Stansted Airports in November 2005 and March 2007 respectively.

⁴ On 15 January 2008 the Secretary of State announced the de-designation of Manchester Airport.

control. Chapter 6 provides a description of the CAA's statutory duties and explains how it considers these should be interpreted in the current context. Chapters 7, 8, 9, 10 and 11 present a summary of the five options that have been identified by the CAA, together with an initial assessment of these options. The final chapter presents a high-level summary of the five options and offers some initial thoughts on the relative merits of these options.

Views invited

- 1.5 Due to the constraints associated with the need to refer Stansted Airport to the Competition Commission, the CAA is allowing seven weeks for written comments on the proposals in this document. Any comments should be sent, if possible by e-mail, to airportsreview@caa.co.uk, by **17 March 2008**. Alternatively, comments may be posted to:

Susie Talbot
Economic Regulation Group
CAA
4th Floor
CAA House
45-59 Kingsway
London WC2B 6TE

- 1.6 The CAA will acknowledge all responses. It expects to make responses available on its website for other parties to read as soon as practicable after the period for written comments has expired. Any material that is regarded as confidential should be clearly marked and included in a separate annex which, subject to further discussion with the author and subject to the criteria the CAA has established for treating information as confidential,⁵ will not be published.
- 1.7 If you have any immediate questions on this document please contact Chris Hemsley on 020 7453 6237 or by e-mail to chris.hemsley@caa.co.uk.

Way forward

- 1.8 This document sets out five alternative approaches to setting the price control for Stansted for the five-year period commencing 1 April 2009.
- 1.9 In order to implement any one of these options it will be necessary to undertake a certain amount of further analysis. In light of the need to consider a number of alternative options, and the statutory timetable to which this review is subject, the CAA is unlikely to be able fully to assess the merits of the various options and to undertake all of the necessary analysis to reach a detailed set of price control proposals before it needs to make its mandatory reference to the Competition Commission (CC).
- 1.10 Following the completion of the CC's review, the CAA will, having regard to the CC's recommendations, undertake any further analysis necessary to

⁵ See paragraphs 3.28 to 3.20 of 'Economic regulation of designated airports (Heathrow, Gatwick, Stansted and Manchester) from 2008 – CAA process for the reviews', CAA, October 2005

reach firm price control proposals and, subsequently, its final price control decision.

- 1.11 The CAA will, however, provide the CC with its views on the relative merits of the available options, including on any further options identified during the consultation period.

Review Timetable

- 1.12 In light of the above, the CAA envisages the following timetable for the remainder of the Stansted Airport price control review:

Date	Event
25 January 2008	CAA issues Consultation on Framework and Options
6 February	CAA holds industry seminar on Consultation on Framework and Options
17 March	Consultation closes
By end April	CAA makes mandatory price control reference to Competition Commission
By end October	CC issues recommendations and reports to the CAA
By mid December	CAA issues Firm Proposals for consultation
By mid February 2009	Consultation closes
February/March 2009	CAA holds oral hearings
By end March	CAA makes final price control decision for Stansted Airport
1 April	New price controls come into effect

Review governance

- 1.13 The governance of the price control review has been consulted upon and set out previously by the CAA⁶.
- 1.14 In summary, the Board of the CAA has formally delegated to a Panel the authority to conduct the review of the price controls for all of the designated airports and to take all decisions for the CAA during this review, including the final decision on the price caps and the remedies to any public interest findings of the CC.
- 1.15 The Panel comprises Harry Bush, Group Director Economic Regulation, and two non-executive directors of the CAA – Jim Keohane and Roger Mountford.

⁶ See, for example, 'Economic Regulation of Designated Airports (Heathrow, Gatwick, Stansted and Manchester) from 2008 – CAA process for the reviews', CAA, October 2005.

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2. Recent developments

2.1 This chapter provides a summary of recent developments relevant to setting price caps for Stansted. The chapter considers in turn:

- the Secretary of State's review of the designation of Manchester and Stansted airports;
- other regulatory developments;
- market developments; and
- the recent performance of Stansted.

The review of the designation of Manchester and Stansted airports

Review of the criteria for designating airports

2.2 In December 2006, the CAA recognised that there was only a limited possibility that Stansted either had – or could be expected to enjoy – a position of market power that gave rise to a significant risk that it would exploit that position through charging unreasonably high prices. The CAA, therefore, recommended to the Government that it should set out the criteria for designation, and consider the case for de-designating Stansted (along with that of Manchester Airport).

2.3 In April 2007, the Department for Transport (DfT) consulted on the criteria for designating and de-designating airports for price control. In May 2007, the Department decided that designation of an airport would be appropriate if:

“(1) the airport, either alone or together with any other airport(s) in common ownership or control, has or is likely to acquire, substantial market power; and

(2) domestic and EC competition law may not be sufficient to address the risk that, absent regulation, the airport would increase and sustain prices profitably above the competitive level or restrict output or quality below the competitive level; and

(3) designation under Section 40 of the Airports Act 1986 would, taking account of the magnitude of the risk identified in (2) and its detrimental effects were it to materialise, deliver additional benefits (i.e. over and above competition law) which exceed the costs and potential adverse effects of such designation (i.e. the incremental benefits are positive).”

De-designation would be appropriate if any of these factors ceased to apply.

Extension of the price control at Stansted

- 2.4 In March 2007, after consultation, the CAA extended the current Stansted price control by one year so that it would end on 31 March 2009. The CAA did this to avoid working on setting a new price control before the Government had reached a decision on whether the airport should be de-designated.

Assessment of the case for continuing designation of Manchester and Stansted airports

- 2.5 In May 2007, the Department for Transport asked the CAA for its advice on whether Stansted and Manchester airports should be de-designated. In July 2007, the CAA published its advice to the Government, building on the methodology, evidence and analysis previously consulted upon by the CAA. The CAA advised that both Manchester and Stansted did not meet any of the three criteria for designation and should, therefore, be de-designated.⁷
- 2.6 In respect of Stansted's market position, the CAA noted that the airport continues to charge below the maximum level permitted by the price control and that analysis suggested the current level of airport charges to be somewhat below that which might represent efficient new entry costs or be expected to remunerate efficiently incurred expansion at the airport. Further, the CAA noted that there are good reasons to believe that there are competitive constraints from other airports (in its immediate market and elsewhere), and from passengers and airlines. The CAA acknowledged that the tightening supply-demand balance is likely to lead to the airport having more pricing power than it has had in the past, but noted that this could be a reasonable consequence of the fundamental balance between supply and demand in the market and which encourages investment in additional capacity.
- 2.7 The CAA also considered the likely effectiveness of competition law to address the risk that Stansted might abuse any position of substantial market power that it might acquire. The CAA noted that competition law could be – and, indeed, had been – used by competition authorities and by airlines in actions against airports. Further, the high level of concentration of airline users at Stansted, and their demonstrated willingness to bring forward competition and breach of contract cases against airport suppliers and airline competitors, suggests strongly that there would be at least two airlines with the means and motivation to pursue legal actions against alleged excessive pricing. These actions would be informed by information resulting from the legacy of economic regulation and the scrutiny of the airport's expansion plans before the recent Stansted Generation 1 (SG1), and prospective Stansted Generation 2 (SG2), planning inquiries.

⁷ 'De-designation of Manchester and Stansted airports for price control regulation – the CAA's advice to the Secretary of State', CAA, July 2007.

- 2.8 Finally, the CAA considered the costs and benefits associated with designation. It noted that there are significant costs associated with the impact of regulation on investment decisions, with long-term detrimental consequences for airport users. These costs would be likely to arise either under the 'standard' approach to setting price controls closely related to the airport's costs and its Regulatory Asset Base (RAB), or, in a different form, under an alternative approach to set 'market-led' price caps. The former could provide a stimulus to the airport to over-invest (relative to demand), while the latter could introduce additional regulatory risks which might act in the opposite direction to deter investment.
- 2.9 Overall, the CAA said there were clear risks that continuing price cap regulation would distort the airport's investment decisions to the detriment of the airport's development, the development of the airport market and therefore consumers more generally. The CAA recognised that it was possible to take an alternative view of the extent of the market power that the airport might enjoy in the future and, therefore, of the balance of evidence on the first criterion. However, there was strong evidence in respect of the other two criteria that provided considerable assurance that the airport should be de-designated.

Secretary of State's decision on the designation of Manchester and Stansted airports

- 2.10 On 15 January 2008, the Secretary of State issued her decision that Stansted Airport should continue to be designated under Section 40 of the Airports Act 1986 ('the Act') and that Manchester Airport should be de-designated⁸. The Secretary of State concluded that Stansted met all three criteria for the continuation of price controls on the airport, while Manchester failed to meet the first (market power) criterion, and as such should be de-designated without a formal evaluation of the second and third criteria.

Relevance of the Government's analysis to the CAA's statutory function

- 2.11 In light of the Secretary of State's decision, the CAA must now ensure that its obligations under Part IV of the Act are fulfilled. In particular, the CAA must prepare for the mandatory reference of Stansted to the Competition Commission and then place a maximum limit on the airport charges levied by the airport (i.e. the CAA must set a price cap).
- 2.12 The reference to the Competition Commission, and the subsequent price control proposals, will probably be made against a background of some disagreement about the current and likely future market position of the airport, with further relevant market information inevitably emerging during the process of the price control review.
- 2.13 The CAA has previously set out its advice that the airport does not currently enjoy a position of substantial market power, whilst the Secretary of State

⁸ 'Decision on the regulatory status of Stansted Airport', DfT, January 2008 and 'Decision on the regulatory status of Manchester Airport', DfT, January 2008.

also stated that "...on balance, it is probably the case that Stansted airport alone does not currently have substantial market power" and that "...[i]n relation to BAA's common ownership of other airports in addition to Stansted airport, the exercise of market power at Heathrow and Gatwick airports is separately addressed through the CAA setting price caps for these two airports".⁹ In respect of the future position of Stansted, the Secretary of State's decision stated that "...it is more likely than not that Stansted airport alone will acquire substantial market power in the future, although this conclusion is finely balanced".

- 2.14 As a consequence, the CAA must apply a price cap to an airport that currently does not currently enjoy a position of substantial market power and where such a position might not be acquired over the next price control period. Indeed, whilst the DfT notes that "...there appears to be a risk that Stansted airport alone will have a position of substantial market power that it is able to exploit if there is no increase in capacity at South East airports", the CAA must ensure that the way that it applies a price cap to Stansted does not discourage, or otherwise distort, the very investment decisions that could mitigate the risk that the airport acquires such a market position.
- 2.15 In particular, the CAA must identify the approach to setting this price cap that best meets its statutory duties, including its duty to impose the minimum restrictions that are consistent with the performance by the CAA of its functions under Part IV of the Act. In addition, as previously set out by the CAA, the appropriate form of the price control will depend to a greater extent than is usually the case on the degree to which users' reasonable interests are protected by the combination of competitive pressures and competition law. Further, it is important for the CAA to ensure that the potential distorting effects of the price control are fully considered so that the overall approach promotes the efficient, economic and profitable operation of UK airports and encourages timely investment at these airports.
- 2.16 The issues that the CAA needs to consider are, therefore, very similar to those considered by the Secretary of State in her analysis of Stansted against each of the three designation criteria. However, whilst the Secretary of State applied this analysis to establish whether Stansted should be price regulated, the CAA must now apply the available evidence to establish the way in which Stansted should be regulated. The Secretary of State acknowledged that the decision was made on balance and that in many areas the decision was finely balanced. The decision emphasises the many areas of agreement with the CAA's advice but came to some conclusions which differed from the advice given by the CAA. The CAA, therefore, assesses, first the evidence and analysis upon which the Secretary of State's decision was based and, second, considers whether there are any resulting implications for the way in which the CAA should fulfil its statutory functions. This is not intended to be a comprehensive assessment of the DfT's analysis

⁹ 'Decision on the regulatory status of Stansted Airport', DfT, January 2008

but is restricted to those issues of relevance to the CAA's function to set price caps for Stansted.

Initial assessment of the Government's published analysis

2.17 The following discussion is organised in three sections, discussing the evidence on the:

- market power held by Stansted;
- potential deterrent effect of competition legislation; and
- impact of applying 'standard' price cap regulation.

Evidence on the market power held by Stansted

2.18 The CAA has considered the analysis and evidence presented by the DfT in its decision document and has the following observations in respect of the analysis that relates to the current and future market position of Stansted and, therefore, the degree of risk that users of Stansted might face in the absence of a price cap at Stansted:

- **Relevance of Heathrow and Gatwick economic regulation:**
When assessing market power (current or future), it is necessary to determine whether the undertaking or group of undertakings is able to raise prices profitably above the competitive level. There will be no market power if the undertaking does not have such an ability. The continuing presence of economic regulation on Heathrow and Gatwick forecloses that ability. As such, it is a relevant factor in considering whether Stansted, in joint ownership with these airports, possesses market power, and serves to narrow the consideration to Stansted's own ability to raise prices, were it to be de-designated. Indeed, the DfT recognised that 'the exercise of market power at Heathrow and Gatwick airports is separately addressed through the CAA setting price caps for these two airports' but treat this only as a factor that prevents the exploitation of substantial market power rather than also being relevant to determining whether substantial market power actually exists at Stansted. The CAA notes that the OFT's guidelines on the assessment of market power explain that 'an assessment of market power may need to take [economic regulation] into account'¹⁰.
- **Test for market power:**
The CAA's assessment (in line with competition law practice) is based on the test as to whether Stansted – based on all of the relevant facts, including BAA's wider airport ownership and the continued price cap regulation of two of these airports – would have the ability profitably to sustain prices above the competitive level. In response, the DfT makes two arguments that differ from the CAA's analysis.

¹⁰ Paragraph 6.7, 'Assessment of market power', OFT, December 2004

First, the DfT appears to have focused on whether the airport has the ability to raise prices at all from the historic or current levels, rather than whether it is able to profitably raise prices above the *competitive* price level. Second, as noted above, the DfT appears to have taken a different view as to whether the existence of price cap regulation of Heathrow and Gatwick is relevant to assessing the degree of market power held by BAA at Stansted. As a separate point, the DfT bases its findings on the market power held by BAA at Stansted on the conclusions of the OFT's December 2007 market study into UK airports, which concluded that, for OFT's purposes, BAA had persistent and substantial market power in the South East of England. However, the CAA notes that the OFT's investigation was concerned with whether there were features of the UK airports market, notably BAA's ownership of airports, that prevent, restrict or distort competition. The OFT's analysis did not consider whether, given the current structure of the market and the continued price cap regulation of Heathrow and Gatwick, BAA currently or prospectively enjoys a position of substantial market power at Stansted. The CAA does not, therefore, consider that it is appropriate to apply the OFT's conclusions about the wider position of BAA to the specific question of the market position of Stansted Airport.

- **Sources of competitive constraints facing Stansted:**

The DfT considers the sources of competitive constraint that arise from within a geographic market that includes London, East Anglia and part of the broader South East. However, the CAA's advice to the Secretary of State highlighted the importance of competitive constraints that arise from both its neighbouring and more distant airports. In respect of the latter, the CAA noted that the Stansted airlines have the ability to move their aircraft and growth plans between a very large number of airports across the European Aviation Area and actively compare the yields on offer from airports across Europe, providing an additional constraint on airport conduct, protecting airlines and their passengers from abusive conduct. This source of competitive constraint is not mentioned by the DfT.

- **Strength of competitive constraints facing Stansted:**

The DfT agreed with the CAA's assessment that the threat of switching aircraft away from Stansted provides a credible discipline on airport behaviour, but took a more cautious view about the prospects for future increases in capacity at Stansted and rival airports, and about the competitive constraints imposed by passengers switching airports. It is also important to consider the strength of the competitive constraints in the context of whether the airport is able to raise prices profitably above the competitive level, and not against the lower hurdle of whether Stansted would be able to raise prices from their current or historical levels.

- 2.19 More generally, the CAA notes that while the DfT has presented some new evidence, it is not such as to alter the CAA's advice. Moreover, the evidence that has emerged from the market since that advice appears to support the conclusions that the CAA set out. For example, the decision by a number of airlines to reduce capacity at Stansted and grow their business elsewhere (with a consequent impact on the growth of the airport) and the airport's decision to reintroduce a scheme of discounts. This evidence is consistent with the view that Stansted does not currently have substantial market power.
- 2.20 In light of this, the CAA is not persuaded that it should depart from its previous view that there are likely to be sufficient competitive constraints on Stansted now and in future to limit the degree of market power held by BAA at the airport. However, the CAA will continue to assess this key issue through the price control review, and remains open to further evidence and analysis on this point.

Evidence on the potential deterrent effect of competition legislation

- 2.21 The CAA has considered the analysis and evidence presented by the DfT in its decision document and has the following observations in respect of the analysis that relates to the potential deterrent effect of competition law and, therefore, the degree of protection that might reasonably be required by users of Stansted Airport:
- **Risk of abuse of market power:**

The DfT's decision does not, on the face of it, appear to analyse the sufficiency or otherwise of competition law against the particular risk of Stansted abusing market power now or in future, and instead considers whether competition law would provide sufficient protection if Stansted *was* dominant and *did* choose to abuse this dominance. Relevant to assessment of this risk is the DfT's view that Stansted alone does not currently have substantial market power, the lack of certainty of it acquiring such a position in the future and the impact of continued price cap regulation of Heathrow and Gatwick on Stansted's market position. Without consideration of the degree of risk that Stansted might acquire a position of substantial market power, the CAA considers that the assessment of this criterion would tend to under-estimate the extent to which competition law could deal with the particular risk of market abuse by Stansted.
 - **Excessive pricing:**

The CAA's assessment is that recent cases in competition law have clarified the definition of excessive pricing, in the context of abuse of dominance, making it easier for all stakeholders to understand what constitutes excessive pricing by a dominant firm, and bring cases (or not) accordingly.
- 2.22 Combined with the CAA's own judgement on the likelihood of Stansted acquiring substantial market power in future, the CAA's view remains that,

given the identified risks, competition law would provide a significant degree of protection to consumers.

Evidence on the impact of applying 'standard' price cap regulation

2.23 The CAA has considered the analysis and evidence presented by the DfT, on the basis of which the Secretary of State decided that the incremental benefits of price cap regulation exceed the incremental costs of such regulation. The DfT acknowledged that the quantification of these costs and benefits was not straightforward. The CAA has the following observations in respect of DfT's analysis as it relates to the impacts of applying 'standard' price cap regulation and, therefore, of the relative merits of adopting alternative approaches for Stansted:

- **The magnitude of the risk of abuse**
The DfT's decision document does not appear to consider (either quantitatively or qualitatively) the magnitude of the risk that Stansted might acquire a position of substantial market power and, should this occur, the magnitude of the risk that such a position would be abused (taking into account the degree to which competition law would address such abuse). Evaluating the magnitude of these risks is an important part of assessing the likely costs and benefits of certain price control approaches.
- **Risk of distortions to competition**
Whilst the DfT's decision document makes reference to the potential for price caps to deter investment at non-designated airports, other potential impacts of such regulation on the development of competition between airports, such as on price or service quality, are not explicitly considered.
- **The impact of regulation on the price level**
The DfT decision appears to treat any increase in prices charged to airlines as a cost of not applying a price cap. However, the appropriate focus for this analysis would be whether prices are likely to rise above the competitive level. This is an important distinction as prices in capital intensive industries will often need to rise in order to prompt, or remunerate, investment but this can be a normal feature of these markets rather than being a sign of some form of market dysfunction. The CAA notes, therefore, that there is likely to be a link between the ability of the airport to increase charges to a level that reflects the incremental cost of investment and its ability to undertake efficient investment.
- **Potential for alternative forms of regulation**
In his peer review Prof Cave notes that alternative approaches to setting a price cap at Stansted could include the "safeguard caps" which have been used in other sectors; these do not correspond to an estimate of efficiently incurred costs, but are set more loosely to guard

against the possibility of major customer detriment. Their purpose is thus to avoid the market distortions and burden of detailed price regulation, while providing users with ex ante protection against excessive pricing.

- 2.24 Combined with the CAA's own judgement on the likelihood of Stansted acquiring substantial market power in the future, and the degree to which competition law is likely to mitigate the risk of abuse, the CAA is not persuaded that it should depart from its previous view that there are very limited incremental benefits and significant costs associated with applying price caps to Stansted. This balance of benefits and costs is likely to affect the appropriate form of the price cap that should be applied to Stansted.

Implications of the Government's decision

- 2.25 Overall, the published decision provides some additional evidence that is relevant to the task now facing the CAA, and in many places confirms and supports the CAA's advice. The Secretary of State's decision appears, therefore, to reflect the different weight placed on the available evidence and analysis.
- 2.26 In particular, the additional evidence that is presented in the decision document appears to support the CAA's original analysis of the market position of Stansted. For example, the DfT confirm that analysis provided to it suggested that there is "a fairly substantial passenger sensitivity to price changes" and that "switching costs were generally low".
- 2.27 The Secretary of State noted, in making her decision on Stansted, that the decision was not intended to constrain the CAA from adopting other approaches which meet their statutory duties while avoiding some of the costs of the current system that respondents have identified.
- 2.28 Against this background, the CAA considers that there is a strong case for considering options for the future regulation of Stansted that place some reliance on the degree of competitive constraint faced by Stansted and the potential disciplining effects of competition law on the conduct of the airport.
- 2.29 The CAA has written to the DfT to request more details of its analysis. The CAA will then consider any additional analysis and evidence that it receives from the DfT and its relevance for the appropriate approach to setting price caps for Stansted.

Other regulatory developments

Previous price control decisions for Stansted

- 2.30 Four price controls have been applied to Stansted, the first of which (Q1) was determined by the Government. All subsequent price controls (Q2 to Q4) were determined by the CAA. The CAA has adopted the single-till approach to setting all of these price controls.

- 2.31 In Q2 and Q3, the CAA set price controls for all three of BAA's London airports, with the price cap for Stansted reflecting the costs, revenues and market conditions faced by all of these airports (i.e. a 'system' approach). In Q4, the CAA set price caps on the basis of the costs, revenues and market conditions of each of BAA's designated airports individually (i.e. a 'stand-alone' approach). The price cap in Q4 was not set in the expectation that Stansted Airport would be able to charge up to the price cap throughout the Q4 period and the price cap calculation allowed for marketing support and other allowances that led to a price cap that was flat in real terms (i.e. it was set as RPI+0).
- 2.32 In practice, therefore, the Stansted price cap has not historically been set solely on the basis of the costs incurred (and forecast to be incurred) by the airport and, in any event, the airport operator has chosen to set airport charges at Stansted significantly below the level permitted in the price cap. For the first time, in 2007/8 Stansted set its charges up to the level implied by the RPI+0 price cap calculation. However, this level is still some way below the maximum level permitted under the price control, which allows the airport to recover in later years any under-recovery of revenue resulting from the published charges being set below the price cap.

Price controls at Heathrow and Gatwick airports

- 2.33 Heathrow and Gatwick airports remain designated, with the current price controls expiring on 31 March 2008. In March 2007, the CAA referred the airports to the Competition Commission, as required by the Airports Act. The Commission reported to the CAA in September 2007, and the CAA published the Commission's report on 3 October 2007. The CAA considered the Commission's recommendations and new information that became available after the Commission had reported. The CAA published its price control proposals for the airports on 20 November 2007.
- 2.34 The CAA proposed significant increases in the price caps applied to airport charges, particularly at Heathrow. The increases reflected the increased costs of security operations, the cost of recent capital projects and allowances for significant capital expenditure. The proposals reflected the situations at the airports where BAA faced the challenge to deliver a better service to passengers and airlines based on refreshed and expanded infrastructure. The CAA also proposed strengthening incentives on both airports, through increasing the amounts which they had to pay if service targets were not met, introducing bonuses for improvement in service above specified performance thresholds, and by subjecting a significant part of the capital expenditure programmes at both airports to 'triggers', under which penalty payments would be incurred for late delivery of specified outputs from projects.¹¹

¹¹ The CAA is consulting on its proposals for Heathrow and Gatwick for two months. Its decision on the price controls will be issued in March 2008.

Market Investigation of BAA's UK airports by the Competition Commission

- 2.35 In June 2006, the Office of Fair Trading (OFT) launched a market study into UK airports. After consultation, the OFT decided on 29 March 2007 to refer the supply of airport services by BAA to the Competition Commission, under the Enterprise Act 2002. One reason for the reference was the OFT's view that in the South East of England and Lowland Scotland BAA's high regional shares of supply (its ownership of Heathrow, Gatwick and Stansted in the former and of Edinburgh and Glasgow in the latter) limits competition between airports. The OFT also mentioned its concern about the impact of the regulatory framework on investment and the effects of development restrictions and capacity constraints.
- 2.36 The Competition Commission has wide-ranging powers to remedy any adverse effect on competition that it identifies in a market investigation, including: recommendations to Government or other agencies; undertakings as to future behaviour; additional monitoring arrangements; and structural remedies that could require BAA to sell one or more of its airports. The Commission published an issues statement in August 2007, and is expected to publish its emerging thinking in March or April 2008. The statutory deadline for the Commission's final report is 28 March 2009, but the Commission plans to publish the report ahead of this deadline.

The Air Transport White Paper

- 2.37 In December 2003 the Government set out its strategic framework for the development of airport capacity over the next 30 years in a White Paper 'The Future of Air Transport'¹². The White Paper did not itself authorise or preclude any particular development, but set out a policy framework within which the relevant public bodies, airport operators and airlines could plan ahead, and which would guide decisions on future planning applications. The Government said that the first priority should be to make best use of the existing runways in the South East, but that there was also an urgent need for additional runway capacity and provision should be made for two additional runways in the South East by 2030. The White Paper said that the first new runway should be at Stansted, to be delivered as soon as possible, around 2011 or 2012. The Government also supported a further new runway and additional terminal capacity at Heathrow to be delivered as soon as possible after the new runway at Stansted, within 2015 to 2020, but only if local air quality targets could be met.
- 2.38 In December 2006, the Government published a progress report on the White Paper, in which it restated its commitment to the strategy in the White Paper, including its policy that "[t]he timing and nature of development at Stansted remain a commercial decision for the airport operator".¹³

¹² The Future of Air Transport, Department for Transport (DfT), December 2003, also referred to as the Air Transport White Paper (ATWP)

¹³ 'Air Transport White Paper Progress Report', DfT, December 2006

- 2.39 On 22 November 2007, the Government published a consultation paper on whether a third runway and sixth terminal should be built at Heathrow. The Government said that in view of the significant economic benefits, it considered that there was a strong case for introducing additional capacity at Heathrow. The Government recognised that Heathrow's operations impacted on large numbers of people across London. Overall, the Government believed that delivering growth at Heathrow within the noise and air quality limits in the White Paper struck the right balance between the environmental, social and economic considerations. The Government asked for responses to its consultation by 27 February 2008.
- 2.40 The Air Transport White Paper supported the construction of a full-length runway to replace Luton's existing runway. In 2005, Luton published a master plan that included a replacement full-length runway. However, in July 2007 Luton announced that it would not pursue the option of a new runway further, but would concentrate on making the most of the existing airport site.
- 2.41 The White Paper also supported extending the current runway and constructing a second runway at Birmingham. In October 2005, Birmingham published a draft master plan which proposed both of these new developments. However, after consultation, the airport decided that a second runway would not be required before 2030 and, therefore, was outside the time horizon of the plan. In January 2008 Birmingham Airport submitted a planning application to extend its current runway.¹⁴

Government strategic review of the CAA

- 2.42 In October 2007, the Government initiated a strategic review of the CAA, led by Sir Joseph Pilling. The review is looking at a number of aspects of the CAA, including what its functions and responsibilities should be, its governance and statutory framework, and its relationships with the Government and those it regulates.

Airport Charging Directive

- 2.43 In January 2007, the European Commission published a draft proposal for a Directive on airport charging. The proposal set out a common framework of non-discrimination, consultation and transparency. The proposal would apply to airports with over one million passengers annually, and Member States would be required to establish a national Supervisory Authority to act as a dispute resolution body in the event of disagreements on issues such as airport charges and service quality. The proposed legislation would permit a higher level of regulation in a Member State, such as the designation of airports for price control. The proposed Directive is currently being discussed and revised by the European Council and European Parliament.

¹⁴ See www.bhx.co.uk for more information.

Market developments

Required security standards at airports

- 2.44 In August 2006, the Government significantly tightened security standards at UK airports. The increased standards included allowing passengers to carry only one item of cabin baggage, and a ban on taking liquids airside. Subsequently, certain standards have been relaxed, although overall the requirements remain significantly above those applying before August 2006. Limited amounts of liquid can now be carried, and the Government has announced its willingness for airports to bring forward plans to relax the one bag restriction without adversely affecting the quality of security screening currently being achieved. The DfT approved the relaxation of the one cabin bag rule for the first wave of airports (including Stansted) from 7 January 2008, although passengers will still need to comply with airline policies on cabin baggage.
- 2.45 The increased security requirements had an immediate and dramatic effect on airports, with security queuing increasing substantially. Over time airports have applied more resources to security, often both additional staff and extra security lanes, to bring queuing times back towards those achieved before August 2006. Airport performance in reducing queuing times has been varied. By the end of 2007, queuing times at Heathrow and Gatwick were broadly back to previous levels. Security performance at Stansted has been a source of contention between the airport and its airline customers. This is discussed in more detail below.

Liberalisation

- 2.46 In March 2007, the European Union and United States concluded an agreement, to come into force in March 2008, liberalising air services between the two areas. The main effect on the UK is the ending of restrictions on the number of services and airlines that can be operated to and from Heathrow and Gatwick airports. In particular, the current restriction, which limits services to two UK and two US airlines between Heathrow and the USA, will be abolished.
- 2.47 International air services agreements with some other countries have been increasingly liberalised in recent years. Notably the UK-India market has grown considerably since the more liberal agreement of 2005, and in November 2007, agreement was reached to remove all remaining restrictions on flights between the UK and Singapore from the end of March 2008.

Airline operations at Stansted

- 2.48 A recent development at Stansted has been the introduction of long-haul services to the USA. In 2005, two airlines started business-class only services: Eos and Maxjet. In January 2008, Maxjet announced that it had been placed into administration. Eos now operates 44 flights between

Stansted and New York (JFK) per week. In January 2007 SilverJet opened similar business-only services from Luton Airport to the US and recently announced services to Dubai. Additionally, American Airlines started services between Stansted and New York from October 2007.

Recent performance of Stansted Airport

2.49 During the current price control period 2003/4 to 2007/8 (referred to as the fourth quinquennium or "Q4"), performance at Stansted has differed from projections at the last price review:

- passenger numbers have been well above the levels forecast at the time of the Q4 price control review;
- operating expenditure was slightly below forecasts during the early years, but now seems likely to be above forecast over the whole period;
- capital expenditure was well below forecasts in the early years; this trend has reversed, but expenditure overall is expected to be below forecast; and
- other revenue has been consistently below forecast.

2.50 A number of airlines have argued that the increase in airport charges at Stansted over Q4 is evidence of market abuse and that the airport's returns are excessive. To support these claims, airlines have referred to the doubling of charges at the airport and its high operating margin.

2.51 The CAA has previously considered whether the increases in charges at Stansted is evidence of market abuse, concluding that the current level of charges at Stansted Airport is not excessive and does not, by itself, suggest that the airport has, or is likely to acquire, substantial market power.¹⁵ Furthermore, Stansted's recent financial performance highlights that, over the first four years of the Q4 price control period, the airport has not generated sufficient revenue to cover the costs has incurred over this period. To illustrate this, the CAA has set out the price cap calculation based on actual operating and capital investment costs and has compared this to the actual revenue generated by the airport. These calculations are set out in Table 2-1.

¹⁵ 'De-designation of Manchester and Stansted airports for price control regulation – the CAA's advice to the Secretary of State', CAA, July 2007.

Table 2-1 Stansted actual costs incurred, revenue received and overall financial performance

<i>£m, nominal prices</i>	2003/04	2004/05	2005/06	2006/07
Opex	76,425	82,400	89,159	98,093
Depreciation	29,793	28,996	32,324	34,664
Price profiling adjustment	(11,574)	(5,821)	(9,995)	(8,794)
Headroom adjustment	1,961	3,713	3,509	1,865
Return on the RAB	61,395	60,279	60,444	64,364
Other revenues	(87,785)	(92,598)	(91,466)	(92,534)
Total regulated revenue requirement	70,214	76,969	83,976	97,658
Actual regulated revenues recovered	45,066	50,533	58,286	63,542
Total revenue surplus / (shortfall)	(25,148)	(26,437)	(25,690)	(34,116)
CAA forecast return on the RAB	6.2%	7.3%	6.8%	6.9%
Actual return on the RAB¹⁶	4.0%	4.8%	4.4%	3.5%
Difference (percentage points)	(2.2)	(2.5)	(2.4)	(3.4)

Source: BAA regulatory accounts and CAA analysis

- 2.52 This analysis shows that during the first four years of the Q4 regulatory period Stansted Airport did not generate sufficient revenues to meet all of its costs, with the shortfall amounting to £110 million over this period. This is a shortfall of approximately £1.30 per passenger, over this period. Further, even if the expenditure that BAA has incurred preparing for expansion of the airport is removed from these figures this only reduces the shortfall to around £100 million over the four years¹⁷.
- 2.53 Further, the CAA does not consider that the change in the level of airport charges is a reliable indicator of the market position of Stansted. The recent increases in the airport charges paid by some airlines at Stansted reflect the fact that a number of long-term discount contracts agreed with the airlines have expired. The level of airport charges still remains below the maximum level permitted by the price cap.
- 2.54 More generally, the level of airport charges at Stansted do not appear to be high relative to other UK, or major international, airports. The CAA has collated evidence to provide a comparison of charges set by Stansted and other UK airports. This analysis is set out in more detail in Annex D, and highlights that Stansted has set, and is likely to continue to set its charges, somewhat below the average level set by UK airports. Indeed, the airport is currently around the 5th or 6th cheapest airport in the UK, based on this analysis. In addition, analysis undertaken by TRL in 2006, considered the airport charges levied by a sample of fifty international airports. Although this sample did not cover Stansted, it showed that Gatwick Airport had one of the lowest levels of airport charges (placing it 43rd out of 50). Given the relative level of charges at Stansted and Gatwick, this suggests that charges at

¹⁶ These calculations are drawn from Stansted's audited regulated accounts.

¹⁷ The reduction in the revenue shortfall reflects the lower estimated financing costs (i.e. the return on the RAB) when these capital costs are removed from the price control calculation.

Stansted are relatively low when compared against other major international airports.¹⁸

- 2.55 In addition, care should also be taken when interpreting the operating margin generated by Stansted as a way to assess whether its profits are reasonable. Airports are capital-intensive businesses that, in order to generate a reasonable return on their assets, will require higher operating margins than less capital intensive businesses.
- 2.56 Annex B also sets out BAA's reported performance for Stansted on a quarterly basis for particular elements of service for the period from March 2006 to September 2007, and monthly data for security queuing. Taken at face value, this seems to show that performance in many areas has been relatively high compared to the performance standards being proposed for Heathrow and Gatwick. This applies to the availability of: passenger and goods lifts, transits, auto walks and escalators and aircraft stands. The availability of jetties over the period has been generally good but with one poor quarter (the period to September 2007).¹⁹ BAA has provided monthly performance data, in terms of the percentage of times that the queue has exceeded ten minutes during three peak periods during the day. This appears to show that queuing performance fell substantially following the imposition of more stringent security standards in August 2006 but has been above 95% for each month in 2007 with the exception of October.
- 2.57 Although the number of passengers at the airport has grown faster than projected at the time of the Q4 review – for example passenger numbers were over ten per cent higher than the projections for 2006/7 – the latest figures show a reversal in traffic growth. In November 2007, passenger numbers at Stansted were over six per cent below those in November 2006, whilst in December 2007 passenger numbers were over eight per cent below those in the preceding December. Overall, the number of passengers using the airport grew by less than half of one per cent during 2007 compared to 2006. BAA reported that one explanation for this trend was the recent reduction in Ryanair's schedules during the winter season. Since this time, the Stansted airlines have continued to expand at a number of other UK airports, which might have implications for the likely future traffic levels at Stansted.

Stansted's growth plans

- 2.58 BAA has titled its plans for expanding the airport as Stansted Generation 1 and Stansted Generation 2. Generation 1 (SG1) seeks to allow the airport to make the best use of its current runway capacity up to 2015. Generation 2 (SG2) aims to build a second runway, to come into operation from 2015 (at the earliest), along with associated terminal and other capacity at the airport.

¹⁸ See TRL, "Review of Airport Charges 2006", available from www.trl.co.uk.

¹⁹ Whether existing jetties are available may be a less sensitive issue at Stansted where no-frill carriers tend to operate without their use to speed up turn around times.

2.59 In April 2006, BAA submitted a planning application to remove the current 25 million passengers per annum limit and to increase the current limit on air transport movements from 241,000 to 264,000. In November 2006, Uttlesford District Council rejected the planning application. BAA appealed against the Council's decision, which led to a public inquiry running from May to October 2007. The Government's decision on the inquiry is expected in early 2008. In January 2007, BAA published details of its proposed SG2 expansion, including a second runway and associated infrastructure. BAA is expected to submit a planning application for SG2 in early 2008.

Questions for consultation

Q.1 Do you agree that the CAA has accurately summarised the relevant regulatory and market developments?

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3. Legal framework

Introduction

3.1 This chapter describes the legal framework within which the review of Stansted Airport is taking place. It covers:

- a summary of the relevant statutory provisions under the Airports Act 1986;
- a summary of broader UK and European competition legislation, including the UK Enterprise Act 2002; and
- a number of other potentially relevant aspects of law and policy.

3.2 At the end of the chapter comments are invited on whether Stansted airport has, since the last reference to the Competition Commission on 28 February 2002, pursued a course of conduct which has operated or might be expected to operate against the public interest.

The CAA's role under the Airports Act 1986

The CAA's statutory functions

3.3 The Airports Act 1986 ('the Act') requires the CAA to impose, in relation to designated airports, such:

"conditions as to airport charges ... as the CAA considers appropriate for regulating the maximum amounts that may be levied by the airport operator by way of airport charges at the airport during the [next] period of five years."²⁰

3.4 At the end of each five-year period the CAA must make such modifications to the charging conditions as it considers appropriate for regulating the maximum amounts over the next five years. For Stansted, the CAA extended the five-year period to six years as provided for in section 40(7) of the Airports Act so that the current price control expires on 31 March 2009²¹. Consequently, the CAA will be setting price controls for the five years from 1 April 2009 to 31 March 2014 (referred to as the fifth quinquennium, or Q5).

3.5 The Airports Act 1986 is relatively prescriptive, when compared to the legal frameworks under which other economic regulators operate, and as such it gives the CAA relatively limited flexibility in a number of dimensions. For example, the CAA has no discretion as to whether it should set a price control condition, its duration²², or the scope of services (or charges) that such a price control condition should cover. However, even within this

²⁰ Section 40(1) and (3) of the Airports Act 1986.

²¹ Extending the current price control condition on Stansted, CAA decision, March 2007

²² Apart from the scope to extend by up to twelve months maximum.

relatively rigid statutory framework, subject to its statutory duties, the CAA does have discretion to determine:

- the level at which it sets maximum limits on airport charges in the following price control period;
- whether the limits should vary over the period, and if so what should drive such variations;
- whether the limits should vary according to the services provided (or in some other way), and if so what should drive such variations; and
- what – if anything – it says publicly about how it currently expects maximum limits to be set in subsequent periodic reviews.

3.6 Before imposing price control conditions, or making modifications to such conditions, as to the maximum amounts that may be levied by way of airport charges, the CAA must make a reference to the Competition Commission, unless the Secretary of State otherwise directs. Such a reference is made up of two largely distinct aspects. The first is the making by the Competition Commission of recommendations to the CAA as to what the maximum amounts capable of being levied by way of airport charges should be during the next period of five years. The second is a determination by the Competition Commission as to whether an airport has pursued a course of conduct over the previous five years in relation to the matters specified in section 43(2) of the Act which has operated, or might be expected to operate, against the public interest. This public interest aspect of the Commission's investigation is described at the end of this chapter.

The CAA's statutory duties

3.7 The CAA is required by section 39 of the Act to exercise its regulatory functions in a manner which it considers is best calculated:

- to further the reasonable interests of users of airports within the United Kingdom;
- 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 its functions as economic regulator.

3.8 The CAA intends to make decisions on the price controls for Stansted for Q5 based on an overall assessment of how the combination of regulatory policy decisions are together best calculated to meet its statutory duties.

3.9 In documents published in December 2005 and May 2006, the CAA set out in some detail the sort of considerations it would have in mind when interpreting and balancing its statutory duties, in the context of its statutory function of setting a price control for Stansted. The interpretation of these statutory duties is an important element of developing appropriate price control proposals. For this reason, the CAA has set out in Chapter 6 how it intends to interpret its statutory duties, building on the material published previously.

International obligations of the UK

3.10 An additional requirement of the Act is that, when performing its economic regulatory functions, the CAA must take into account such international obligations of the UK as may be notified to it by the Secretary of State (Section 39(3)). The obligations so notified to the CAA are found in:

- Article 15 of the Convention on Civil Aviation (Chicago Convention) 1944;
- provisions relevant to the imposition of charges in air services agreements in force between the European Community and its Member States and the Government(s) of any third country or countries; and
- provisions relevant to the imposition of charges in air services agreements in force between the Government of the United Kingdom of Great Britain and Northern Ireland and the government(s) of any third country or countries.

Article 15 of the Convention on Civil Aviation (Chicago Convention) 1944

3.11 Article 15 of the Convention on International Civil Aviation 1944 (the Chicago Convention) provides that every airport in a contracting state which is open for public use by its national aircraft shall be open under uniform conditions to aircraft of other contracting states. Any charges made for the use of airport and air navigation facilities by non-national aircraft may not be higher than those that would be paid by national aircraft engaged in similar operations. In other words, it stipulates no discrimination in the levying of airport charges between aircraft from different member states simply on the grounds of their nationality.

EU/US agreement of 2007

3.12 The EU/US Air Transport Agreement comes into force on 30 March 2008 and replaces the Bermuda II air services agreement between the UK and US governments as amended and supplemented by the Exchange of Notes of 11 March 1994.

3.13 User charges are covered by Article 12 of this agreement and establish the principles against which charges imposed on US airlines should be fixed. Charges are to be just, reasonable, not unjustly discriminatory and equitably

apportioned among categories of users. The terms available to US airlines should be not less favourable than the most favourable terms available to any other airline. Charges imposed on US airlines may reflect, but not exceed, the full cost to the competent charging authorities of providing appropriate airport and other facilities and services, including a reasonable return on assets after depreciation. Facilities and services should be provided on an efficient and economic basis. The article further provides that each contracting party must encourage:

- consultations between charging authorities and airlines;
- an exchange of information between charging authorities and airlines as may be necessary to permit an accurate review of the reasonableness of charges in accordance with the principles of the article; and
- competent charging authorities to provide users with reasonable notice of any proposals for changes in user charges to enable users to express their views before changes are made.

Other bilateral agreements

3.14 Where other bilateral air service agreements between the UK and other governments include an article on user charges these generally refer to the Chicago Convention Article 15 on uniform access conditions and charges.

Better regulation

3.15 The CAA's approach to applying the principles of Better Regulation was set out in the CAA's December 2005 consultation document.²³ These principles are that regulatory activities should be carried out in a way that is proportionate, consistent, accountable, transparent and targeted only at cases where action is needed.

3.16 The Legislative and Regulatory Reform Act 2006 received Royal Assent in November 2006 and entered into force in January 2007. Under this Act all those performing specified regulatory functions are placed under a statutory obligation to have regard to these better regulation principles. The CAA's functions as economic regulator, as set out in Part IV of the Airports Act, are not specified for this purpose²⁴. However, in line with good regulatory practice, in carrying out its function to set a price control for Stansted the CAA would expect to follow the principles of Better Regulation.

²³ 'Economic Regulation of Designated Airports (Heathrow, Gatwick, Stansted and Manchester) from 2008: CAA process for the reviews', CAA, October 2005.

²⁴ The Legislative and Regulatory Reform (Regulatory Functions) Order 2007 specified all of the regulatory functions of the CAA subject to a number of exceptions, which include the CAA's functions under Part IV of the Airports Act. The CAA's functions as economic regulator are specified in Part IV of the Act.

- 3.17 The CAA may also be subject to provisions of the Regulatory Enforcement and Sanctions Bill which is currently proceeding through Parliament and is, in part, directed towards minimising regulatory burdens.

UK and European competition legislation

- 3.18 The CAA's statutory functions and duties are set out in the Airports Act. However, as an 'administrative body of the State', the CAA is also obliged to comply with the UK's duties under EC law in carrying out its statutory functions and duties.
- 3.19 Article 10 of the EC Treaty requires that Member States take all appropriate measures to ensure that they fulfil all obligations arising out of the EC Treaty or resulting from action taken by EC institutions. Further, specifically in relation to competition, Article 3(g) states that the activities of the EC shall include a system ensuring that competition in the internal market is not distorted.
- 3.20 UK airports and airlines operating in the UK are also subject to the provisions of UK and European competition legislation.

The general prohibitions of UK and European competition law

- 3.21 The relevant provisions of UK and EC competition law are set out respectively in the Competition Act 1998 and the EC Treaty.
- 3.22 UK and European competition law²⁵ contain prohibitions of:
- agreements that have anti-competitive intent or effects – the Chapter I (UK) and Article 81 (EU) prohibitions; and
 - conduct that abuses a dominant position – the Chapter II (UK) and Article 82 (EU) prohibitions.
- 3.23 The European Court of Justice has defined a dominant position as:
- 'a position of economic strength enjoyed by an undertaking which enables it to prevent effective competition being maintained on the relevant market by affording it the power to behave to an appreciable extent independently of its competitors, customers and ultimately of consumers.'²⁶
- 3.24 The OFT also states that 'an undertaking will not be dominant unless it has substantial market power'²⁷. Whether an undertaking has market power will depend on the circumstances of each case, with particular focus on the extent to which it faces competitive constraints. Relevant considerations

²⁵ UK and European competition law are based on very similar prohibitions, with the latter requiring an effect on trade between Member States.

²⁶ Case 27/76 United Brands v Commission [1978] ECR 207.

²⁷ For more information see the OFT's guideline on the Assessment of market power, OFT, December 2004.

include the market shares of the undertaking and its competitors, barriers to entry/expansion and buyer power.

3.25 It is the abuse of dominance, rather than the existence of dominance, that is prohibited by UK and European legislation. Abuse of dominance can be categorised into two main types of prohibited abuse, although conduct could have both effects:

- exploitative abuses, whereby a firm can increase prices to consumers and earn monopolistic profits, or use its market power to reduce the need for it to innovate and improve efficiency in order to compete; and
- exclusionary abuses, whereby a firm seeks to distort or reduce competition in the longer-term by harming fair, open competition (enabling it to exploit consumers in the future).

3.26 A firm that is dominant 'has a special responsibility not to allow its conduct to impair undistorted competition on the common market'²⁸. Whilst the price regulation of Stansted would be considered as part of any competition case, price regulation would not of itself exempt the airport from the prohibitions included within competition law.

3.27 Fines may be imposed on undertakings found to be in breach of competition law up to a maximum of 10% of relevant worldwide turnover.

Enterprise Act 2002

3.28 In addition to the provisions of the Competition Act and the EC Treaty, the OFT and the Competition Commission have powers under the Enterprise Act 2002 which can be used to address features of a market that prevent, restrict or distort competition in a market.²⁹ The OFT undertakes market studies in a variety of different policy contexts, and there is a range of possible outcomes, including a market investigation reference to the Competition Commission. The Competition Commission has greater powers than the OFT in relation to the gathering of information and the imposition of remedies in the event that it is found that there are features of a market that are having adverse effects on competition and on consumers. The OFT has the ability to accept undertakings in lieu of a prospective reference to the Competition Commission³⁰, which can sometimes provide a relatively quick route to the resolution of problems. However, it cannot require an undertaking to offer such undertakings.

3.29 The CAA does not have concurrent powers to apply the Enterprise Act in relation to airports. On 30 March 2007, the OFT made a reference to the Competition Commission under section 131 of the Enterprise Act 2002 for an investigation into the supply of airport services within the UK by BAA. The

²⁸ *Michelin v Commission*, case 322/81 [1983] ECR 3461, [1985] CMLR 282, paragraph 57

²⁹ The European Commission also has powers to conduct sector enquiries under regulation 2003/1.

³⁰ For example, on 22 September 2005 Ofcom accepted undertakings from BT in lieu of a reference to the Competition Commission.

Competition Commission has indicated that it plans to report by December 2008. While there is no direct legal connection between the Competition Commission's market investigation and the CAA's review of the future price controls for Stansted, the Competition Commission's conclusions and recommendations in the market investigation could have a bearing on the CAA's final decision on the price controls for Stansted in Q5 which it expects to make in March 2009.

Other potentially relevant aspects of law and policy

European directives

- 3.30 Airports are also subject to the provisions of relevant EU regulations and directives, such as the EU directive on ground handling that is designed to open up the ground handling market at the larger airports in the EU to greater competition.
- 3.31 The European Commission has been developing proposals for an EU directive on airport charges. The directive is still in the early stages of the co-decision procedure and so it is too early to say what the final position will be on the scope of the directive, or when the directive's provisions will be applied to UK airports. This is discussed in more detail in Chapter 2.

ICAO policies and guidance

- 3.32 The International Civil Aviation Organisation (ICAO) has developed policies and guidance that is relevant to the setting of airport user charges. From time to time ICAO publishes its policies on charges, most recently in 2004.³¹ It should be noted that while the UK Government is involved in the development of ICAO's policies on charges levied by airports and air navigation service providers those policies do not have the status of an international obligation of the UK to which the CAA must have regard when setting price controls.

Public interest issues

New public interest issues

- 3.33 As noted in paragraph 3.6 above, the Competition Commission can find that in its airport related activities a designated airport has pursued a course of conduct over the previous five years that has operated or might be expected to operate against the public interest. The Commission's conclusions are final and binding on the CAA. However, once a condition has been imposed the CAA may, under section 51(6) of the Airports Act, further modify or revoke the conditions provided this would not permit the occurrence (or recurrence) of any of the adverse effects of the course of conduct.

³¹ ICAO's Policies on charges for airports and air navigation services – Seventh Edition – 2004, Doc 9082/7.

- 3.34 The CAA is asking interested parties for views and evidence by 17 March 2008 on whether Stansted has, since the last reference on 28 February 2002, pursued a course of conduct which has operated or might be expected to operate against the public interest. The CAA will pass on all responses to the Competition Commission when it makes the reference.
- 3.35 Depending on the number and range of issues raised, though, it might not be practicable for the CAA to give a full and considered view on each of the issues raised, in which case it would simply forward the relevant evidence on the issues raised to the Commission for its own consideration. If it were to follow its practice at previous reviews, the Competition Commission would publish its own invitation for submissions on public interest issues shortly after receiving the CAA's reference.

Existing public interest conditions

- 3.36 In October 2006, the CAA consulted on whether the existing public interest conditions at Heathrow, Gatwick and Stansted imposed by the CAA following adverse findings by the Competition Commission at previous reviews should remain, be amended or could be reviewed³². The public interest conditions applying at Stansted relate to the provision of information on charges for a number of "specified services" and to a turnover related levy on off-airport suppliers of airline catering and cleaning services.
- 3.37 The CAA set out its initial views in an update published in May 2007.³³ Then – in November 2007 – the CAA published proposals for the equivalent conditions at Heathrow and Gatwick³⁴. In respect of these two airports, it proposed some minor amendments to the 'specified services' conditions, to reflect changes to the structure of charges at the airports. It also proposed that the turnover related levy conditions should be revoked, as the Airports (Groundhandling) Regulations 1997 would prevent the re-imposition of such levies.
- 3.38 The CAA expects to publish its decision on whether the existing conditions should be retained, modified or revoked at the same time as it publishes its decision on the new price controls, currently planned for March 2009.

Questions for consultation

- Q.2 Do you agree that the CAA has accurately summarised the relevant legal framework?**
- Q.3 Has Stansted Airport, since the last reference on 28 February 2002, pursued a course of conduct which has operated or might be expected**

³² Heathrow, Gatwick and Stansted airports: Review of existing public interest conditions - Consultation paper, CAA, October 2006.

³³ Heathrow, Gatwick and Stansted airports: Review of existing public interest conditions – an update, May 2007.

³⁴ Price control review - CAA price control proposals for Heathrow and Gatwick airports, November 2007.

to operate against the public interest? If so, could you provide supporting evidence?

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4. Key challenges in setting price controls at Stansted

- 4.1 This chapter sets out the key challenges in setting price controls at Stansted. It is structured in two main sections. The first considers the factors relevant to all airports, and how these might differ from those typically facing a regulator setting a price control on a business with monopoly – or near monopoly – power. The second considers the particular circumstances of Stansted.

General issues faced in regulating airports

- 4.2 There are a number of features of airports that are likely to affect the appropriate nature of any price cap regulation. This section discusses four such features: the differences between airports and utility network businesses; the cost and revenue structure of airports; and the determinants of airport charges in the short and the long term.

Differences from network utilities

- 4.3 Airports do not share the key characteristics of the other major businesses that are subject to ex ante regulation through price controls. Energy and water networks can be characterised as natural monopoly businesses, where the prospects for significant competition between competing infrastructure providers is extremely limited. The regulation of these networks is unlikely, therefore, to affect materially the profitability, or the prospects for investment by, competing providers. Further, many of the outputs provided by these businesses, on which consumers place considerable value, are capable of objective measurement³⁵.
- 4.4 In contrast, there is strong evidence of some degree of competitive interaction between UK airports. The strength of individual interactions, and whether they are sufficiently weak to warrant continued price regulation, is an issue on which there is a range of views and which will differ between airports. However, the fact that there are competitive interactions – that the conduct of one airport can affect the operations and profitability of other airports – does not appear to be substantially in doubt.
- 4.5 Further, the nature of the ‘product’ provided by airports is very different from that which is provided by network utilities. Airports provide a broad range of different services to airlines and passengers, many of which can be provided at a range of different levels of service quality. The value placed by customers on service quality can often be difficult to establish with any great certainty and can be difficult to measure in a robust, objective manner.

³⁵ For example, aspects of service quality, such as the voltage of electricity supplies, can be readily measured.

The cost and revenue structure of airports

- 4.6 Airports are capital-intensive businesses. This means that a large proportion of their costs are fixed and that variable operating costs account for a relatively low proportion of total costs. Further, airports generate revenue from their provision of aeronautical services (accommodating the landing and parking of aircraft, and processing passengers) and from non-aeronautical services, such as car parking and retail activities.
- 4.7 In addition, whilst some capacity expansion can be achieved by relatively moderate capital and operating expenditure, eventually airports are likely to reach points where the next increment of capacity is most efficiently provided by a relatively large (lumpy) increment. This has implications for the pattern of pricing that is likely to emerge from a well-functioning airports market: as demand grows over time there can be periods of relatively high and relatively low levels of capacity scarcity.

Determinants of charges in the short term

- 4.8 In general, the prices set in an airport market in the short-term are likely to be highly dependent upon the balance between the demand for airport capacity and the available supply of airport capacity in the relevant market.
- 4.9 If the available capacity is significantly above market demand this will tend to put downward pressure on the level of airport charges. Indeed, the capital-intensity of airports means that they will face a relatively strong incentive to lower their charges in order to make best use of capacity, as higher passenger numbers bring additional revenues whilst having a relatively low impact on the airport's total costs. In principle, airport charges could, therefore, fall to a level where the airport is only just earning enough revenue to meet the additional costs associated with each extra passenger³⁶. As the costs associated with each additional passenger tend to be very low, this level of airport charges might also be very low. Indeed, as additional passengers generate retail revenues, it is conceivable that airport charges could fall to zero (or, in principle, that the airport pays the airline to operate services).
- 4.10 As market demand grows, the tightening supply-demand balance is likely to result in upward pressure on airport charges reflecting the relative scarcity of that capacity. When assessing its pricing decisions the airport will consider the incremental passengers and/or airline services that might be attracted by lower airport charges and trade this off against higher prices and lower growth in passenger numbers. Where there is relatively little available capacity³⁷ at the airport the incentive to increase prices will be greater, reflecting the physical limits to the potential growth that might be generated

³⁶ More technically, prices might fall to a level that reflects short-run avoidable costs: those costs that would be avoided if the passenger did not use the airport (or the airline service were not operated).

³⁷ In this context, available capacity could be unused capacity or capacity that is being put to relatively low-value uses but which could be used more effectively.

by lower charges. In addition, where there are relatively low levels of available capacity at competing airports there will be an incentive and the ability to increase airport charges.

- 4.11 It should be noted that, in the absence of binding price caps, the level of pricing in the short-term will tend to reflect a number of forward-looking factors – potential demand, incremental costs and the response of competitors – but would not be expected to reflect the historical accounting costs incurred by the airport.

Determinants of charges in the long term

- 4.12 Over the longer-term, the short-term dynamic described above would be supplemented by the potential for airports to expand their capacity, in response to the rising level of airport charges.
- 4.13 In order to prompt investment in additional capacity, prices would need to rise to a level at which the expected incremental revenue from the additional capacity exceeds the incremental cost of investment (including the costs of financing the project)³⁸. In addition, an airport would need to be compensated for the risk that it is accepting in committing to the investment decision that, once started, cannot be easily delayed or reversed³⁹.
- 4.14 As a result, the level of airport charges would, over time, be expected to reflect the future costs of capacity expansion⁴⁰. Further, the fact that airport charges fall below the level of average cost in some periods (as described above) means that in some other periods they will also need to rise above the level of average cost, in order for investments to be remunerated over their lifetime.
- 4.15 The process described above – with prices rising and falling as the supply-demand balance varies – assumes that airports charge airlines on the basis of short-term contracts. However, the volatility of short-term prices, along with the desirability of reducing the risks of longer-term capacity enhancements, might be expected to prompt the airport operator to enter into longer-term contracts with airlines. Indeed, such long-term contracts have emerged at a number of UK airports and are relatively common in other capital-intensive sectors⁴¹.

³⁸ More accurately, incremental investment only requires that the expected level of prices be such that expected incremental revenues exceed expected incremental costs. However, the current level of prices might inform market participants' expectations about the level of future prices.

³⁹ In economics literature this is referred to as the value of the "real option". In this context, the airport would be surrendering the "option" to delay or cancel the investment project and would need to be compensated for the value associated with holding this option.

⁴⁰ Or, in principle, the cost of new entry into the market.

⁴¹ For example, the construction of gas production facilities and large power stations are typically backed by long-term energy sales contracts, to reduce the risk associated with the investments.

Summary – general characteristics of airports

- 4.16 This section has set out a high-level description of the characteristics of airports, how these differ from those of network utility businesses, and the resulting impact on the potential pattern of airport charges that might be expected in a well-functioning airport market.
- 4.17 In such a market, the following are likely to be observed:
- in the absence of longer-term contracts, airport charges will tend to vary over time, reflecting the balance between demand and available capacity;
 - when there is considerable spare capacity airport charges will fall towards levels that reflect the incremental costs associated with accommodating additional passengers and/or airline services; and
 - when there is little spare capacity airport charges will rise towards levels that reflect the incremental cost of capacity expansion and/or new entry.
- 4.18 Significantly, there is no reason to expect that in such a market airport charges would necessarily reflect the level of historical costs incurred, either at any particular point in time or on average over time.

Specific issues faced in regulating Stansted

- 4.19 The following sections consider the particular circumstances faced by Stansted and how they are likely to affect the appropriate approach to setting price caps at the airport.
- 4.20 The CAA discussed the particular challenges associated with setting price caps for Stansted in its December 2005 publication.⁴² In this document, the CAA drew attention to the impact of the uncertainty about the future rate of growth in demand at Stansted and of the ‘lumpiness’ of certain airport investments. The CAA has also previously discussed the importance of considering the degree of competitive interaction between airports when developing the appropriate regulatory framework to be applied to an airport. These issues are discussed in more detail below.

Uncertainties in the rate of demand growth

- 4.21 In respect of demand uncertainty, the CAA noted that the growth in passenger numbers at Stansted had fluctuated markedly, albeit around a strong growth trend, in contrast to the lower and relatively narrow range of annual changes in passengers at Heathrow and Gatwick (and in contrast to the relatively low and stable growth observed in some other regulated sectors of the economy, such as electricity and water).

⁴² ‘Price control review – consultation on policy issues’, CAA, December 2005.

- 4.22 The CAA also noted that the rate of growth at Stansted has proved to be difficult to predict accurately but that there was risk associated with the future rate of growth of demand at the airport and the composition of the users of the infrastructure, and their infrastructure requirements.
- 4.23 Further, the CAA highlighted the link between this uncertainty and the precise timing of infrastructure investment at Stansted. Investment that is too late could lead to capacity being unduly constrained and associated loss of value to end users (e.g. through air fares being higher than might otherwise be the case). Conversely, investment that is too early could lead to much higher costs being incurred, and accordingly higher charges, than would otherwise be the case.

'Lumpiness' of investment

- 4.24 In respect of the lumpiness of investment, the CAA noted that in some utilities markets capacity expansion is possible in relatively small increments, which track demand growth reasonably closely. For airports seeking to expand capacity to meet growing demand, a significant amount of capacity growth can be achieved through such incremental investment. However, there comes a point in time at which the efficient response to sustained increases in demand is the provision of substantial, or 'lumpy', quantities of new airport infrastructure, such as an additional runway and associated infrastructure. Similar issues arise in relation to the major redevelopment and expansion of terminal infrastructure.
- 4.25 Further, the CAA highlighted the potential impact of large and lumpy investment on price caps, particularly where price caps reflect a Regulatory Asset Base that is relatively low compared to the capital investment contemplated.

Extent of competitive interaction between airports

- 4.26 In December 2005⁴³ the CAA also discussed the importance of having regard to the extent of competitive interactions between airports, and set out for consultation its approach to analysing airport competition. The CAA also stressed the importance of ensuring that the regulatory framework provided a level playing field between Stansted and non-BAA airports, on the basis that fair competition between airports promotes the efficient, economic and profitable operation of UK airports and is also likely to be in the interests of all users of airports over the long-term. Further, the CAA noted that a greater impact from competition would increase the possibility that regulation at designated airports could be reduced.
- 4.27 The CAA published its initial analysis of the competitive constraints facing Stansted in December 2006⁴⁴, concluding that, on the basis of the evidence

⁴³ CAA 2005, *op. cit.*

⁴⁴ 'Supporting Paper II' of 'Initial proposals for Heathrow, Gatwick and Stansted airports', CAA, December 2006.

available at that time, whilst there was some risk that Stansted might come to enjoy a position of substantial market power at some point in the longer term, there was no evidential basis for a finding that such an outcome could reasonably be expected.

- 4.28 During 2007, the CAA undertook further analysis of Stansted's market position, and provided advice to the Secretary of State as to whether the airport met the criteria for designation⁴⁵ – a discussion of this process and the CAA's conclusions is set out in Chapter 2.
- 4.29 The CAA's advice presented evidence that Stansted faced significant competitive constraints, although a number of the Stansted airlines disagreed with the CAA's conclusions as to the strength of these interactions and, in particular, whether they were sufficient to limit the market power held by the airport.
- 4.30 In addition, as also discussed in Chapter 2, the analysis undertaken by the DfT might have a bearing on the balance of evidence on the current and/or likely future market position of Stansted Airport. Indeed, the DfT acknowledged that "...on balance, it is probably the case that Stansted airport alone does not currently have substantial market power" and that "...[i]n relation to BAA's common ownership of other airports in addition to Stansted airport, the exercise of market power at Heathrow and Gatwick airports is separately addressed through the CAA setting price caps for these two airports" but that "...it is more likely than not that Stansted airport alone will acquire substantial market power in the future, although this conclusion is finely balanced"⁴⁶.
- 4.31 The CAA set out in Chapter 2 its reasons for concluding that the additional evidence that is presented in the DfT's decision document appears to support the CAA's original analysis of the market position of Stansted and that there is a strong case for considering options for the future regulation of Stansted that place some reliance on the degree of competitive constraint faced by Stansted and the potential disciplining effects of competition law on the conduct of the airport.

Questions for consultation

- Q.4 Do you agree with the summary of the general issues faced in regulating airports? If not, what other issues should be considered?**
- Q.5 Do you agree with the summary of the specific issues faced in regulating Stansted? If not, what other issues should be considered?**

⁴⁵ 'De-designation of Stansted and Manchester airports for price control regulation – the CAA's advice to the Secretary of State', CAA, July 2007.

⁴⁶ 'Decision on the regulatory status of Stansted Airport', DfT, January 2008.

5. Identifying price control options

- 5.1 This chapter identifies options for the future price control at Stansted.
- 5.2 Prior to identifying the options, it assesses the consequences that the application of a 'standard' building-block approach might be expected to have, drawing on analysis contained in previous CAA publications⁴⁷. It also considers approaches to price control regulation that have been taken in other regulated sectors. The final section goes on to identify five options for the future price cap regulation of Stansted.

Consequences of adopting a 'standard' building-block approach

- 5.3 The previous chapter focused on the broad challenges presented by the nature of airports and, in particular, the circumstances of Stansted Airport. This section builds on that discussion by considering the 'standard' approaches to price cap regulation, and the potential impacts that these approaches have on the incentives faced by the regulated companies. This is followed by a consideration, in light of the challenges set out above, of the likely impact of 'standard' building-block price cap regulation on Stansted and the case for not applying, without modification, such an approach. The final section explains why the individual circumstances at Heathrow and Gatwick airports have led the CAA to propose an approach to setting the price caps for these airports that is based on a 'standard' building-block calculation.

'Standard' approaches to price cap regulation

- 5.4 The potential adverse effects of the two main (albeit theoretical) approaches to price cap regulation are well documented. First, rate-of-return (or 'cost of service') regulation allows a company to pass-through the costs that it incurs, and to earn a predetermined return on the regulated assets. This approach will tend to provide the regulated company with an incentive⁴⁸ to incur additional capital costs in order to boost the asset base and, therefore, its profitability⁴⁹ and does not provide the company with an incentive to increase cost efficiency.
- 5.5 On the other hand, RPI-X style regulation provides a company with a predetermined revenue allowance, based on an assessment of the efficient costs of operating the business over a fixed period. This approach will tend to provide the regulated company with an incentive to reduce the outputs, such as service quality and investment, thereby reducing the company's costs and increasing its profits.

⁴⁷ See 'Airports price control review - initial proposals for Heathrow, Gatwick and Stansted', CAA December 2006 and 'De-designation of Manchester and Stansted airports for price control regulation - The CAA's advice to the Secretary of State', CAA, July 2007.

⁴⁸ This incentive effect is referred to as the Averch-Johnson effect in economic literature.

⁴⁹ Assuming that the allowed cost of capital is above the company's actual cost of capital.

- 5.6 In practice, UK regulators tend to apply price caps that include elements of both of these approaches: for example, forecast costs are based on a predetermined return on regulated assets, and within-period efficiency gains are retained by the company. It is also common to define a Regulatory Asset Base (or RAB) in order to inform the calculation of the price used in the RPI-X framework, so that an increase in capital expenditure increases the level of the price cap. In such circumstances, the balance of incentives faced by the regulated company will depend upon the circumstances faced by the company and the detailed design of the price control. Further, this basic approach tends to be supplemented by a range of incentives, ensuring that agreed outputs are delivered (and often rewarding additional outputs) whilst disallowing inefficient expenditure.
- 5.7 UK regulators have also recognised that price caps can be modified, or removed, where competitive constraints have, or are anticipated to, emerge. For example, Ofgem removed the last of the price caps on the retail business of British Gas from April 2002⁵⁰, whilst Ofcom recently removed those applied to BT's retail activities. As a result, the application of price caps is increasingly being targeted only to those areas where the natural monopoly characteristics of the underlying activity are such that competition cannot provide an adequate degree of protection for consumers.
- 5.8 Indeed, the CAA has, in practice, previously augmented this 'standard' approach with additional regulatory processes to cover investment decision-making. For example, at Heathrow and Gatwick the process of constructive engagement – joint airport-airline working – has provided many of the important inputs into the CAA's price control proposals. In this way, a degree of commercial negotiation has reduced the need for intrusive, regulator-led processes.

The impact of 'standard' price cap regulation on Stansted

- 5.9 In December 2006⁵¹, the CAA set out its concerns about the potential impact of applying a building-block approach to Stansted and the possibility that such regulation is distorting the dialogue between and conduct of Stansted and its users, due to the possibility of a mechanistic link between the level of investment undertaken by the airport and the level at which price caps are set (and, therefore, the likely level of prices paid by airlines). These effects are particularly likely to be observed if the value of the RAB is significantly below that of comparable new investment, resulting in prices that are somewhat below those needed to support new investment.
- 5.10 In particular, where future investments are substantial relative to the size of the existing RAB, there is a risk that *specific* investment decisions could be significantly influenced by the effect of an increase on the RAB on the

⁵⁰ The majority of price controls on the retail business of British Gas were removed a year earlier. A further example is the removal of the price control applied to the Rough gas storage business from 1999.

⁵¹ CAA 2006, *op cit*.

general level of the price cap. For example, a RAB-based approach could give a regulated company an enhanced incentive to build *new* facilities if the act of investing gives rise to a loosening of the RAB-based price cap, and thereby permits the company to raise prices to its *existing* users compared to the level it would otherwise be permitted to charge.

- 5.11 The CAA argued that this effect might affect the conduct of the airport and of airline users. First, the airport might be expected to assess the case for significant new investment based partly on additional revenues that it would be permitted to charge for the use of existing facilities, rather than basing its assessment on the costs and benefits flowing from new facilities alone. In this way, a RAB-based approach to regulation could, in certain circumstances, distort the airport's incentives to make efficient, timely investment in appropriate facilities.
- 5.12 Second, and partly as a consequence of the potential distortions to the airport's incentives, airlines might oppose investment on the basis that new investment tends to increase price caps⁵² whereas in more normal commercial circumstances pricing would be determined by market circumstances and commercial negotiation. As a result, airlines' understandable desire to restrain increases in airport pricing becomes focussed on delaying or opposing investment which might, against a background of different incentives, be seen as benefiting future airlines and their customers.
- 5.13 Further, the CAA explained that, given these distortions to incentives, the standard building-block approach to price controls did not appear to be consistent with its statutory duties. For example, over-specified or premature investment would risk undermining the efficient, economic and profitable operation of Stansted and of other, competing, airports. This could undermine the development of competition in the UK airports sector, to the ultimate detriment of users of Stansted and other airports over the longer term.
- 5.14 In principle, the potential adverse effects discussed above might have been evident in previous price control reviews. However, the CAA has not previously placed sole reliance on a building-block calculation when setting the price cap and, in practice, the CAA's price cap regulation of Stansted has not had a significant impact on the operation of, or charges set by, the airport. Instead, normal commercial and competitive pressure has provided the principal protection for users of the airport and stimulus for the airport to invest in incremental capacity and in service quality.
- 5.15 Against this background, in December 2006 the CAA described the ways in which the 'standard' building-block approach might need to be amended and also an alternative approach. In respect of the first, the CAA set out an approach that bases the level of the price cap on the 'standard' building-block

⁵² Relative to the level at which they would be absent this investment.

price cap calculation and augments this with a mechanism that would link the level of the price cap with regulatory approval of the SG2 project including its scope, scale, specification, timing and costing.

- 5.16 The alternative approach, by contrast, was to set a price cap at a level unrelated to the level of investment undertaken by BAA, but at a level high enough to avoid disincentivising investment (either by Stansted or other airports) though not so high as to compromise the reasonable interests of users. This latter approach was referred to as a 'market-led' approach, by virtue of the reliance being placed on market-based interactions to determine the level of prices. These options are discussed in more detail below.

The regulation of Heathrow and Gatwick airports

- 5.17 Following extensive consultation, the CAA proposes to continue to regulate Heathrow and Gatwick on the basis of building-block price cap calculations, supplemented by a range of incentives covering, for example, the delivery of capital investment and of minimum standards of service quality. It is useful, therefore, to consider why the circumstances at these airports differ from those at Stansted in such a way as to justify the CAA proposing different approaches to the regulation of these airports.
- 5.18 It is important, however, to recognise that it should not, in principle, be unexpected that the CAA is proposing different approaches to regulating different airports, even where these airports are under common ownership. Indeed, the principles of Better Regulation specifically refer to the need for regulation to be proportionate and targeted to the nature of the problem at hand. As the characteristics of each airport differ, so do the particular challenges faced by the airport's operator and its users and, therefore, the solutions proposed by the CAA.
- 5.19 It is informative to consider the extent to which the three challenges discussed in the preceding section – demand uncertainty, lumpiness of investment and the extent of competitive interactions – apply to Heathrow and Gatwick, albeit that there are likely to be other differences between the individual circumstances of the three airports.
- 5.20 In respect of Heathrow, the airport is pursuing expansion plans that would increase the value of the airport's RAB by a significant amount in absolute and relative terms – in the region of 40 per cent⁵³ by the end of the next five-year price control period. However, there is airline support for the renewal and enhancement of airport facilities and, prospectively, pending Government decision, expansion of the airport. Relative to Stansted, there is less disagreement about the timing and nature of such expansion. Indeed, airport-airline discussions, under the guise of constructive engagement, have

⁵³ Projected closing 2007/08 RAB at Heathrow of £9,118m and Q5 capital expenditure projected at £3,744m, as set out in 'Price control proposals for Heathrow and Gatwick Airports', CAA, November 2007.

resulted in some consensus on a number of key price control inputs⁵⁴. Furthermore, the strong demand for the use of Heathrow has tended to reduce the uncertainty associated with forecasting demand at that airport. These factors combine to reduce substantially, but do not eliminate, the risk that the CAA's regulation has an adverse impact on investment at the airport.

- 5.21 In addition, Heathrow appears to enjoy a very strong market position, in part due to the combined impact of its surface access links and, through its mix of short- and long-haul services, the significant network effects that limit the degree to which airlines and passengers can switch away from the airport. This is likely to reduce the reliance that the CAA can place on competitive constraints to protect the reasonable interests of users.
- 5.22 In respect of Gatwick, an important distinguishing factor is that the airport operator is not currently pursuing plans for a significant expansion of the airport's capacity, such as new terminals or runways, although the proposed capital investment programme is significant relative to the airport's current asset base⁵⁵. It is also notable that there is broad agreement between the airport and its users over the appropriate capital investment programme, albeit that there have been disagreements over the timing of certain projects. Further, whilst the exact market position of Gatwick is less clear (than that of Heathrow), the airport benefits from a strong local catchment area and, when compared to Stansted, has less extensive overlaps with rival airports both in terms of the relevant catchment areas and in terms of airline services.

Approach taken by other regulators

- 5.23 This section provides a summary of the approaches taken by other regulators that might be relevant to establishing a suitable approach for Stansted. It highlights examples where UK sectoral regulators have adapted their approach to price control regulation in response to the circumstances faced by the companies they regulate and/or the degree of competition.
- 5.24 In general, a number of themes have emerged from the way in which the UK's independent economic regulators have discharged their duties, including:
- Price caps are not always limited to a calculation of the historical costs incurred by an undertaking and it is increasingly common for regulators to apply incentive-based regulation.
 - Price caps are only applied to the parts of an undertaking's business that face insufficient competitive pressure.

⁵⁴ For example, there has been substantial progress on agreeing the scope of the bulk of the capital investment programmes at both Heathrow and Gatwick, and on the scope and level of service quality standards to apply at each airport.

⁵⁵ Q5 capital expenditure projected at £893m, some 57 per cent of the projected closing 2007/08 RAB at Gatwick of £1,569m (source: CAA price control proposals for Heathrow and Gatwick Airports, November 2007).

- Over time price caps have been relaxed and/or removed in response to the existence of existing and/or potential competitive pressure.

Some illustrative examples of these themes are provided below.

- 5.25 One such example is the way in which the British gas and electricity markets are regulated⁵⁶. These markets have made a transition from a position where the industries were dominated by price controlled, vertically-integrated firms to one where competition has replaced price regulation for all but the core monopoly activities.
- 5.26 For example, when British Gas was privatised in 1986 it was the sole purchaser of UK North Sea gas, the monopoly retailer to consumers and the owner of the high-pressure network, local distribution networks and storage facilities. These activities were subject to extensive regulation by Ofgem⁵⁷, including the application of price controls.
- 5.27 The British retail gas market was progressively opened up to competition between 1992 and 1996. In response to the development of retail competition, the price caps on British Gas were lifted in 1999. In addition, a number of other activities have been opened up to competition, accompanied by a reduction in the degree of price regulation, including gas storage, connections and metering.
- 5.28 Similarly, the majority of the British electricity market is free from price control regulation, other than the national and regional electricity monopoly networks. Further, generation capacity (and that of cross-border electricity networks⁵⁸) is provided in a competitive environment, in response to market demand, and is not subject to price regulation.
- 5.29 The regulation of the British energy networks also provides an example of how the 'standard' building-block approach to price cap regulation can be adapted, including through the use of incentives to encourage efficient investment by the monopoly network owners and, in parallel with the restructuring of market participants, reduce to a minimum the parts of the industry not subject to competition. For example, incremental investment in the high-pressure gas transmission network attracts an additional return, to encourage the network owner to expand in response to market demand. This arrangement is accompanied by a series of long-term (+15 years ahead) and short-term (including within-day) capacity auctions, which provide existing and new market participants non-discriminatory access to existing and incremental capacity.
- 5.30 The regulation of UK fixed-line telecommunications provides further examples of how regulation adapts to changing circumstances. For example,

⁵⁶ Ofgem is the sectoral regulator for the gas and electricity markets in Great Britain (but not for Northern Ireland).

⁵⁷ The Office of Gas and Electricity Markets, and its predecessor body Ofgas.

⁵⁸ Electricity infrastructure allowing energy flows between the GB market and the neighbouring EU markets are referred to as "interconnectors".

Ofcom applied different cost of capital allowances for the natural monopoly (copper access network business) and the rest of BT. In addition, in its Strategic Review of Telecommunications, Ofcom accepted undertakings from BT to separate its network and other businesses. Subsequently, Ofcom removed the price controls from BT's retail business.

The options identified

- 5.31 This section describes the key features of the options that have, so far, been identified for setting price caps for Stansted Airport. Subsequent chapters discuss these options in more detail, including the potential rationale for these approaches and their respective costs and benefits.
- 5.32 As noted above, in December 2006 the CAA set out its concern that the application of a 'standard' building-block price cap would risk distorting investment decisions, airport and user conduct, and not best meet its statutory duties. At this time, the CAA identified two options for setting a price cap for Stansted: a market-led price cap; and an augmented RAB based, or building-block, price cap.
- 5.33 The CAA has met with Stansted airlines, both individually and through the Stansted LACC, and discussed their views on the appropriate approach to setting the price control for Stansted. The CAA invited the Stansted airlines to provide the CAA with a short written description of any options that they thought should be considered further. easyJet provided the CAA with an outline of an approach referred to as Terminal Development Tendering, which is discussed in more detail below (as Option 3).
- 5.34 The CAA also raised the issue with BAA, but had no significant discussions with it in this respect. However, BAA had previously set out its views on the approach to regulating Stansted Airport in its submission to the CAA's December 2005 and December 2006 consultation documents.
- 5.35 It should be noted that the options included here might not represent all of the potential approaches to setting a price cap for Stansted: stakeholders are invited to raise alternative options. The CAA requests that stakeholders identify the key features of any alternative options and set out, in brief, why such options are consistent with the CAA's statutory duties.
- 5.36 This document considers the following options:
- Augmented building-block price cap (BBPC);
 - Legacy price cap (LPC);
 - Terminal Development Tendering (TDT);
 - Market-led price cap (MLPC); and
 - Precautionary price cap (PPC)

Each of these options is discussed in more detail in later chapters. The description included below is only intended to provide an overview of the five options, to highlight their distinguishing factors.

Option 1 – Augmented Building Block

- 5.37 This approach would involve setting the level of the price cap using the ‘standard’ building-block price cap calculation, based on historical costs incurred and a forecast of costs to be incurred over the next five-year period.
- 5.38 As described above, such an approach runs the risk of distorting both airport and airline incentives and behaviour. It would, therefore, be necessary to supplement the price cap with additional regulatory processes, in order to mitigate the risk of investment decisions being distorted. In principle, these regulatory processes could place reliance on airport-airline consultation and discussion in order to establish agreement over key aspects of the airport’s investment programme. However, given the incentives on the parties, and the experience of poor airport-airline relations at Stansted, it appears likely that the airport and airlines will not reach substantive agreement on any capital investment plan. It is, therefore, probable that the CAA will be required to determine a number of major elements of the investment plan, potentially extending to decisions on the detailed design of the facilities.
- 5.39 The CAA would also need to establish whether any investment plan was consistent with its duties in respect of users – including prospective airlines and passengers – of other airports, whether designated or not. The CAA would expect to consider, amongst other things, whether: the incremental benefits of expansion of Stansted to its users exceed the incremental costs borne by users; the costs of the proposed development are no greater than necessary; and whether the impact of investment at Stansted unreasonably prejudices feasible investments by rival UK airports, and the development of competition within the UK airport market.
- 5.40 Such scrutiny is a feature of price controls at Heathrow and Gatwick including through constructive engagement. However, the fact that the incentives of the airport and airlines are likely to be distorted, by the impact of the price control on their profits, complicates the CAA’s task: it reduces the reliance that can be placed on their views, in part as their interests might not be aligned with those of passengers and/or future airport users. A consequence of this is that the degree of necessary regulatory scrutiny is likely to be more extensive than might be expected for an equivalent project that had received broad airline and airport support under constructive engagement.

Option 2 – Legacy Price Cap

- 5.41 The key feature of a Legacy Price Cap approach is that a price cap is applied to the existing (i.e. legacy) airport assets – based on the ‘standard’ building-block approach – but incremental investment in capacity and/or improved

service quality would fall outside of this price cap and be free to earn a more commercial return⁵⁹.

- 5.42 This approach would, in principle, allow investment in capacity or service quality to be driven by demand for its use, with the airport either entering into contracts with airlines or undertaking more speculative investment at its own risk. As the price cap on the existing assets would not be adjusted to reflect any expenditure relating to the incremental capacity this would reduce the risk that the price cap unduly distorts investment decisions.

Option 3 – Terminal Development Tendering

- 5.43 The concept behind a Terminal Development Tendering approach was originally outlined by easyJet to the CAA in meetings in December 2007. Under the TDT approach competitive processes would be introduced into the provision of terminal facilities, by putting the development of additional terminal capacity (and related facilities) out to competitive tender. In this document the CAA describes its view of one way in which this concept could be implemented, and highlights some of the detailed design features that need to be resolved.
- 5.44 One key feature of this approach is that the results of the terminal tender would be used to determine whether runway investment was permitted under the price control – with a successful terminal tender ‘triggering’ the construction of a second runway (and other core infrastructure). BAA would not be permitted to participate in this tender to provide terminal facilities but would provide the runway infrastructure.
- 5.45 The terms of the tender would be drawn up by the CAA, in consultation with the airport operator, airport users and expert engineering and financial consultants. This tender would set out the timing, nature and extent of the proposed runway and access infrastructure as well as the price at which this infrastructure would be charged to any provider of terminal facilities. The CAA would also set out the minimum standards for any terminal facilities, together with rules governing the treatment of new entrant airlines and the interface between the terminal and remainder of the airport. It might also be necessary to increase the degree of transparency over airport charges, reflecting the potential for separate charges to be levied for runway and for terminal access and that some of these charges might vary between existing and new assets.

Option 4 – Market-led price cap

58. The MLPC approach places reliance on the competitive constraints faced by Stansted to protect users, and involves the CAA setting a price cap that enables airport-airline interaction to set prices, enabling the CAA to maintain

⁵⁹ In practice the Airports Act would require the CAA to apply a price cap to any incremental capacity. Consistent with the overall rationale for this approach, this price cap could be set in a similar manner to the Precautionary Price Cap proposal, set out as Option 5.

a lower degree of involvement in the detailed operation and development of the airport.

- 5.46 A Market-led Price Cap (MLPC) would be set by reference to a judgement of the relative risks of setting it too high or too low, considered in the context of the CAA's statutory duties. In particular, the price cap would be set sufficiently high so as to remove the risk of serious distortions to investment decisions and to competition, but would also have regard to the degree of risk faced by users that the airport might abuse its market position.
- 5.47 The MLPC would not seek to reflect the short-term balance between supply and demand in such a way as to "second guess" what the market price should be. Rather, the MLPC would be set for five years, based on a forward-looking assessment of the level at which the price cap would not unduly distort behaviour, in the expectation that the level of charges paid would vary below this level, in response to market circumstances – i.e. that the resulting prices paid would be market-led.
- 5.48 In practice, this would involve setting the MLPC at a level that reflects forward-looking measures of costs, such as the current cost of replacing or expanding airport capacity, and have regard to evidence of prices charged by other airports, rather than being based on the level of historical costs incurred at Stansted. As a result, the level of the price cap would not increase in response to investment, removing the distortions associated with the building-block price cap approach.

Option 5 – Precautionary price cap

- 5.49 The final option would also rely on competitive constraints to protect users' reasonable interests. The price cap would be focused on mitigating the risk that circumstances changed in such a way that the airport was likely to abuse its market position. This approach would, therefore, apply the price cap as a precautionary measure, in the expectation that it would not, in practice, be required to constrain prices. For this reason, the CAA has referred to this approach as the precautionary price cap (PPC).
- 5.50 Like the MLPC, the PPC would not seek to reflect the short-term balance between supply and demand in such a way as to "second guess" what the maximum permitted market price should be at any one time. Rather, the PPC would be set for five years, based on a forward-looking assessment of the level above which prices might, if sustained over a period, be viewed as excessive under general competition law.
- 5.51 The main benefit of a PPC approach is that the price cap would mitigate the risk that prices rise to an excessive level in the event that the airport acquires substantial market power. This would remove the need for users to rely on competition law to provide them with protection from being exposed to abuse in the short term. Further, this supplementary protection would correspond to the period over which users might be less able to rely upon competitive

pressure and competition legislation to protect their interests, and potentially remove the need for airlines to take legal action should Stansted seek to increase prices to an excessive level.

- 5.52 The PPC shares some of the characteristics of the MLPC approach, in that the price cap is based on forward-looking measures of cost, and is not linked to the historical costs incurred by the airport. The main distinguishing feature between these two approaches is that the PPC places greater reliance on competitive constraints to protect the reasonable interests of users. This means that the PPC would be set somewhat above the level implied by the MLPC approach.

Transitional arrangements

- 5.53 Some of the above options could be modified to provide for a transition from the level of the current price cap. Such a transitional period could be justified on the basis that it is probably more important to establish a credible long-term framework for investment, rather than focus on the level of the price cap in the short term. Transitional arrangements would also enable airline customers to plan their response to any potential changes in airport charges, whilst facilitating airport-airline commercial arrangements.

Questions for consultation

- Q.6 Do you agree that the circumstances faced by Stansted Airport mean that the 'standard' approach to setting price caps is unlikely to be appropriate for the airport?**
- Q.7 Has the CAA identified all of the relevant potential options for setting a price cap at Stansted Airport? If not, what are the key features of any alternative proposals and how would these proposals be consistent with the CAA's statutory duties?**

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6. Framework for assessing the options: the CAA's statutory duties

- 6.1 This chapter sets out how the CAA will assess the range of options currently identified or those that might be identified in the course of subsequent consultation.
- 6.2 The CAA's assessment must be derived from its statutory duties, as set out in the Airports Act. It is useful, therefore, to consider how these statutory duties should be interpreted.
- 6.3 A number of the arguments set out below have previously been subject to consultation⁶⁰. However, the CAA has sought to expand further on its interpretation of its statutory duties, in order better to facilitate the development of appropriate price cap proposals for Stansted.
- 6.4 The following sections discuss the CAA's statutory duties in turn. As set out in Chapter 3, the CAA is required by section 39 of the Airports Act 1986 to exercise its regulatory functions in a manner which it considers is best calculated:
- to further the reasonable interests of users of airports within the United Kingdom;
 - 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 its functions as economic regulator.
- 6.5 However, it should be noted that the CAA considers that it is required to balance the four duties and that the Airports Act does not imply that any one of the objectives should be given greater weight than the others.

Reasonable interests of users

The first of the CAA's statutory duties is:

“to further the reasonable interests of users of airports within the United Kingdom”

- 6.6 The CAA would expect to bear in mind the impact of decisions on the full range of users: airlines; passengers; cargo shippers; and users during the next price control period and beyond. It will not always be the case that airlines' views represent the views of passengers, nor does the CAA consider

⁶⁰ See, for example, 'Airports price control review - Initial proposals for Heathrow, Gatwick and Stansted', CAA, December 2006

its duty to users applies exclusively to current users or future users, but a balance between the two.

- 6.7 In addition, the CAA would consider the impact of its regulation of designated airports on the users of both designated and non-designated UK airports – the CAA does not consider that it can set price caps at Stansted without considering the potential impacts on other airports, and on the users of these airports.
- 6.8 As to how the CAA should set price controls in a manner best calculated to further users' reasonable interests, this is likely to depend upon the circumstances, and the regulatory options available. However, the focus on "reasonable" interests does imply that a distinction should be drawn between the commercial interests of an airport user and the set of interests to which the CAA should have regard. For example, it could be in the commercial interests of incumbent airlines to argue – either explicitly or implicitly – for measures that would have the effect of restricting the access given to potential competitors. This would not be likely to be viewed by the CAA as being a "reasonable" interest.
- 6.9 In order to provide stakeholders with additional information about the way in which the CAA might view a proposed approach to setting a price cap, it has identified three broad impacts of a price cap that appear to be particularly relevant to the duty in respect of furthering the reasonable interests of users:
- protection against excessive prices;
 - delivery of service quality; and
 - impact of uncertainty on users.

These are discussed in turn below.

Protection against excessive prices

- 6.10 One aspect of the "reasonable interests" of airport users is that consideration should be given to the degree to which they might be exposed to the risk of inappropriately high prices and/or low service levels. Consumers in other sectors of the economy – and of the majority of UK airports – are protected by the combination of competitive pressure, competition law and, in a small number of cases, price regulation). The appropriate degree of protection from price regulation depends, therefore, on the strength of competitive pressure and the effectiveness of competition law.
- 6.11 Further, the CAA's statutory duties do not necessarily imply that the risk of abuse occurring should, or indeed can, be removed completely, for a number of reasons. First, the desire to remove this risk might need to be balanced against other objectives. For example, a 'low' price cap could effectively remove the risk of excessive pricing, but might also prevent efficient airport expansion. Second, there are inevitable limits on the availability of

information that mean that circumstances might change in such a way as to mean that prices that appeared reasonable at one point become abusive at a later stage (or, indeed, vice versa).

- 6.12 Further, when assessing whether a level of charges is excessive the CAA considers that it is useful to make comparisons with what might be expected in the context of an airport market operating under normal competitive constraints. In this respect, the CAA considers that any assessment of the level of charges should be made against measures of forward-looking cost and, in particular, benchmarks of efficient new entry costs and of the costs of airport expansion. Such measures can be useful as charges in a reasonably competitive capital-intensive industry would be expected to rise to a level that facilitates new entry and/or efficient expansion, whilst also putting downward pressure on airport charges at times of relative over-capacity, potentially leading to these charges moving in the direction of short-run avoidable costs.

Delivery of service quality

- 6.13 Aside from excessive pricing (for a given level of service quality), abuse can also take the form of reductions in quality (for a given level of price). In both cases, the price-quality combination offered could constitute abusive conduct. The CAA's statutory duties imply, therefore, that the price cap proposals should reflect the risk that service quality falls to inappropriate levels and the likely impact of the proposals on the service quality received by airport users.
- 6.14 It may also be important to consider both whether the level of prices suitably reflects the standard of service received and whether the price-service combination offered meets the needs to airport users. However, it should also be noted that airport operators will need to consider the needs of current users and of prospective users which, due to the long-lived nature of airport assets, might require investments to take place to enable future service offerings that are not valued by current airport users. For example, new terminals might need to be designed in a way that enables airlines with different business models, or using different aircraft, even if current airlines do not expect to require these facilities. In this way, the interests of current airlines might not align with those of future airlines and, more generally, those of passengers.

Impact of uncertainty on users

- 6.15 In addition to the prices paid and service quality received, it may also be relevant to consider the degree of risk to which airport users are exposed. Additional risk can, for example, increase the cost of airline operations by raising the cost of financing their businesses.
- 6.16 However, it is important to distinguish between the regulatory risk generated by virtue of the airport being subject to price controls and the underlying business risks that reflect the characteristics of the aviation sector. Airport

users are exposed to a range of operational risks, not least the risk that the cost of other key inputs increase or, in the context of airlines, that there is a marked reduction in demand. The normal response to such uncertainty is longer-term contracting, in order to ensure that risk is borne by those most able to manage it. For example, airlines typically enter into contracts to reduce their exposure to fuel price risk and there are examples of airlines entering into longer-term contracts for access to airport infrastructure.

- 6.17 It should also be noted that regulatory uncertainty is a matter of relative degree, as all price control approaches involve an element of regulatory risk.

Efficient, economic and profitable operation of airports

The second of the CAA's statutory duties is:

“to promote the efficient, economic and profitable operation of such airports”

- 6.18 Promoting the economic and efficient operation of airports by airport operators connotes that investment and the day-to-day management of the airport should be undertaken economically and efficiently. In light of the long-term nature of many airport investments, and the link between investment and the delivery of service quality, this assessment will require the CAA to consider both short-term and longer-term incentive effects. For example, the need to promote efficient and economic investment implies that the framework of regulatory policies creates the appropriate incentives on the regulated airport operator, and other operators, to make investment decisions that match users' requirements, subject to the constraints and opportunities within which they operate.
- 6.19 There is the potential for some tension between the promotion of profitability on the one hand, and furthering users' reasonable interests on the other. However, the CAA would expect that encouraging airports to provide the investment that users want and are prepared to pay for effectively requires it to allow for reasonable returns in setting maximum limits. To this extent profitability is consistent with furthering users' reasonable interests.
- 6.20 Further, and in common with the assessment against the first duty, the CAA would consider the impact of its regulation of designated airports on the efficient, economic and profitable operation of both designated and non-designated UK airports. This implies that, for example, the CAA should consider whether its regulation of Stansted would unduly affect the profitability of other UK airports.
- 6.21 The following discussion considers the broad impacts of a price cap in respect of promoting: first, the efficient and economic operation of airports; and, second, the profitable operation of airports. These are discussed in turn below.

The economic and efficient operation

- 6.22 The economic and efficient operation of airports implies that the CAA should exercise its functions in a manner that ensures that key decisions associated with the operation of the airport – including investment decisions – are economic and efficient.
- 6.23 In general, the economic and efficient operation of airports implies that the CAA should consider whether the airport will have an incentive to reduce the cost of the services that it provides. However, an additional element is whether the airport provides the appropriate services, in terms of facilities that users demand, and an appropriate level of service quality.

The profitable operation of airports

- 6.24 In this context it is useful to distinguish between the impact on Stansted Airport and on other UK airports.
- 6.25 In relation to the impact on Stansted, the CAA's duties imply that a designated airport should be permitted to recover efficiently incurred costs. By implication, a price cap should be set no lower than a level that enables the airport operator to remunerate efficiently incurred capital and operating costs.
- 6.26 In relation to the impact on other airports, the CAA's duties relate to all UK airports and are not limited to just those airports that are designated. A practical implication of this is that the CAA must consider the impact of its regulation of the designated airports on non-designated airports and on users of non-designated airports. Reflecting this, the price control should seek to avoid undermining the development of competition between airports and, therefore, acting against the long-term interests of passengers. In this respect, it is particularly important to ensure that regulation does not introduce a systematic bias against investment at non-designated airports and in favour of investment at designated airports.

Investment in time

The third of the CAA's statutory duties is:

“to encourage investment in new facilities at airports in time to satisfy anticipated demands by the users of such airports”

- 6.27 The CAA recognises that the decisions that it takes on price controls, including the policies and statements that accompany such decisions, can have a significant impact on the incentives of an airport operator to invest. The CAA therefore has a responsibility to develop regulatory policies that create the appropriate incentives on airport operators to bring forward investments as far as possible in time to meet anticipated demand.

- 6.28 Further, and in common with the assessment against the first and second duties, the CAA would consider the impact of its regulation of designated airports on the prospect for investment at both designated and non-designated UK airports. This implies that, for example, the CAA should consider whether its regulation of Stansted would unduly discourage competing UK airports from investing in new facilities.
- 6.29 The CAA has identified the importance of ensuring that the regulatory framework provides the best chance of the right level of investment, in the right infrastructure, delivered at the right time⁶¹.
- 6.30 In this respect, the CAA has identified three broad impacts of a price cap that relate to the CAA's duty in respect of encouraging investment in time to meet demand:
- investment at designated airports;
 - investment at non-designated airports; and
 - the impact of uncertainty on airport investment incentives.

These are discussed in turn below.

Investment at designated airports

- 6.31 The level and nature of capital investment is an important element of the operation of an airport. Investment not only determines the availability of capacity but it also has a substantial impact on the level of service quality that can be provided to airport users.
- 6.32 The long-term nature of investment, and the uncertainty associated with future demand, increases the importance of ensuring that the airport faces appropriate incentives to manage demand uncertainty, through appropriate demand forecasting and developing the airport in a way that enables it to respond to changes in the level and/or nature of demand.
- 6.33 A further important aspect is the value that can be achieved through effective airport-airline discussion. If airports and airlines have incentives to cooperate and take forward development proposals together this is likely to improve the quality of the investment plan, as it is likely to be based on a better understanding of the needs of airport users. However, the airport and its current airline users will not necessarily be expected to agree over all aspects of the airport's development. The airport operator might need to incorporate the needs of future airline users and/or ensure that the airport's developments properly reflect the interests of current and future passengers.
- 6.34 Overall, it is likely that the impact of the price control on incentives to invest will be an important element of the CAA's overall assessment. In particular,

⁶¹ 'Airports price control review - Initial proposals for Heathrow, Gatwick and Stansted', CAA, December 2006

the CAA will need to consider whether the structure of the price control encourages the right level of investment, in the right infrastructure delivered at the right time.

Investment at non-designated airports

- 6.35 As discussed in Chapter 6, the CAA's statutory duties relate to all UK airports, and not just designated airports. A consequence of this is that the CAA must consider the impact of the price caps at designated airports on non-designated airports, the users of these airports and the impact on investment at these airports.
- 6.36 The long-term nature of many airport investments, and the fact that once they are built it is difficult to recover their value by putting them to alternative uses, means that major investment decisions are likely to have a significant impact on the development of the airports market and on competition between airports. Once an airport has expanded its capacity, competing airports must respond to this situation over the longer-term.
- 6.37 It is important, therefore, for the CAA to ensure that its regulation of designated airports does not unduly distort investment decisions between designated and non-designated airports. Potential adverse impacts could arise in a number of ways. For example, if the price cap at a designated airport were set at a particularly low level this could put downward pressure on the revenue that a competing airport could earn, undermining potentially efficient investment.
- 6.38 Furthermore, if the price control framework resulted in an incentive on designated airports to invest in over-specified projects, or to invest prematurely, this would risk introducing a systematic bias towards investment at designated airports and away from investment at non-designated airports. This would risk undermining the long-term development of the airports market.

Impact of uncertainty on airport investment incentives

- 6.39 The long-term nature of many airport investments means that the financial return to investment might be expected to be generated sometime in the future. In the context of a regulatory framework that only permits price controls to be set for an initial period of five years, this implies that the incentives faced by a designated airport to invest will, in part, depend upon the airport's expectations about the future regulatory treatment of these investments. Further, any significant uncertainty associated with the future regulatory treatment of investment, will tend to increase the required financial return associated with the project, discouraging investment and/or raising costs to airport users. The CAA will, therefore, need to assess the potential impact of its proposals on uncertainty and on the prospects for efficient investment.

- 6.40 However, this uncertainty should be set in context, as regulation is not the only source of risk: designated and non-designated airports are exposed to a range of operational and market risks. Further, it should be noted that the potential for the price cap and investment at designated airports to affect non-designated airports means that the regulatory uncertainty can also adversely affect these non-designated airports.

Minimum restrictions

The fourth of the CAA's statutory duties is:

“to impose the minimum restrictions that are consistent with the performance by the CAA of its functions”

- 6.41 The duty to impose the minimum restrictions necessary implies that any regulatory solution should be proportionate to the risks it is aimed to address. In the context of setting limits on airport charges, this suggests that it might not necessarily be desirable to bear down heavily on airport charges, for example by setting a relatively tight price cap, in circumstances in which competition from other airports – together with general competition law – is likely to provide reasonable protection of users' short and longer term interests.
- 6.42 The CAA notes that this objective is also consonant with the objective of the five principles of better regulation.

Questions for consultation

- Q.8 Do you agree with the CAA's interpretation of its statutory duties? If not, how should the CAA interpret these duties, and on what basis?**

7. Option 1: the augmented building-block approach

Introduction

7.1 This chapter sets out the key features of an augmented building-block price cap (BBPC) approach, the level of the price caps that might be implied by such an approach and an initial assessment of this approach against the CAA's statutory duties.

Key features of the augmented building-block approach

7.2 Chapter 5 explained why the CAA does not consider that a price cap based *solely* on the 'standard' building-block price cap calculation would meet its statutory duties in respect of Stansted.

7.3 Against this background, this chapter presents an option – the augmented building-block approach – that bases the level of the price cap on the 'standard' building-block approach but augments this with additional regulatory processes to provide detailed scrutiny over the design, timing and cost of the airport's capital investment programme. These two aspects of this approach – the 'standard' building-block price cap and the necessary 'augmentation' – are discussed in turn below.

The 'standard' elements of a building-block price cap

7.4 In order to set a 'standard' building-block price cap it is necessary to determine not only the building-block price cap but also the package of incentives that is typically applied as part of the price control framework. These are discussed below.

Building-block price cap calculation

7.5 In general terms, the building-block calculation sets the price cap in order to allow the airport to recover an appropriate proportion of the capital costs previously incurred and the costs expected to be incurred over the next five-year period. In practice, however, there are a number of different approaches to this calculation and the way that the price cap is implemented.

7.6 In its recent price control proposals document for Heathrow and Gatwick airports the CAA set out details of how the 'standard' building block price cap calculation has typically been applied to designated airports. Under this approach a regulated asset base (RAB) is defined and valued. As time progresses, capital expenditure is added to the RAB and the balance of the RAB is depreciated. The RAB has a significant influence on two of the fundamental building blocks that make up the company's revenue requirement: the cost of capital⁶² (the return on the RAB) and the

⁶² The cost of capital allowance is calculated by multiplying the regulator's assumed cost of capital by the average value of the RAB for each year. No adjustment is made to the RAB as a result.

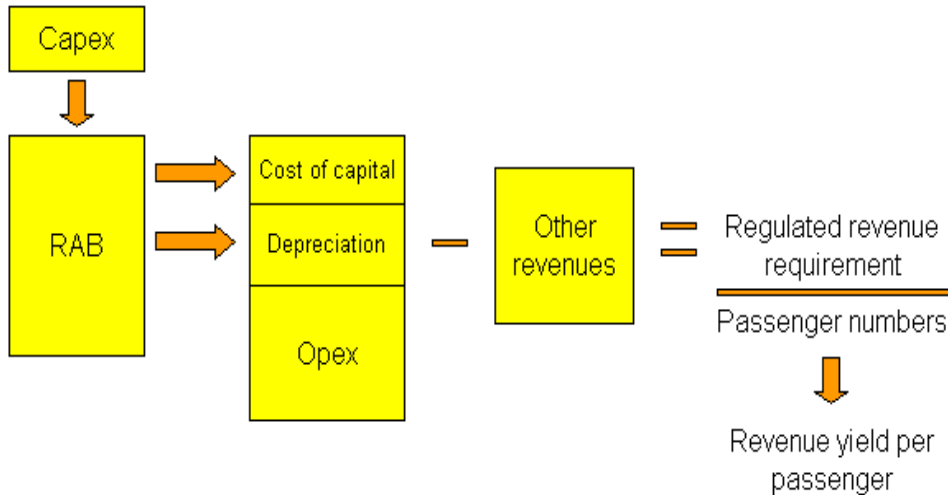
depreciation allowance⁶³ (return of the RAB). These two building blocks are then added to the projected level of operating expenditure to calculate the total revenue requirement for the business.

7.7 Account is then taken of the projected revenues from commercial activities and from non-regulated charges, deducting these from the total revenue requirement – this is referred to as the ‘single till’ approach.

7.8 After deducting these revenues, the remainder represents the revenue to be recovered through regulated airport charges. As the CAA currently sets price controls in the form of a revenue yield per passenger, the required regulated revenues are then divided by projected passenger numbers.

7.9 Figure 7-1 below illustrates the key components of the building block approach. Together these combine to produce a projection of the revenues from airport charges which an efficiently-run airport would need to meet the capacity, service and investment requirements of airport users.

Figure 7-1 The standard regulatory building block approach



7.10 The key factors driving the regulated revenue requirement tend to be: the prevailing value of the RAB, and the projected increases to the RAB from net capital expenditure; the projected cost of capital; the projected operating expenditure and revenues from commercial activities and non-regulated charges. In addition, the assumptions made about future traffic levels are likely to have a significant impact on the level of the price cap.

Process for establishing the individual building blocks

7.11 Each of the individual building blocks would need to be established in order to calculate a BBPC. This process involves CAA and CC analysis, the work of external consultants and consultation with interested parties. This is a complex and resource-intensive task. In practice, much of this work will be

⁶³ The depreciation allowance is determined by the overall value of the RAB, and the asset lives and age of the existing assets contained within it. The RAB is reduced annually by an amount equal to the annual depreciation allowance.

conducted during the Competition Commission's review, before reverting to the CAA later in the year.⁶⁴

- 7.12 At Heathrow and Gatwick, the CAA has been able to draw on extensive evidence provided through constructive engagement (CE). This is a process established by the CAA, which encourages structured consultation between each airport operator and its airline users in order to provide an opportunity for users and the airports to put forward evidence to influence the regulatory process. In addition, the CAA commissioned a number of independent consultancy studies and undertook its own detailed analysis in certain areas to provide a comprehensive set of inputs into setting price caps at Heathrow and Gatwick.
- 7.13 However, at Stansted there is a significant divergence between the views of the airport operator and those of its airline customers on the future development of the airport. In contrast to Heathrow and Gatwick, there is likely to be considerable disagreement over the appropriate capital expenditure programme for the airport, both in terms of expenditure relating to increasing the capacity available from the current runway (referred to as 'Generation 1', or SG1) and any second runway (referred to as 'Generation 2', or SG2⁶⁵).
- 7.14 In addition, there are aspects of the building-block calculation that are unlikely to be agreed by both the airport and airlines, due to the 'zero-sum' nature of the calculation. In particular, based on the views already expressed by the respective parties, the following aspects of the building block calculation are likely to be particularly contentious:
- traffic forecasts;
 - cost of capital; and
 - opening value of the RAB, including whether costs incurred by the airport operator associated with the Stansted G2 project (referred to as 'preliminary expenditure') should be capitalised in the opening RAB.
- 7.15 Further, when the CAA establishes the appropriate opening value of the RAB for the next price control period, it assesses whether the airport has undertaken its capital investment programme in an efficient manner. Where there is evidence of inefficient expenditure, it is open to the CAA to disallow appropriate amounts from the airport's price control allowance. This approach contrasts with the process of capital scrutiny described below, where such ex post scrutiny would be supplemented by detailed ex ante approval of investment plans.

⁶⁴ The CAA will continue its analysis during the CC's review and will be working closely with the CC to avoid any unnecessary duplication of work.

⁶⁵ The airport operator further distinguishes between phase 1 and phase 2 of the SG2 project. Phase 1 relates to the first phase of capital expenditure required to bring the second runway into operational use. Phase 2 would deliver additional capacity, when demand was sufficient to justify further expansion.

Incentives and price cap design

- 7.16 The design of the price control emerging from the Competition Commissions' report and the CAA's proposals for Heathrow and Gatwick to some extent set the scene for considering the design of the price control for Stansted. However, there are some major distinguishing factors between Stansted on the one hand and Heathrow and Gatwick on the other which may point to the need for some differences in the detail of the 'standard' price control at Stansted, in order that it is best calculated to meet the CAA's statutory objectives. Some of those differences were set out in the CAA's consultation paper in December 2006 and were addressed in the CAA's policy update in May 2006.⁶⁶
- 7.17 For example, the CAA would need to establish the:
- form of the price cap, including the degree of volume-risk sharing;
 - treatment of within-period and between-period over/under-recoveries of actual revenue against forecast revenue; and
 - need for, and form of, any service quality incentives.
- 7.18 In respect of the first, the current Stansted price control is expressed in terms of a maximum allowable yield per passenger. This means that within the five-year control period all of the volume risk is borne by the airport – higher traffic volumes will increase, and lower traffic volumes will reduce, the maximum allowed revenue.
- 7.19 In its December 2005 consultation paper the CAA considered whether this was the most appropriate allocation of this risk. Following this consultation the CAA's May 2006 policy update rejected such an approach for Heathrow and Gatwick but it considered it worthwhile to develop possible options for volume sharing at Stansted, alongside an option to continue with the existing approach. This potential difference in the treatment of Stansted reflected greater uncertainty around rates of growth and that significant variances from forecasts could lead to significant variances in profitability. It also reflected airlines' continuing concerns that the projections adopted for the price control might favour BAA, although they did not support volume sharing.
- 7.20 The CAA has not developed risk-sharing options in the interim, but notes that, in principle, it would be open to the airport and its users to enter into contracts that distribute risk in a different way to that implied by the price control settlement. The CAA proposes to ask the Competition Commission to consider this issue further.
- 7.21 In respect of the second issue, it would be necessary to set out in the Regulatory Policy Statement the CAA's intended approach to both within-

⁶⁶ 'Airports price control review - Initial proposals for Heathrow, Gatwick and Stansted', CAA, December 2006 and 'Airports review - policy update', CAA, May 2006.

period and between-period under/over-recoveries. For Heathrow and Gatwick the CAA has proposed to allow the Q5 charge control to recover any under- or over- recovery (in terms of the absolute amounts rather than the amount per passenger) generated during Q4.

- 7.22 The circumstances for Stansted might, however, justify a different approach. Whereas the general over – or under – recovery for Heathrow and Gatwick has arisen through small year-by-year forecasting errors in the composition of traffic, the under-recovery of published charges against the price control at Stansted has been accumulated because the airport has set published charges lower than the price cap through the charge control period, and the cumulative shortfall is significant. It would also be necessary to consider the impact of the treatment of under/over-recoveries on the incentives faced by the airport to invest, as allowing under-recoveries to be rolled forward would improve the ability of the airport to recover its investment costs, facilitating appropriate investment by the airport.
- 7.23 In respect of service quality, the regime proposed for Heathrow and Gatwick includes two mechanisms directed at providing incentives for service quality: a standards and rebates mechanism, to encourage the airport to meet certain minimum standards, and a bonus scheme to reward the airport for exceeding individual standards across the whole airport. The standards and rebates mechanism was first introduced at Heathrow and Gatwick in 2003 following a public interest finding by the Competition Commission that charges did not reflect differences in quality to the extent that would occur in a competitive market. The Competition Commission made no equivalent public interest finding in respect of Stansted at that time.
- 7.24 In principle, the airport should face incentives to ensure that service quality is appropriate and reflects the levels specified in any capital projects for which costs are allowed under the BBPC. These incentives could be defined in commercial agreements between the airport and its airline users. The CAA would need to consider whether there was a case for supplementing any such incentives with specific measures under the price control. It is mindful of the risk that such regulation could ‘crowd out’ normal commercial negotiations and arrangements.

‘Augmentation’ of the building-block calculation

- 7.25 Chapter 4 explained the key challenges for setting price caps for Stansted, highlighting the scale of the expansion contemplated by the airport owner, whilst Chapter 5 explained the potential impact of applying a ‘standard’ building-block price cap and, in particular, the risk that it might distort investment decisions and competition between airports.
- 7.26 A price cap based on the ‘standard’ building-block calculation would, therefore, need to be augmented in a way that mitigates this risk to investment and competition, and reflects the particular circumstances of Stansted. This would involve determining a process for approving capital

expenditure and, related to this, could include a package of incentives designed to encourage timely delivery of investment projects. These two aspects are discussed below.

Process for approving capital expenditure

- 7.27 A major issue for the Stansted Q5 price control review is the treatment of expenditure relating to the potential expansion of the airport. The expansion could be very significant, involving the construction of a second runway and associated facilities, and would be likely to have a major impact on the costs incurred by the airport.
- 7.28 However, there will not be a definitive decision on whether this expansion will be permitted or on the detailed design and cost of such an expansion before the Q5 price controls are implemented. Any building-block price control may, therefore, need to provide a mechanism for dealing with uncertainty associated with this very significant element of the airport's capital investment plan.
- 7.29 The process of scrutiny of additional capital expenditure and approval could take one of two general forms:
- **Airline-Airport led**
This approach would involve a process of airline-airport discussions with a view to reaching agreement on key aspects of the capital expenditure programme, with subsequent assessment by the CAA in order to resolve any disagreements and to ensure that agreements are consistent with the CAA's statutory duties.
 - **Regulator-led**
This approach would involve the regulator taking a more active role in the process for establishing the appropriate capital expenditure programme. The CAA would invite submissions from the airport operator, consult upon a range of proposals and then take decisions as to whether the proposed capital expenditure should be allowed.
- 7.30 The LACC Stansted has set out one proposal for how such a regulator-led process could work. This process would require the CAA to set a 'default price cap' relating to core facilities and services that would apply in the event that investment in additional capacity was not undertaken. This would then provide a baseline against which airport-airline discussions could take place about the provision of facilities and services above this basic service, including expansion of the airport. BAA would then be required to provide airlines with information on the additional costs and benefits to users which would arise from any proposed investment plan.
- 7.31 These discussions would centre around a series of CAA-led workshops, with CAA arbitration on disputes that might arise during the process, at the request of the airport or any airline. In addition to this ongoing involvement,

the CAA would also need to approve the final investment programme, to ensure that the proposals were consistent with its statutory duties. It would be open to the airport and airlines to propose alternative funding arrangements, including direct funding from airlines outside of the price cap.

7.32 In light of the distorted incentives and experience of airport-airline relations at Stansted, it appears unrealistic to assume that the airport and airlines will reach agreement on all – or even a significant part – of the capital investment plan.

7.33 In practice, therefore, the CAA is likely to be called upon to determine a number of the major elements of the investment plan, potentially extending to include the detailed design of the facilities. This would be a complex task that would involve extensive analysis, drawing on a range of detailed consultancy studies.

7.34 In contrast to the studies commissioned for Heathrow and Gatwick, which focused on a small range of issues against a background of broad user support for the overall investment programme, it could be necessary to assess all of the major elements of the capital investment programme. For example, CAA, CC and external scrutiny might be required of the following:

- **Design of facilities**

This could include the location and specification of the runway and taxiways, as well as the terminal and surface access facilities. The design of the facilities will also need to consider the appropriate level of service quality, in light of the cost of and the value attached by airport users (current and future) to various approaches.

- **Timing of facilities**

This would require analysis of the various traffic forecasting methodologies and the assumptions used to generate these forecasts. It might also be important to consider the alternative phasing of any expansion, trading off higher up front costs with more flexible phasing at higher overall cost.

- **Efficient cost**

The analysis of alternatives would require a detailed understanding of the efficient cost of providing the various options and how these costs might be affected by different options for phasing expansion.

7.35 Under this approach, before the investment was undertaken, the airport would require regulatory approval not only for the broad scope and cost of its proposed investment plan – as is the case under the ‘standard’ approach – but also potentially for the detailed design, timing and cost of individual investment projects. This approval would depend upon whether the CAA considered that the investment plan was consistent with its statutory duties, including those to other airports and their users. This contrasts with the ‘standard’ approach where more reliance is placed on the incentives placed

on the airport operator by the more limited ex post review of the airport's actual investment decisions.

- 7.36 The fact that the incentives of Stansted and its users are likely to be distorted further complicates the CAA's task, as it reduces the reliance that can be placed on their views, in part as their interests might not be aligned with those of passengers and/or future airport users. A consequence of this is that the CAA is likely to require significantly more information, and take on a more proactive role, than might be the case if the CAA could have placed reliance on airport-airline agreement as a signal of whether the proposals were likely to be consistent with its statutory duties.
- 7.37 For the CAA to gain the necessary degree of comfort that proposals met its statutory duties the CAA would, therefore, need to undertake a detailed assessment of whether: the incremental benefits of expansion of Stansted to its users exceed the incremental costs borne by users; the costs of the proposed development are no greater than necessary; and the impact of investment at a designated airport unreasonably prejudices feasible investments by rival UK airports, and the development of competition within the UK airport market.
- 7.38 In addition, where the CAA has had a significant impact on the design and timing of the investment programme, its subsequent involvement in the operation of the airport will tend to increase, as the service quality offered by the airport operator will be affected by the decisions previously taken by the CAA.

Need for and design of capital expenditure triggers

- 7.39 A further element of the price control treatment of investment is the potential need for, and design of, capital expenditure triggers. These incentives link the price cap to the achievement of certain milestones in the capital investment programme. A deferral of investment would tend, therefore, to reduce the revenue that the airport is allowed to recover from users.
- 7.40 The CAA has proposed capital triggers for Heathrow and Gatwick and stated that the choice of triggers should be guided primarily by the following criteria:
- triggers should be based on the achievement of steps with demonstrable benefit to users;
 - the airport should have management control or substantial influence over the determining elements of the success of the projects;
 - performance should be objectively measurable with an unequivocal test of success;
 - the optimum capital programme (in terms of content, order and phasing) should be reasonably predictable for a sufficient period;

- the existence of an incentive mechanism should not itself distort delivery of the programme away from the best outcome that can be achieved based on all emerging information; and
- the additional risk implied by basing reward more on delivery and less on capital spend should be the best use of the airport's capacity to bear risk.

7.41 In considering whether the CAA should apply capital investment triggers at Stansted, the CAA is mindful that there is less consensus between the airport and airlines around the composition of the investment programme and, more fundamentally, there is greater uncertainty around the rate at which traffic will grow and therefore the optimum phasing of the programme.

7.42 The CAA recognises that users may want some comfort that the airport would not be rewarded for failing to deliver new investment for which an allowance for returns had been made in any price cap projections. However, it is also mindful that its incentives should not force the airport to continue with a given programme even if new information on demand or alternative solutions means that the investment is unnecessary or sub-optimal. This greater degree of uncertainty means that constructing a meaningful set of capital expenditure triggers could be more difficult than at Heathrow or Gatwick.

Illustration of a building-block price cap

7.43 The following section sets out an illustration of the building-block price cap calculation. This illustration requires each of the building blocks to be estimated. For this purpose, the CAA has used data provided by BAA⁶⁷. While the CAA has carried out a high level sense check of BAA's projections, it has not yet drawn any conclusions on BAA's forecasts. To provide some further context, the CAA has also set out an illustration of the potential impact on price caps of some plausible variations in a number of key 'building blocks'.

7.44 As discussed above, in order for this option to be implemented, it would be necessary to scrutinise each of the building-blocks, which would include consideration of the underlying cost and revenue information at a greater level of disaggregation than presented below.

7.45 The relative importance of each building block varies between airports, depending in particular on the stage of the airport in its investment cycle, which affects the capital charges, and the nature of the airport's operations and traffic mix, which can affect both operational expenditure (opex) and other revenues. Table 7-1 sets out the scale and proportions of these building blocks at Stansted as forecast by the CAA for the current control period Q4 when setting the price control in 2003.

⁶⁷ In particular, the illustration relies on BAA's most recent long-term financial forecasts for Stansted, provided to the CAA in September 2007.

Table 7-1 Stansted building blocks for Q4 price cap

Totals for Q4, 2007/08 prices	£m	% of total revenue requirement
Opex	642	52%
Depreciation	197	16%
Cost of capital allowance	405	33%
Total revenue requirement	1,243	100%
Commercial revenues	648	52%
Other adjustments	36	3%
Required revenue from airport charges	557	45%

Source: CAA policy paper, December 2005

Traffic

- 7.46 The CAA understands that BAA's traffic forecasts for Stansted in Q5 and beyond have been produced using the same framework that it uses to forecast traffic for Heathrow and Gatwick, with the addition of a final adjustment, at Stansted only, to allow for the potential impact on passenger throughput of increases to air fares arising from higher airport charges.
- 7.47 Table 7-2 below presents BAA's traffic forecasts for Stansted. BAA considers that EU-US 'Open Skies' is unlikely to have a significant impact on traffic volumes at Stansted. BAA's projections also assume: (i) the granting of permission to develop traffic beyond 25 million passengers per annum (mppa) (pending the result of the SG1 Inquiry); and (ii) SG2 opening in summer 2015.

Table 7-2 Indicative building block price cap: BAA forecast passenger numbers (mppa)

Year	Passenger, millions
2006/07 (actual)	23.8
2007/08	24.7
2008/09	25.1
2009/10	26.1
2010/11	27.3
2011/12	28.6
2012/13	30.0
2013/14	31.5
2014/15	33.0
2015/16	38.0
2016/17	41.5
2017/18	45.0

Source: BAA

- 7.48 Recent data from BAA suggests that actual passenger numbers in 2007 were only 0.3 per cent higher than in 2006, suggesting that the passenger number projections included by BAA in its submission might need to be revised. These forecasts also assume that the airport will be granted the necessary

planning consents to expand its operations. Any failure to do so would also require a revision of these forecasts.

Operating costs

- 7.49 Operating costs include the costs of staffing the airport, police costs, rent & rates, utility costs (including gas, electricity and water), maintenance of equipment such as escalators, lifts, travelators etc as well as cleaning, IT and other corporate costs such as HR, legal and marketing. Table 6-3 sets out BAA's projections of operating costs over Q5 including BAA's forecasts for 2007/08.
- 7.50 Following the DfT's decision that direct charging for ongoing aerodrome air navigation services at Stansted (and other airports) should be brought to an end by 1 April 2008, the operating cost projections also include an estimate of the payment that BAA will be making to NATS for providing these services.⁶⁸
- 7.51 Table 7-3 sets out BAA's projections of operating costs over Q5 including BAA's forecasts for 2007/08.

Table 7-3 BAA projections of operating costs for Q5

£ million 2007/08 prices	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	Q5 total
Opex	138	145	147	154	159	165	168	792

Source: BAA

Commercial and other revenues

- 7.52 Commercial revenues are one of the key regulatory building blocks: under the single till, they make a substantial contribution to each airport's overall revenue, thereby reducing the amount to be raised by airport charges. The single till regime also provides an ongoing incentive for an airport operator to secure higher commercial revenues within the control period. In order that users benefit appropriately from growing commercial revenues, the CAA needs to come to an informed view about the future path of commercial revenues at each airport and to factor this into the price cap calculation at the start of Q5. Commercial revenues include income from catering, car parks, bureaux de change, retail outlets and from property.
- 7.53 The revenue from non-regulated charges includes income from non-aeronautical services which are provided by the airport to airlines and other companies operating at the airport primarily for the purposes of providing services to passengers and other end-users. In broad terms, the charges relate to servicing of aircraft, the handling of passengers, baggage and cargo, and the occupation and use of airport property.

⁶⁸ Aberdeen, Edinburgh, Gatwick, Glasgow, Heathrow and Stansted are currently designated by the Secretary of State for Transport under section 77(3) of the Transport Act 2000 for the so-called 'direct charging' of aerodrome ANS. The DfT has announced a policy decision to end direct charging, although the timing of this may vary between these airports.

7.54 Table 7-4 sets out details of BAA's projections of commercial and other revenues over Q5 including BAA's forecasts for 2007/08.

Table 7-4 BAA projections of commercial and other non-aeronautical revenues over Q5

£ million 2007/08 prices	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	Q5 total
Commercial revenues	96	96	99	103	107	111	106	525
Non-regulated charges	16	10	10	10	10	10	10	51
Other revenues	0.2	0.2	0.2	0.2	0.2	0.2	0.2	1
Total other revenues	112	107	109	113	117	121	116	577

Source: BAA

Capital expenditure

7.55 BAA has grouped investment at Stansted into two distinct categories; that which supports the growth of the airport within the capacity constraints of the existing runway (SG1) and investment supporting the progression through planning and subsequent development of a second runway and associated infrastructure (SG2). It should be noted that all of the numbers presented in this document are based on a submission made to the CAA in September 2007. BAA has recently updated their projections, but the CAA has not used these updated projections for the purpose of calculating the illustrations set out in this document.

SG1 capital expenditure

7.56 BAA forecasts that passenger numbers at Stansted will reach around 33 million passengers by 2014/15 and around 38 million in 2015/16 assuming the opening of the second runway in 2015. BAA states that Stansted has a programme of investment to deliver the infrastructure able to deal with this volume and profile of traffic. BAA has identified three programmes for Q5 which it refers to as, 'Capacity', 'Safety, Security & Sustainability' and 'Asset Replacement'.

7.57 The capacity programme is focused on the delivery of infrastructure to enable throughput of around 35 million passengers by 2015/16. BAA states that work commenced on the arrivals extension in March 2007 with a phased completion scheduled from Summer 2008. Further developments are expected to include a new satellite, a departures extension and, in parallel with the creation of this additional space, improvements identified for the baggage handling system. BAA states that apron stand construction will continue beyond 2007/08 with completion of new cul-de-sacs by Winter 2009 and the Hotel taxiway extension, which it expects to complete by Winter 2015.

7.58 In relation to safety, security & sustainability, BAA states that the plans incorporate the completion of a £3m investment in security improvements following the changes to security screening requirements that occurred from August 2006.

7.59 In respect of asset replacement, BAA also considers that significant parts of the mechanical and electrical infrastructure are now in need of major overhaul and/or replacement and plans to manage this through its asset replacement programme.

SG2 capital expenditure

7.60 In development proposals announced in January 2007, BAA illustrated the plans for a second runway and associated infrastructure to support growth to approximately 68 mppa in segregated mode by 2030. The development proposal has been reflected in BAA's investment forecasts and assumes:

- construction of a parallel runway, 3,048 metres long and 2,200 metres to the south-east of the existing runway;
- operation of the two runways in 'segregated mode', which means one runway for landings and the other for take-offs; and
- an opening cost in 2015 of £1.4 billion (2005 prices) with further phases of expansion up to 2030 taking the overall cost to £2.27 billion (2005 prices). BAA compares this to the original Government estimate of around £4 billion at 2005 prices (excluding wider road and rail costs);

7.61 BAA states that there would be a phased approach to the development, in line with growth in passenger demand. At the time of opening, the development would provide infrastructure to accommodate an extra ten million passengers a year. Based on these assumptions, BAA's forecast capital expenditure over the next ten years is set out in Table 7-5 below.

Table 7-5 BAA forecast of capital expenditure over Q5 and Q6 £m (2007/08 prices)

Year	G1 Expenditure	G2 Expenditure	Total
2008/09	130	9	139
2009/10	85	24	109
2010/11	58	20	78
2011/12	32	210	242
2012/13	28	310	337
2013/14	54	544	599
2014/15	47	250	296
2015/16	49	38	87
2016/17	36	26	62
2017/18	36	(7)	29

Source: BAA

Note: The figures above are in real 2007/08 prices and do not include any allowance for construction price inflation.

Depreciation (return of the RAB)

7.62 The purpose of the depreciation allowance within the building block approach is to remunerate the company for its capital expenditure over the long term. The CAA's policy on depreciation, which was set out at the Q4 review, is that

the RAB should be rolled forward according to projected depreciation. In the event that actual depreciation is higher or lower than projected depreciation, the difference would be reflected in the closing value of the RAB. Any divergence between projected and actual depreciation will therefore feed through into future price caps.

- 7.63 BAA's forecast depreciation is calculated from two sources. First, the regulatory fixed asset register, based on individual asset lives and the remaining net book values of the individual asset records. Second, depreciation arising from new assets is calculated according to forecast capital expenditure, assumed asset lives and completion dates. BAA's projections over Q5 are set out in Table 7-6 below.

Table 7-6 BAA projections of depreciation for Q5

£ million 2007/08 prices	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	Q5 total
Depreciation	40	44	45	44	44	45	221

Source: BAA

Cost of capital (return on the RAB)

- 7.64 The CAA's November 2007 proposals document for Heathrow and Gatwick airports set out details of the CAA's proposals for the cost of capital allowances for each airport as well as the analysis and assumptions that were used to derive these figures. In summary, the CAA considered that the cost of capital should be based on a pre-tax real weighted average cost of capital of 6.2 per cent at Heathrow and 6.5 per cent at Gatwick. However, the CAA does not expect that the cost of capital of Stansted would be equal to either of these values. Indeed, reflecting the relative degree of demand variation at the airport – and that the variability of returns is a key determinant of the cost of capital under a CAPM framework – the CAA would expect the Stansted cost of capital to be somewhat above that of Gatwick (and Heathrow).

- 7.65 For the purposes of illustrating the building-block methodology, and in line with its approach to the other building blocks in this document, the CAA has used the cost of capital assumption suggested by BAA in its modelling (i.e. 8.04 per cent). For the avoidance of doubt, the CAA has not undertaken any analysis to consider whether this level is reasonable or appropriate. In due course the CAA would need to consider both the level of risk associated with the operation of the airport business and any impact that the price control settlement might have on the level of this risk, or its distribution between the airport, airlines and end users.

Other elements of the building-block calculation

- 7.66 A number of other assumptions need to be taken in order to present an illustration of a building-block price cap, these include:

- The unwinding of revenue deferral made at the time of the Q4 price control review
The CAA has included a profile to illustrate the unwinding of the Q4 revenue deferral.
- Adjustments for additional security costs
At this stage, the CAA has not included an allowance for BAA's estimate of the cost of unanticipated additional security requirements imposed by Government during Q4. BAA's estimate of these costs would require further scrutiny by the CAA and the CC before they could be included in price caps. Likewise, the CAA has not yet had the opportunity to consider the impact of any revised queuing standards at Stansted as currently proposed for Heathrow and Gatwick.
- The opening value of the Regulatory Asset Base (RAB)
The CAA has used BAA forecasts to establish an illustrative value for the value of the RAB at the start of 2009/10, including – for the purposes of this illustration – capitalised preliminary expenditure on Stansted G2.

Bringing together the evidence into a building-block price cap

- 7.67 This section brings together the illustrative 'building blocks' discussed above which combine to determine BAA's estimate of the amount of revenue to be raised across Q5 from airport charges under a building block approach to setting price caps. This scenario is merely indicative at this stage, depending as it does on the combination of a large number of factors, several of which would require further investigation and consultation between the parties if the CAA were to adopt a building block approach. As noted above, in practice much of this analysis would be carried out by the CC under its scrutiny of the building blocks. The table below sets out an indication of a Q5 price cap for Stansted based on BAA's estimate of each of the building blocks.
- 7.68 As with Heathrow and Gatwick, the CAA has applied an opening yield adjustment in this illustrative scenario to reflect the reclassification of baggage infrastructure costs from non-regulated charges to airport charges, the cessation of the fuel levy and the inclusion of ANS costs in airport charges. These changes would be neutral for airlines as a group at Stansted, as the increase in overall airport charges would be offset by a reduction in other non-regulated BAA or NATS charges. In aggregate these changes result in an increase of 68p to airport charges, although this may fall differently on different airlines. The table below sets out an indication of a Q5 price cap for Stansted based on the assumptions described above.

Table 7-7 Indicative Revenue Requirement in Q5 for Stansted (2007/08 prices)

	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	Q5 total
Opening RAB		1268	1343	1374	1572	1875	
Capital Expenditure		114	83	262	372	660	1,491
Depreciation		(44)	(45)	(44)	(44)	(45)	(221)
Q4/Q5 profiling		3	(5)	(21)	(32)	-	(55)
Price smoothing adjustment		3	(2)	-	8	(9)	-
Closing RAB		1343	1374	1572	1875	2481	
Operating costs		147	154	159	165	168	793
Depreciation		44	45	44	44	45	221
Q4/Q5 profiling		(3)	5	21	32	-	55
Price smoothing adjustment		(3)	2	-	(8)	9	-
Cost of capital		101	105	114	133	168	621
Total revenue requirement		286	311	337	366	390	1,690
Commercial revenues		99	103	107	111	106	526
Non-regulated charges		10	10	10	10	10	50
Other revenues		0.2	0.2	0.2	0.2	0.2	1
Net revenue requirement		177	197	220	245	274	1,113
Passengers (millions)		26.1	27.3	28.6	30.0	31.5	143.5
Yield per passenger	6.40	6.79	7.23	7.69	8.17	8.69	

7.69 The bottom line in the table shows profiling of the price cap set as simply as possible i.e. with a single rate of change in prices between each year from the last year of Q4 to the last year of Q5. This implies an X factor of 6.5% (i.e. airport charges rising by RPI+6.5% per annum through Q5).

Sensitivity of airport charges to key 'building blocks'

7.70 The information on 'building blocks' collated in this chapter provides a tentative baseline from which an illustration of a price cap has been derived. It is also worth considering the potential impact on required revenues from airport charges, and hence the rate of change of airport charges over Q5, of plausible variations in a number of key 'building blocks'. The section presents quantified estimates of the sensitivity of airport charges at Stansted to such variation in inputs.

7.71 The modelling has been conducted on the basis of a number of simplifying assumptions which should assist in providing a consistent comparable basis for considering the impacts of different inputs:

- all impacts of varying an input are measured against a 'reference' price cap for Q5, which is built up from the proposed values for each of the building blocks;

- the profile of the price cap is set as simply as possible, with a single rate of change in prices between each year from the last year of Q4 (including the opening yield adjustment described above) through to the last year of Q5;
- sensitivity analysis is conducted by varying only one input at a time;
- variations in other inputs have been treated as independent of all others (i.e. changing the assumed level of capital expenditure has not changed the projected levels of operating costs or commercial and non-regulated revenues); and
- sensitivities should not be considered as additive (i.e. the impact of changing both capital expenditure and commercial revenue projections should not be interpreted from the sum of the separate sensitivities), as the interactions between them have not been incorporated within this analysis.

7.72 The results of the sensitivity analysis are as follows:

- Traffic: if passengers levels were five per cent higher each year than BAA's traffic projection, this would reduce the rate of growth of prices (i.e. reduce the X value) in Q5 by 1.7 per cent, leading to airport charges in 2013/14 being some £0.67 per passenger lower than otherwise.
- Capital expenditure: if the SG2 project were not to go ahead on the timescale proposed by BAA (i.e. only SG1 capital expenditure is undertaken in Q5), then this would reduce the rate of growth of prices in Q5 by four per cent, leading to airport charges in 2013/14 being some £1.47 per passenger lower than otherwise.
- Operating expenditure: a five per cent reduction in the level of the operating cost projection (i.e. across all years) would reduce the rate of growth of prices in Q5 by 1.3 per cent, leading to airport charges in 2013/14 being some £0.51 per passenger lower than otherwise.
- Cost of capital: a reduction in the cost of capital to 6.5 per cent (i.e. as per Gatwick) would decrease the rate of growth of prices in Q5 by 3.8 per cent, leading to airport charges in 2013/14 being some £1.42 per passenger lower than otherwise.

Comparing an augmented building-block price cap to the CAA's statutory duties

7.73 The following section sets out a discussion of the advantages and disadvantages of the building block approach in the context of the CAA's statutory duties in relation to the setting of price caps for Stansted.

Reasonable interests of users

- 7.74 The building block approach is intended to produce an outcome that protects users of airports from unduly high prices and is, therefore, a response to a lack of sufficient constraints on the airport's market power. The degree to which this is an appropriate response will, however, depend upon the strength of these constraints and will vary between different airports.
- 7.75 By scrutinising each of the price control building blocks individually and by compiling evidence and forming a view on relative efficiency, other revenues, cost of capital etc the CAA can ensure that prices are broadly cost-reflective. In addition, the building block approach has the advantage of allowing the CAA to set conditions and / or levels of expenditure that are consistent with a given level of service quality. These service levels can be considered with users ex ante to ensure that their reasonable interests are protected.
- 7.76 On the other hand, the building block approach does introduce a risk that investment decisions might be distorted, at the expense of users' reasonable interests. In particular, the building block approach can create an incentive for the regulated company to undertake capital expenditure in order to increase its total return on that expenditure⁶⁹. In theory, this incentive could lead to the company carrying out more investment than is necessary or to undertake investment sooner than it is required.
- 7.77 To some extent, constructive engagement and regulatory scrutiny can mitigate this risk to ensure that users' reasonable interests are protected. However, available evidence suggests that there is likely to be considerable disagreement between the airport operator and the airlines over the nature, timing and cost of any significant investment at Stansted. This will necessitate considerable regulatory scrutiny and, ultimately, the CAA to take a number of important decisions about the capital investment programme. One consequence of this is that, in the event that there is insufficient demand to use the facilities, the airport operator might look to the regulator to find other ways to recover its costs. An alternative approach would be to provide the airport with higher cost allowances for the project, to compensate it for any increase in its risk exposure.
- 7.78 In order to understand whether these distortions are necessary to protect the reasonable interests of users it is useful to consider the nature of incentives if alternative regulatory approaches were adopted. For example, where airports enjoy very substantial market power there is a risk that, absent such regulation, there might be an incentive on the airport to under-invest. In such circumstances, the distortions caused by the price cap (and the consequent mitigation measures) might be unavoidable. In this context, Chapter 4 explained how these factors relate to the circumstances faced by Stansted.

⁶⁹ Unless the allowed cost of capital is set below the company's actual cost of capital.

7.79 Further, a BBPC based on historical costs incurred might result in a price cap that does not reflect the current cost of airport capacity, or the efficient cost of expanding capacity. In this respect, there could be a significant divergence between the level of the price cap suggested by the BBPC calculation and the level of prices that might be expected in a competitive airport market, where prices would tend to reflect forward-looking measures of cost.⁷⁰ Indeed, the difference between the current BBPC and BAA's cost projections for expanding Stansted is one feature that distorts airport investment incentives.

Efficient, economic and profitable operation of airports

- 7.80 The building block approach provides a powerful ongoing incentive for the airports to deliver the required outputs at lower than projected costs, mirroring the incentives faced by an airport that faces significant competitive constraints.
- 7.81 Within the price control period, any resulting savings from efficient and economic operation accrue directly to the airports and its shareholders, rather than its customers, creating a stimulus for cost savings. Over time, such revealed efficiency savings can be shared with, or transferred to, users by embedding the new lower unit cost performance and updated assessments of future potential efficiency gains in the regulatory assumptions on which the subsequent price control is based.
- 7.82 In addition, the building block approach is likely to promote the profitable operation of designated airports by allowing the regulated company to earn a reasonable rate of return, provided that the company is able to meet or exceed the CAA's targets on efficiency and / or service quality and that the airport is able to recover its costs from airport users.
- 7.83 However, as set out above, the BBPC might have the effect of artificially suppressing the price of airport capacity at the regulated airport (i.e. hold it below the level that would prevail in a competitive airport market). This might be expected to undermine the profitability of airports that compete with the designated airports.
- 7.84 Further, a BBPC can distort capital investment decisions in a number of ways. As set out in Chapter 4, a BBPC might encourage Stansted to favour capital-intensive solutions over those involving higher operating costs. As explained above, at Stansted, an augmented building-block approach will probably result in the CAA determining significant elements of the capital investment programme. This approach would, therefore, represent a considerable extension of regulatory oversight, with its associated costs, that might be inconsistent with the CAA's duty to impose the minimum restrictions necessary. Such an increase in regulation might also be expected to 'crowd out' normal commercial dialogue and negotiation between the airport

⁷⁰ See Chapter 4 for a more detailed explanation of how airport charges might be expected to be determined in a well-functioning airport market.

operator and its users, and risk introducing a disjunction between the business of taking forward a project in response to commercial pressures, within the general planning framework, and regulatory decision-making processes, with their necessary formality and consequent loss of flexibility and greater risk of dispute and delay.

- 7.85 Other potential impacts include discouraging the airport from identifying efficiency savings that have an up-front cost and longer-term payback and dampening the incentives for innovation.

Investment in time

- 7.86 Under the building block approach, there is a clear link between the level of the price cap and the amount of investment that has been undertaken in the past as well as the level of investment planned for the future.

- 7.87 Therefore, the building block approach creates a strong incentive for the regulated company to undertake capital expenditure as it is guaranteed a return on assets that enter the RAB, provided that they are efficiently incurred and that they can be recovered from users. This in turn creates a risk that regulated companies will seek to gold plate assets by undertaking investment that may not be necessary or by unduly bringing forward investment. As noted above, this potential distortion should be compared to those that might arise if a BBPC were not in place. Where airports enjoy positions of very substantial market power such distortions might be a necessary cost, in light of the magnitude of the risk that the airport would under-invest. However, where airports face significant competitive constraints a BBPC would be unlikely to be appropriate.

- 7.88 Indeed, the potential for the BBPC to keep the level of airport charges below the level that might be expected in a competitive airport market might discourage investment by competing airports and divert investment from non-designated airports to designated airports. This would risk undermining the long-term development of a competitive airport market, to the ultimate detriment of airport users.

Minimum restrictions

- 7.89 In order to set a reliable building block price cap, the CAA must assemble extensive evidence on the regulated company's current cost base, its projected operating and investment costs against forecast outputs, and the scope for future efficiency savings. This leads to an intrusive form of regulation that requires a significant amount of input from the regulated company, the regulator and other stakeholders, both in the lead up to the setting of the price caps but also as part of any within-period adjustment to assess the case for allowing any additional capital expenditure associated with a second runway. In addition, the regulatory involvement in the initial capital investment decision will tend to lead to greater involvement in the day-

to-day operation of these assets, as airport operation is, to a significant degree, determined by prior investment decisions.

- 7.90 Further, as the BBPC has a number of potentially significant disadvantages, the justification for the BBPC depends crucially on the likely magnitude of the adverse effects arising under alternative approaches. In particular, the greater the constraints on the airport's market power (absent regulation) the lower the risk that the airport pursues abusive conduct. In such circumstances the justification for adopting the BBPC approach, with its attendant intrusions, would be less.

Initial CAA view: augmented building-block price cap

- 7.91 This chapter set out the key features of an augmented building-block approach and an illustration, using BAA figures, of the potential level of such a price cap.
- 7.92 The CAA also considered the extent to which a BBPC might meet its statutory duties. Overall, this approach would represent a considerable extension of regulatory oversight, with its associated costs, that might be inconsistent with the CAA's duty to impose the minimum restrictions necessary. Such an increase in regulation might also be expected to 'crowd out' normal commercial arrangements. Further, notwithstanding the regulatory processes put in place to mitigate the potential for competition between airports to be distorted, some residual risk of such distortions would probably remain.

Questions for consultation

- Q.9 Has the CAA correctly identified the key effects arising from an augmented building-block approach?**
- Q.10 Do you agree with the comments made by the CAA on the degree to which the augmented building-block approach might meet its statutory duties?**

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8. Option 2: legacy price caps

Introduction

- 8.1 This chapter sets out the key features of a Legacy Price Cap (LPC), the level of the price caps that might be implied by such an approach and an initial assessment of this approach against the CAA's statutory duties.
- 8.2 The concept of the LPC approach arose in discussions with airlines, although it was not formally suggested as an option for detailed consideration.

Key features of a Legacy price cap

- 8.3 The key feature of an LPC is that a price cap is applied to the existing airport assets, but incremental capacity would fall outside of this price cap. The airport charges levied in respect of the existing assets would be based on the standard building-block approach.
- 8.4 In principle, any capacity or service quality delivered above the existing level would not be subject to a prescriptive price cap⁷¹. This would allow the airport either to enter into contracts with airlines for additional capacity and/or service or to undertake more speculative investment at its own risk. The price cap on the existing assets would not be adjusted to reflect any expenditure relating to the incremental capacity or service quality.
- 8.5 This approach has some intuitive appeal. Users of existing infrastructure would continue to be afforded the protection of a price cap, removing any risk of exploitation resulting from any inability on their part to switch away from the airport, whilst new capacity is treated much like a new airport, and would be allowed to earn a return free from such regulation. This approach would avoid linking the price cap to the level of investment undertaken – meeting one of the key concerns previously expressed by the CAA.
- 8.6 However, there are a number of features of an LPC that would need to be determined, including the:
- boundary between the legacy assets and 'new' assets;
 - treatment of services shared by the legacy and 'new' operations; and
 - need to apply a price cap to the 'new' operations

These are discussed below.

⁷¹ In practice, as the Airports Act requires the CAA to control airport charges, the LPC would need to be implemented in a way that applies a price cap to both the existing and incremental assets. Reflecting the rationale for this approach, this price cap relating to incremental investment would be set following the PPC approach so that the pricing of access to incremental assets is given the considerable freedom to be set by the commercial interaction between the airport and airlines.

Defining the boundary of the legacy assets

- 8.7 It would be necessary to distinguish between assets and costs relating to the existing operations (i.e. which fall within the scope of the legacy price cap) and those which relate to new operations. This could be implemented in a number of ways. The CAA has identified the following potential approaches to the definition of the legacy operations:
- existing level of operations (e.g. as at 1 April 2009);
 - expansion currently planned by Stansted on its existing runway; or
 - maximum level of operations possible on a single runway.
- 8.8 In practice, each of these approaches would require a level of 'output' to be determined, against which Stansted's delivery of 'new' operations can be judged. This is likely to require definition of the various aspects of the services delivered by the airport to customers, including the runway, apron and terminal capacity, as well as the quality of service delivered, such as security processing times, terminal cleanliness and (under a single till approach) define the relevant costs and revenues relating to the relevant retail activities⁷².

Treatment of shared services

- 8.9 Some aspects of an airport's operations cannot easily be identified as relating to legacy or new operations, such as air traffic control facilities, fire services and surface access infrastructure (such as parking and rail assets).
- 8.10 If the legacy operations were defined as being those involved in the current level of operation these complexities might be expected to be very significant. There would be a need to apportion the costs of the existing runway and terminal between legacy and 'new' users.
- 8.11 If the legacy operations were defined to include all of the outputs of a single runway at Stansted this problem might be expected to be less significant. For example, a new runway might be constructed with a new terminal, dedicated aprons and car parking. However, Stansted's current expansion plans would involve 'new' passengers making use of existing surface access infrastructure and users of the existing terminal making use of the assets constructed as part of the second runway project.
- 8.12 This implies that an LPC would need to include some form of agreement on the allocation of capital and operating costs between the legacy and 'new' operations, as well as more complicated issues such as the treatment of any assets that are redeployed between the regulated and non-regulated parts of the airport. The issues involved in developing such an agreement would be

⁷² For example, the revenues associated with "existing" retail activities, or generated by "existing" traffic, would need to be identified as part of the price cap calculation for the "existing" assets.

likely to be highly controversial, by virtue of the ‘zero-sum’ nature of cost allocation negotiations.

The need to apply a price cap to the ‘new’ operations

8.13 Within the current regulatory framework, the CAA is required to apply price caps to designated airports. As Stansted would remain designated under the LPC approach, there would be a need to apply a price cap to both the legacy operations and the ‘new’ operations.

8.14 However, the CAA does not consider that this presents an insurmountable obstacle to adopting an LPC. For example, the CAA could propose a building-block price cap for the legacy assets and a “precautionary price cap” (PPC) for the new assets, whereby the price cap would be set at a high level, but below a level that would permit excessive charging in the short-term. The PPC approach is discussed in more detail in Chapter 11.

Illustration of a Legacy Price Cap

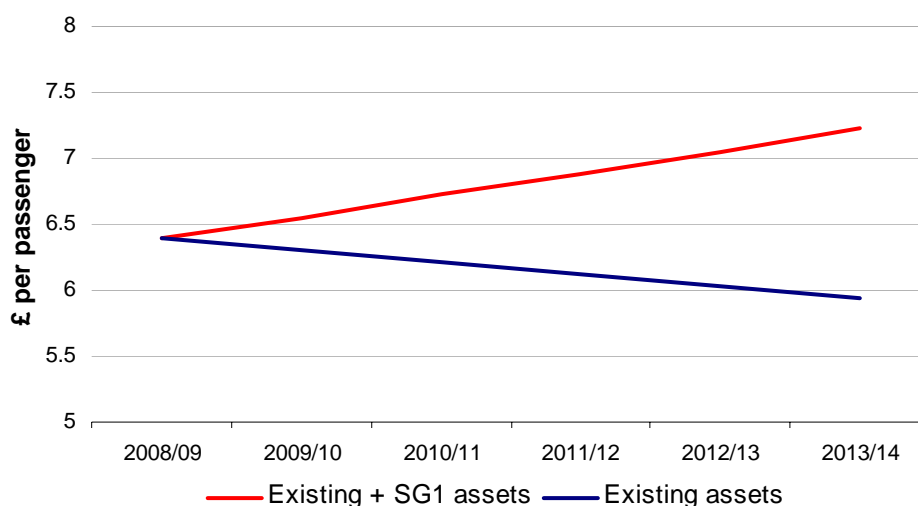
8.15 It is possible to illustrate the potential level of an LPC, by making some simplifying assumptions about the scope of the legacy assets. For this purpose, the CAA has taken two approaches:

- Approach 1: treat the existing assets as falling within the legacy price cap
- Approach 2: treat the assets planned under Stansted’s Generation 1 proposals as falling within the legacy price cap.

8.16 Under both approaches the CAA adopted a consistent approach to that followed in the preceding chapter to illustrate the augmented building-block approach

8.17 The results of this illustrative analysis are set out in Figure 8-1. .

Figure 8-1 Illustration of the potential level of an LPC



Source: CAA analysis

- 8.18 The above illustration shows that were the LPC to be set on the basis of the existing assets alone then it would be likely to fall from its current level towards around £6 per passenger. If the LPC were set to cover the existing assets and those proposed under BAA's Stansted Generation 1 (SG1) then the price cap would tend to rise towards £7 per passenger. In both cases, these illustrative price caps fall somewhat below the levels that might be associated with the construction of a new runway and associated infrastructure. These calculations, and the assumptions made, are discussed in more detail in chapter 7.
- 8.19 This analysis suggests that one practical consequence of an LPC is that it is likely to result in airport charges that are significantly lower for the incumbent airline users than for new entrants.

Comparing a legacy price cap to the CAA's statutory duties

- 8.20 In this section, the CAA sets out an initial consideration of the LPC against its statutory duties. To assist with the explanation of the potential effects of an LPC, the CAA has adopted the following conventions:
- "Legacy airlines" / "Legacy users"
These are the airline services that make use of the legacy assets and are, therefore, covered by the building-block LPC.
 - "New airlines" / "New users"
These are the airline services that make use of 'new' assets (i.e. not the legacy assets) and are, therefore, not covered by the building-block LPC.
- 8.21 Therefore, references to "new airlines" should be read as those that make use of "new" assets whether or not they currently operate at Stansted.
- 8.22 It should also be noted that the magnitude of many of the effects discussed below might be affected by the detailed design of the LPC.

Reasonable interests of users

- 8.23 An LPC could be viewed as offering a fixed-price contract to the legacy users of Stansted Airport. If the LPC covers the existing assets only, this 'contract' would be available to the existing users of the airport. If the LPC covers the existing assets and the capacity delivered by the existing runway, this 'contract' would be available to the existing users and additional users (up to the point where the existing assets became fully used).
- 8.24 However, the lack of a contractual relationship between the airport and passengers means that 'users' in this context principally relates to airlines, as the existence of grandfathered slot access rights granted to airlines provides a way for 'existing' and 'new' users to be identified. The same cannot be said of passengers.

- 8.25 An LPC approach would provide legacy airlines with protection against increases in the level of charges above the level of the LPC. Reflecting the likely level of the LPC, this would effectively ensure that prices charged to the legacy airlines could not reach excessive levels.
- 8.26 However, the LPC would mean that legacy and new airlines would be treated differently. New airlines would be likely to face airport charges that reflected the prevailing balance between supply and demand whilst those benefiting from the LPC would face charges that reflected historical costs incurred, rather than current market conditions. As the value of the RAB reflects the historical regulatory policy – including the previous system approach to regulation, the depreciation profile assumed for the airport and the inflation of the RAB by the retail price index – there is no reason to believe that it represents a reasonable proxy for the current cost of the relevant assets.
- 8.27 This raises the prospect that the charges might materially vary between legacy and new airlines. However, these price differentials might not reflect any differences in the quality of service provided in exchange for these charges. Furthermore, Stansted Airport's expansion plans involve the segregated use⁷³ of the two runways, meaning that all airlines will make use of both runways. The second runway will, therefore, deliver benefits to the legacy airlines, in terms of the better punctuality and added resilience of the airport, as well as providing such airlines with an option to expand their operations. This raises the possibility that such charging could constitute undue price discrimination between airlines, as it could result in legacy airlines being granted preferential access – in the form of lower charges for an equivalent, or even better, service – compared to new entrant airlines.
- 8.28 Indeed, it could be argued that one of the effects of the LPC approach could be unduly to constrain legacy prices below the competitive level, thereby resulting in a windfall gain to the legacy airlines. Such gains to airlines would appear to fall outside the definition of what is reasonable under the CAA's statutory duties and would, therefore, not be considered to be beneficial to the reasonable interests of all users.
- 8.29 Further, these price differentials might act to distort competition in the airline market. New entrant airlines would be more likely to face higher charges than the incumbent (i.e. legacy) airlines, potentially raising the entry barriers faced by new entrant airlines. This would raise concerns that the LPC might reduce the effectiveness of competition between airlines, to the ultimate detriment of passengers.
- 8.30 Indeed, there is a risk that the legacy airlines might face an incentive to oppose expansion of the airport, and benefit from the reduction in competitive pressures that might result, whilst enjoying airport charges capped to a level

⁷³ That is, using one runway for landings and one for take-offs.

that is likely to be somewhat below the prevailing market price⁷⁴, so increasing their profitability.

Efficient, economic and profitable operation of airports

- 8.31 In common with a building-block price cap, an LPC would provide incentives to Stansted to increase its efficiency, by improving the operating and capital efficiency of the legacy assets.
- 8.32 However, there is a risk that the differential treatment of the legacy and new airport assets might introduce a number of perverse incentives that would impair the economic and efficient operation of the airport. First, due to the differential between the potential returns that could be earned on legacy and new assets, the airport might face an incentive to focus operating and capital expenditure on the new assets, rather than the legacy assets.
- 8.33 Second, the LPC might encourage airlines to make intensive use of the legacy assets and discourage use of new assets, as the prices charged for use of the former are likely to be lower (potentially for an equivalent service). Whilst this incentive effect might manifest itself in a number of ways, depending upon the exact design of the LPC, it might be expected to distort the use of the airport's assets. For example, if the full capacity of the first runway were included within the legacy assets this might result in large numbers of movements on this runway (in response to the lower prices), potentially with congestion and delays, at the same time as the second runway is left under-utilised. Such a distortion to the operation of the airport would risk running counter to the CAA's statutory duties.
- 8.34 Third, it appears that an LPC could distort airline operations in a way that discourages the economic and efficient operation of the airport. If the LPC is defined to cover all of the capacity that can be delivered using the existing runway, then this might introduce an incentive for airlines to expand into this capacity in order to lock-in the favourable price control treatment through the grandfathering of slots, even if these services were not otherwise profitable. Similarly, airlines would face a disincentive to close under-performing routes for fear that they would lose the preferential access rights, much in the way that airlines at Heathrow are reported to maintain services in order to retain valuable slots at the airport. However, if the LPC were set to cover only the capacity currently in use at the airport the incentive to over-expand would be removed (although the artificial incentive not to reduce services would remain).
- 8.35 Fourth, it could be argued that the LPC would increase the risk associated with investment in incremental capacity, as all variation in traffic above the capacity of the legacy assets would be treated as relating to the "new" assets. This could imply that the "new" assets would require a higher cost of capital, increasing the cost of incremental investment.

⁷⁴ That is, the level reflecting underlying supply and demand in the market.

- 8.36 More generally, it appears that an LPC risks introducing a price control framework whereby the incentives of the airport and airlines are not aligned and, importantly, are unlikely to encourage outcomes that promote the economic and efficient operation of the airport or that are ultimately in the interests of passengers and other end users.
- 8.37 Finally, it should be noted that the need to distinguish between the legacy and new assets, and determine an appropriate treatment for any shared services, might require a detailed set of rules. This introduces an additional risk of unintended consequences and intrusive regulation.
- 8.38 The CAA analysis of the potential merits of terminal competition considers similar issues to those discussed above⁷⁵.

Investment in time

- 8.39 The LPC removes the link between investment in 'new' assets and the price cap, and thereby the mechanistic link between new investment and the airport's returns that risks significantly distorting major investment decisions. Indeed, if the LPC only covers the existing assets currently in use, then it would remove the link between any incremental investment and the level of the price cap.
- 8.40 However, this approach could have the effect of focusing all volume risk onto the incremental assets and, in effect, insulating the legacy assets from this risk. This could artificially distort the risk profile faced by the airport and, in particular, increase the risk associated with expansion. Where this increase was a result of the approach to regulation, rather than reflecting underlying risks, this could discourage timely investment.
- 8.41 If the LPC were defined to cover the current and future runway capacity deliverable from the existing runway, then this approach would risk distorting investment incentives relating to these assets. For example, such an approach would, depending upon the cost of capital allowance, provide the airport with an incentive to invest in assets relating to the existing runway – and treated as 'legacy' assets - in order to raise the level of the LPC, even if users did not place sufficient value on this investment.
- 8.42 Further, as noted above, an LPC might distort investment between the legacy assets and new assets, reflecting the differential returns that the airport might earn from investment within and outside of the LPC. Indeed, the airport might face an incentive artificially to restrict the expansion of the legacy assets, in order to boost the returns that might be earned from the assets that fall outside of the LPC.

⁷⁵ 'Airports review - policy issues: consultation paper', CAA, December 2005 and 'Airports review - policy update', CAA, May 2006.

Minimum restrictions

- 8.43 The LPC appears to be a relatively simple approach that has intuitive appeal – price capping existing assets whilst leaving new assets outside of the price control and subject to market pressures. On the face of it, this appears to be consistent with the principle of imposing the minimum restrictions necessary.
- 8.44 However, as discussed above, the need to distinguish between legacy and new assets, and to establish an appropriate treatment for any shared services, is likely significantly to complicate the application of the LPC in practice. Further, it appears that the LPC would risk introducing a number of incentive effects that might require additional regulatory intervention – again resulting in additional complexity.
- 8.45 A further issue for consideration is whether, in fact, the price cap on the legacy assets is securing any additional benefits (and is, therefore, a necessary restriction). Whilst it could be argued that the LPC is protecting the interests of airlines that face higher switching costs, it is not clear whether a price cap is a necessary additional protection, in light of the available evidence on the degree of market power held by the airport.
- 8.46 An alternative perspective is that the LPC distributes income from the airport to the legacy airlines without benefiting passengers. For example, if the legacy airlines are operating in a competitive market, their airfares will be largely determined by the costs faced by their competitors. These competitors might be located at other airports or be using the ‘new’ assets at Stansted, facing costs that reflect current market conditions. In such circumstances, the main beneficiary of the LPC would be the legacy airlines. It is, therefore, unclear whether passengers would benefit from the LPC. They would, however, face the consequences of the distortions that the LPC might cause over the longer term.

Other considerations

- 8.47 Whilst the CAA is required to set a price cap that best meets its statutory objectives under the Airports Act, it must also be mindful of other legal constraints that might affect the degree to which its price control proposals might require, encourage or facilitate Stansted to breach its obligations under other UK or European legislation or the UK’s other international obligations.
- 8.48 In this respect, there is potential for this approach either to encourage or require BAA to adopt pricing practices that could raise legal issues in light of the EC Treaty, UK competition law and/or the UK’s international obligations.

Initial CAA view: Legacy price cap

- 8.49 In principle, the approach provides one way of removing the distortions to major investment decisions.

- 8.50 However, depending upon the exact design of the LPC, it appears that an LPC approach might introduce a number of other distortions to airport and airline conduct. The differential treatment of legacy and new entrant airlines also raises concerns that the approach might distort the airline market. Indeed, it is notable that where similar approaches have been adopted by other regulators, incumbents were not given preferential access rights.
- 8.51 Further, the need to distinguish between legacy and new assets, and to establish a treatment of shared services, raises the prospect that implementing the approach would, in practice, result in considerable complexity, with the associated risk of unintended consequences.

Questions for consultation

- Q.11 Has the CAA correctly identified the key effects arising from an LPC?**
- Q.12 Do you agree with the comments made by the CAA on the degree to which the LPC might meet its statutory duties?**

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9. Option 3: terminal development tendering

Introduction

- 9.1 This chapter sets out the key features of a Terminal Development Tendering (TDT) approach. The underlying concept of such an approach was originally outlined by easyJet in meetings with the CAA in December 2007. However, in this chapter the CAA describes its view of one way in which the concept of a TDT approach could be implemented, and highlights some of the detailed design features that need to be resolved. The CAA understands that easyJet are continuing to develop its preferred approach.
- 9.2 In contrast to the other options, it is difficult to provide an illustration of the calculation of the price cap, as the price cap is set based on the results of a competitive tender. However, the CAA has set out a description of the process that might be followed under this approach.

Key features of a terminal development tendering approach

- 9.3 The TDT approach seeks to introduce competitive processes into the provision of terminal facilities, by putting the development of additional terminal capacity (and related facilities) out to competitive tender and to use the results of this tender to determine the price caps applied to the existing and new infrastructure.
- 9.4 The TDT approach can usefully be considered in two parts. The first relates to the process for assessing and approving any airport expansion. The second relates to how the price cap is set if this investment takes place and if it does not.

Process for assessing and approving airport expansion

- 9.5 The results of a tender process would be used to determine whether runway investment was permitted under the price control – with a successful terminal tender ‘triggering’ the construction of a second runway (and other core infrastructure). BAA would not be permitted to participate in this tender to provide terminal facilities but would provide the runway infrastructure.
- 9.6 The terms of the tender would be drawn up by the CAA, in consultation with the airport operator, airport users and expert engineering and financial consultants. This tender would set out the timing, nature and extent of the proposed runway and access infrastructure as well as the price at which this infrastructure would be charged to users of any new terminal facilities. The CAA would also set out the minimum standards for any terminal facilities, together with rules governing the treatment (including minimum standards of service) of new entrant airlines and the interface between the terminal and remainder of the airport.

Process for determining the price cap

- 9.7 The terminal tender would also determine the price cap to be applied to the new and existing infrastructure. However, an important distinguishing feature of the TDT approach is that the airport operator would levy charges on the terminal provider, much as a landlord would levy rent on a tenant. Users of the new terminal would then face charges from the terminal provider and from the airport infrastructure provider.
- 9.8 The charges levied by the airport operator on terminal providers relating to use of the new runway infrastructure would be set out in the CAA tender, based on an assessment of the long-run average cost of the capital expenditure necessary to deliver the runway, with the successful tender setting out the proposed price for terminal access⁷⁶. The prices for the existing runway and terminal infrastructure would be capped by the sum of the charges for the new runway and for access to the new terminal(s).
- 9.9 However, one feature of a TDT approach that would need to be determined is the level of the price cap that would apply in the event that the terminal tender(s) was unsuccessful and the investment in a second runway did not take place.
- 9.10 In principle, this price cap could be set following the principles set out in Option 1, 4 or 5 of this paper. The choice between a price cap based on the building-block calculation and one relying on forward-looking measures of incremental and/or replacement cost is likely to have a significant impact on the incentives faced by BAA and, potentially, airline users.
- 9.11 Under a (historical cost) building-block approach the decision to undertake runway investment would cause the price cap for the existing assets to move from a price cap based on a measure of historical costs incurred to one based on a measure of incremental cost – as the cost of new investment determines the price cap for the existing assets once a tender is accepted. Airlines using the existing assets would, therefore, tend to face increased airport charges if runway investment is approved, whilst BAA would tend to receive higher revenues. These incentive effects might distort BAA's investment incentives and adversely affect the incentives faced by existing airlines to support runway investment.
- 9.12 The alternative approach – to set the price cap with reference to an estimate of the incremental or replacement cost at Stansted – would tend to reduce the magnitude of any distortions to BAA's and/or airlines' incentives, as the runway investment would lead to a smaller change to the price cap applied to the existing assets.

⁷⁶ An alternative approach would be to allow the new terminal provider to set its charges free from any price cap. However, this would raise the issue of how to compare any competing tenders.

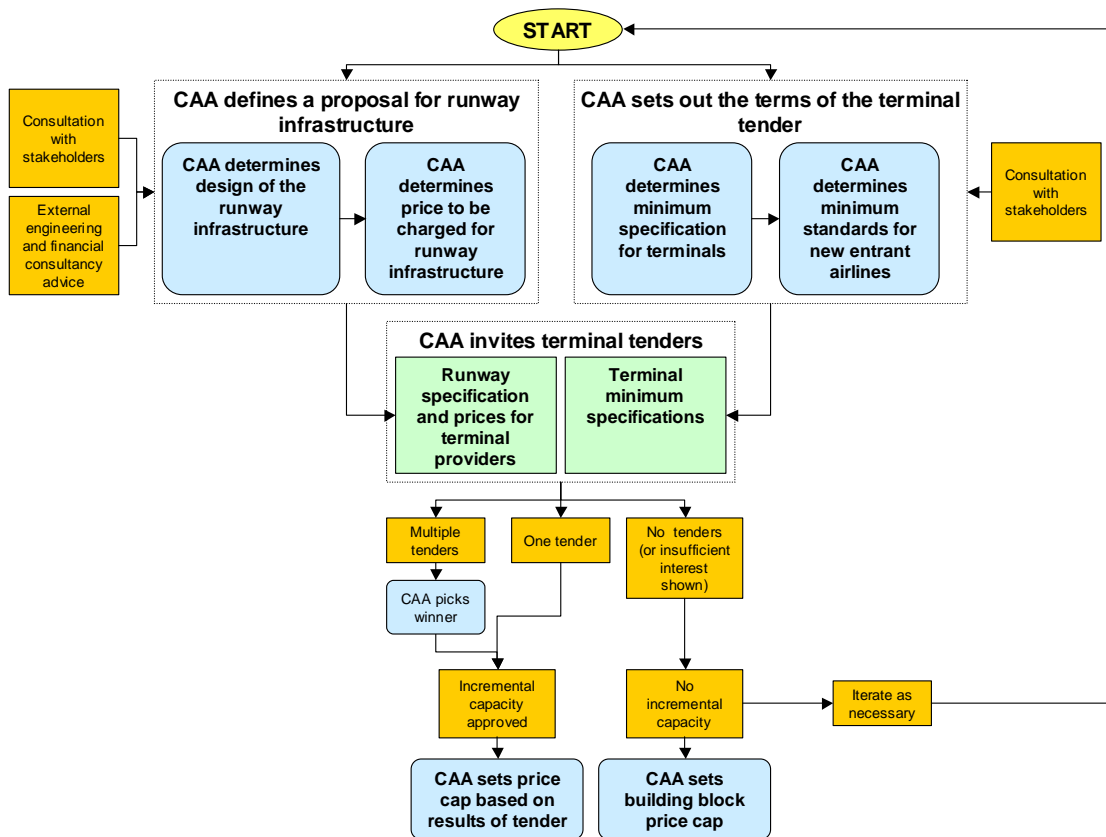
Illustration of a terminal development tendering approach

9.13 There are four main steps to the TDT approach:

- setting out the terminal tender document;
- inviting parties to submit tenders;
- the evaluation of tenders; and
- setting the price cap.

These are discussed below. A summary of this process is set out in Figure 9-1.

Figure 9-1 Summary of TDT approach



Terminal tender document

9.14 The process for a terminal tender would commence with the CAA setting out the terms of the terminal tender document. A key element of this document would be the runway and other access facilities development plan. This document would include the following:

- the location, length and specification of the runway;
- the number, location and specification of the taxiways (potentially in the form of a phased expansion plan);

- the nature and key design elements of the surface access arrangements;
 - the total capital cost for the above investment plans; and
 - a proposed delivery timetable.
- 9.15 These features of the terminal tender would be set by the CAA, in consultation with the airport operator, airport users and other interested parties.
- 9.16 In addition, the tender document would need to include a maximum access price that the runway operator would be allowed to charge to any terminal developers, over the lifetime of their assets. Again, this would be set by the CAA, drawing on advice from engineering and financial consultants. This calculation of an access price would require the CAA to make a number of assumptions, including the appropriate cost of capital and depreciation profile. Arrangements would also need to be made to enable the repair and maintenance of the assets.
- 9.17 Further, it would be necessary for the CAA to set out certain features of the terminal development in order to ensure that any terminal development facilitated further (competing) terminal developments, operated efficiently with the remainder of the airport and had access arrangements that did not raise artificial barriers to competitive airline entry and/or expansion.⁷⁷

Terminal tender

- 9.18 The TDT would be open to all parties other than BAA. BAA would be excluded from the tender in order to introduce a form of external 'market testing' into the process.
- 9.19 As the TDT would require parties to give a binding commitment to pursue a particular development, there would be a need to specify a range of technical requirements for this tender – such as credit requirements and the rights and responsibilities of the contract counterparties.

Tender evaluation

- 9.20 There are three potential outcomes for the tender process:
- **Single qualifying tender**
The CAA would compare the tender to the minimum specifications set out in the invitation to tender. If the tender meets these requirements, the CAA would approve the tender and the associated runway development.

⁷⁷ Indeed, an outline planning permission is likely to include certain restrictions on the location and nature of terminal buildings.

- **No qualifying tenders**
The CAA would not approve the runway development. It would be open to the CAA to revisit the specification of the runway facilities and to run another tender.
- **Multiple qualifying tenders**
The CAA would need to assess the qualifying tenders for the potential value that might accrue to airport users – in terms of the proposed access price and level of service provision – and pick the winning tender.

9.21 Given the potential impact of this process on tendering companies and BAA, it is likely that arrangements would need to be made for appeals.

Pricing determination

9.22 The TDT approach would result in a number of individual price caps, covering the existing facilities, new facilities and split between the runway and terminal assets.

Table 9-1 Summary of individual elements of the TDT approach price caps

Scope of price cap	Basis for price cap
New runway assets	Set out in terminal invitation to tender (determined by CAA)
New terminal assets	Set out in successful terminal tender
Existing runway assets	Set equal to the price cap for the new runway assets
Existing terminal assets	Set equal to the price cap for the new terminal assets

9.23 It might also be necessary to develop greater transparency of charges, in the event that charges for terminal use and for runway use were separately determined and potentially levied by different parties. Further, consideration would need to be given to the way in which terminal charges should be regulated. In principle, the degree of competitive constraint faced by a terminal would affect the need for, and appropriate form of, any price cap regulation, although some regulation might be needed of the interface between the runway activity and the terminals. A precedent for such an approach might be found in the legal and/or structural separation present in other regulated sectors such as telecoms and energy.

Comparing a terminal development tendering approach to the CAA's statutory duties

9.24 In this section the CAA sets out an initial consideration of the TDT approach against its statutory duties. However, this assessment is less detailed than those presented against other options, as the detail of this proposal was only made available to the CAA in December.

9.25 It should also be noted that the magnitude of many of the effects discussed below might be affected by the detailed design of the LPC.

Reasonable interests of users

- 9.26 The level of the price caps would be set in relation to the incremental cost of runway and terminal development – with the latter set by the results of the terminal tender. In principle, prices based on incremental costs do not appear likely to be considered to be excessive. A price cap at this level would, therefore, appear to provide a considerable degree of protection to users against any exploitation of any substantial market power that the airport might acquire.

Efficient, economic and profitable operation of airports

- 9.27 The CAA has previously considered the issue of terminal competition in its initial consultation on policy issues for the Q5 price control reviews⁷⁸ and in the following policy update⁷⁹. This analysis highlighted that terminal competition might entail substantial additional costs, in terms of the impact on investment incentives and airport coordination, over and above the potential benefits from such regulatory intervention. Imposing competition between terminals would go beyond the terms of the CAA's statutory duties to set price caps at designated airports, and could only be initiated by the CAA as a particular remedy to airport actions which were found to be against the public interest or unduly discriminatory. Any possible remedy in the form of proposed greater competition within an airport would be likely to be subject to Competition Commission scrutiny.
- 9.28 Following consultation in the first half of 2006, the CAA concluded⁸⁰, on the case for regulatory intervention to stimulate competition within airports, that the balance of evidence presented so far was against taking such regulatory action. The CAA remained open to further evidence, though, and it noted that several airlines requested that this topic be kept open as the review progressed, in order to allow them to submit views at a later stage. Consulting now, in the specific context of the Stansted price control review, on the terminal development tendering option provides a further opportunity for parties to consider the benefits and disbenefits of a variant of terminal competition which might meet the CAA's statutory duties.
- 9.29 Further, the impact on the operation of non-designated airports is likely to depend upon the balance of the airport's investment incentives. This is discussed in the following section.

Investment in time

- 9.30 A key issue for the TDT approach is whether it will result in appropriate investment incentives for the second runway. These incentives will depend upon the incentives faced by BAA and by the parties tendering to provide the terminal infrastructure.

⁷⁸ Airport price control review – consultation on policy issues, CAA, December 2005.

⁷⁹ Airport price control review – policy update, CAA, May 2006.

⁸⁰ Airport price control review – policy update, CAA, May 2006.

- 9.31 In this respect, the TDT approach involves a link between the new investment and the level of the price cap applied to the existing assets. Such a link might be expected to distort the investment incentives faced by BAA, as the approval of the second runway would lead to the price cap moving to a level that reflects incremental costs. In the event that the price cap is set using a historical cost building-block approach, the approval of the investment would tend to lead to a significant increase in BAA's revenues.
- 9.32 Further, this link between the investment decision and the level of prices faced by existing users would tend to affect the incentives faced by these users to participate in the tender – or the way in which they participate – and the support that these users might offer to expansion.
- 9.33 In addition, there is no guarantee that the fact that there is a party willing to develop a terminal ensures that the runway development is efficient and/or justified. For example, the terminal development proposal could be for a significantly smaller volume of capacity than that delivered by the runway proposal. This raises the possibility that all or part of the capacity created by a runway could be stranded and that BAA would be unable to recover its costs, even though it would not have control over the investment decision. This might prompt the airport operator to look to the regulator to find ways for it to recover its costs in other ways. An alternative approach would be to provide the airport with higher cost allowances for the project, to compensate it for any increase in its risk exposure.

Minimum restrictions

- 9.34 The TDT approach introduces some 'market testing' and, over the longer-term, some terminal competition. However, the approach involves a very significant degree of involvement by the CAA, with it approving the key features of the runway development proposals and certain minimum standards for the terminal developments. In the event that there are multiple qualifying tenders the CAA would also be required to choose, following consultation, which better meets its statutory duties.
- 9.35 The decisions taken by the CAA on the design of the invitation to tender are also likely to affect the nature of the successful tenders and the balance of investment incentives faced by BAA and potential terminal developers. This would be a significant increase in the involvement of the CAA in the development of Stansted Airport and of the development of the airport market. Further, the regulatory involvement in the initial capital investment decision will tend to lead to greater involvement in the day-to-day operation of these assets, as airport operation is, to a significant degree, determined by prior investment decisions.
- 9.36 Furthermore, in the absence of BAA's consent, it is unclear whether the current regulatory framework allows this approach to be adopted, not least since it would prohibit BAA from pursuing its own terminal development plans. Prohibiting BAA from participating in the tender would affect the

property rights held by the airport and it is unclear whether there is a legal mechanism by which the CAA could implement this approach, in the absence of BAA's consent.

- 9.37 More generally, while the CAA has no powers to require a restructuring of any designated airport, a theoretical extension of this approach could involve all terminals being owned, or at least operated, by companies independent of the owner of the airport infrastructure. This, or indeed other approaches, could facilitate a reduction in the scope of regulation to runway use alone. However, such an approach would introduce operational complexities and could require complex regulation of the runway-terminal interface. The CAA previously considered some of these issues in the context of terminal competition.⁸¹
- 9.38 The merits of alternative regulatory approaches – that would involve changes that fall outside of the scope of the Airports Act – including introducing competition between terminals at Stansted could, however, be considered further by the Competition Commission in its Market Investigation.

Initial CAA view: terminal development tendering approach

- 9.39 A TDT approach requires the CAA to determine a very significant part of the overall investment plan (including the timing and position of any second runway) and to set out the rules by which an independent terminal operator would interact with the remainder of the airport. This would also lead to greater CAA involvement in the day-to-day operation of the airport. It is, therefore, unclear whether this option would yield significant benefits compared to Option 1 or, indeed, overcome the disadvantages of that approach.
- 9.40 Further, without BAA's consent, it is unclear whether the current regulatory framework would allow this approach to be adopted, not least since it would prohibit BAA from pursuing its own terminal development plans.
- 9.41 This option may also face a number of other practical problems, including that any planning application for a new runway will need to set out sufficient detail about the location and size of terminal buildings to enable the planning inspector to assess the likely significant environmental and other effects of the proposed development. This might reduce the degree to which competing terminal providers could bring forward alternative proposals for the development of the airport's terminal infrastructure.

Questions for consultation

- Q.13 Has the CAA correctly identified the key effects arising from a TDT approach?**

⁸¹ Airport price control review – policy update, CAA, May 2006

Q.14 Do you agree with the comments made by the CAA on the degree to which the TDT approach might meet its statutory duties?

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10. Option 4: market-led approach

Introduction

- 10.1 In December 2006 the CAA set out its Initial Proposals for applying price controls to Heathrow, Gatwick and Stansted airports⁸². In this document, the CAA identified that the price control on Stansted could be set by reference to a judgement of the relative risks of setting the price cap too high or too low, considered in the context of the CAA's statutory duties. The CAA referred to this approach as a 'market-led price cap' (MLPC).
- 10.2 This chapter sets out the key features of an MLPC, the level of the price caps that might be implied by such an approach and an initial assessment of this approach against the CAA's statutory duties.

Rationale for market-led and precautionary price cap approaches

- 10.3 The rationale for the market-led and precautionary price cap proposals are similar and, as a result, draw on similar evidence in order to reach a price cap proposal. At heart, both approaches focus on the effects of setting a price cap at a certain level. The likelihood and magnitude of these effects will depend upon the level at which the price cap is set.
- 10.4 In general terms, the link between the level of the price cap and the effects can be thought of in terms of the:
- **Risk that users are exposed to excessive prices**
The higher the level of the price cap the greater the risk that users are exposed to exploitative abuse, e.g. in terms of unreasonably high prices.⁸³
 - **Risk that investment at designated or non-designated airports and/or competition between airports is distorted**
The higher the level of the price cap the smaller the risk that investment at non-designated airports and/or competition between airports is distorted, and the smaller the risk that investment at Stansted is deterred by a cap that falls below the actual cost of expanding capacity.
- 10.5 These considerations point in different directions: the first suggesting a lower price cap and the second a higher price cap. The price cap should, therefore, be set at a level that balances these different risks.
- 10.6 The relative magnitude of the risks is affected by the strength of the competitive constraints faced by Stansted. For example, the greater the degree of competitive interaction between Stansted and other airports the smaller the former risk (i.e. of abuse) and the greater the latter risk (i.e. of distortions to investment and/or competition). These risks also affect

⁸² 'Initial Proposals for Heathrow, Gatwick and Stansted', CAA, December 2006.

⁸³ Or other forms of exploitative abuse.

different stakeholders, with the risk of abusive pricing principally affecting airlines and other users at Stansted, whilst the distortions to competition and investment are also likely to have material effects on other airports and their users.

- 10.7 It follows that where there is evidence of material competitive constraints on Stansted the risks associated with setting a price cap too high will be smaller, whereas the risks associated with setting a price cap too low will be greater, and vice versa.
- 10.8 The balance between these considerations provides the main difference between the rationale underlying the MLPC and that of the PPC: the PPC places greater weight on the existence of effective competitive constraints to address the risk of excessive prices and would lead to the price cap being set somewhat above the level implied by the MLPC approach.

Key features of a market-led price cap

- 10.9 AN MLPC would not be derived mechanistically from calculations of costs, and would not therefore be linked to the investment costs incurred. Instead, the price cap would be set by reference to a judgement of the relative risks of setting it too high or too low, considered in the context of the CAA's statutory duties.
- 10.10 As explained above, the MLPC places reliance on market processes to determine the level of prices paid by users, in common with the PPC approach described in the following chapter.
- 10.11 However, the degree of reliance placed on competitive constraints is somewhat less than is the case for the PPC approach. As a result, the MLPC approach would result in a price cap set at the lowest level that would not unduly distort investment or competition between airports. A consequence of this is that the level of the MLPC would tend to be somewhat below the level at which prices would risk being judged to be excessive under competition legislation.
- 10.12 The MLPC would not seek to reflect the short-term balance between supply and demand in such a way as to "second guess" what the market price should be. Rather, the MLPC would be set for five years, based on a forward-looking assessment of the level at which the price cap would not unduly distort behaviour, in the expectation that the level of charges paid would vary below this level, in response to market circumstances – i.e. that the resulting prices paid are market-led.
- 10.13 Against this background, the CAA has identified three key features of the market-led approach:
- reliance is placed on the combined impact of competition, competition law as well as price caps to protect the interests of users

- the actual level of airport charges paid, and the associated service quality received, by airport users in any given period would be determined by the commercial interaction of the airport and its users and not necessarily by the level of the price cap; and
- the price cap should reflect the potential for efficient investment in the market in which Stansted operates, and the degree of competitive interaction between airports, suggesting that prices should reflect forward-looking costs and, importantly, will not necessarily be limited to the recovery of historical costs.

10.14 It is important to note that setting the level for an MLPC is not a purely quantitative exercise; the MLPC would be set by reference to a range of quantitative evidence, qualitative considerations and, ultimately, rely on the CAA's assessment of the balance of this evidence. Further, the MLPC could be applied in a number of different forms, including as: a maximum per passenger yield; a maximum annual airport revenue; or a maximum airport revenue over a five-year period⁸⁴. For ease of comparison to the current form of the price cap, discussion has focused on a maximum per passenger yield.

10.15 However, there are a number of features of an MLPC that would need to be determined, including the:

- form of any regulatory policy statement; and
- need for any transitional arrangements

These are discussed below.

Regulatory policy statement

10.16 As explained in Chapter 3, the CAA is required, and only able, to set a price cap for the five-year period from 1 April 2009 to 31 March 2014. However, airport investments typically have asset lives well in excess of this five-year period. In response, the CAA's price control proposals have typically been accompanied by a Regulatory Policy Statement (RPS).

10.17 A RPS is intended to give guidance on how the CAA might apply the price control framework in future regulatory periods and what factors might lead to the CAA considering within-period adjustments to the price caps. It is, therefore, a tool to manage within-period uncertainty and to reduce the degree of uncertainty associated with its approach to future price control reviews, whilst recognising that the CAA is unable to fetter its future decisions.

⁸⁴ This could be implemented by setting an annual price cap whilst allowing any under/over-recovery to be carried forward to subsequent years.

10.18 The CAA has identified two areas of potential uncertainty that the RPS could usefully cover:

- circumstances that might warrant a tightening of the price cap; and
- circumstances that might warrant a loosening of the price cap

These are discussed below.

Circumstances that might justify a reduction in the (real) level of the price cap

10.19 An MLPC is intended to provide a five-year price cap together with a longer-term framework for airport charges and for airport-airline interactions. The CAA would not, therefore, envisage that it would reduce the MLPC unless there was a very significant change in circumstances, as to do otherwise would undermine the incentives faced by the airport to invest and by the airport and airlines to enter into long-term contractual arrangements.⁸⁵

10.20 However, consistent with the approach set out above, at subsequent price control reviews the CAA would expect to review the evidence base used to establish the MLPC and assess whether this evidence suggests that the MLPC is set at an unreasonably high level. For example, should the CAA identify that there had been a material reduction in the costs of expanding capacity in the market this might lead to a reduction, over time, in the long-term level of the MLPC. When deciding whether to revise the MLPC at the Q6 review the CAA would be mindful of the need not to undermine long-term contracts and investment incentives.

Circumstances that might justify an increase in the (real) level of the price cap

10.21 Consistent with the preceding discussion, the CAA would not envisage that it would increase the MLPC unless there was a very significant change in circumstances. However, the CAA would expect to review the evidence base used to establish the MLPC and assess this evidence against its statutory duties, considering *inter alia* whether continuation of the current level of the price cap would distort airport competition, investment at Stansted or investment at other UK airports.

Transitional arrangements

10.22 The CAA acknowledges that implementing an MLPC might be viewed as a considerable change in the approach to setting price caps, albeit one that was first set out by the CAA in general terms in December 2006⁸⁶. There might be a case, therefore, for transitional arrangements, whereby the price cap is set on a path to reach the level implied by the MLPC approach.

⁸⁵ It is important to distinguish between an increase in the nominal level of the price cap from an increase in the real level of the price cap. This section considers the latter. Under the MLPC, it would appear appropriate to specify the price cap in such a way as to ensure that, over time, it increased in line with a suitable price index (as is the case under the RPI-X formulation of the price cap).

⁸⁶ 'Airports price control review - Initial proposals for Heathrow, Gatwick and Stansted', CAA, December 2006.

- 10.23 However, the degree of the potential change should be set in context. The Q4 Stansted price cap was not set solely on the basis of a building-block calculation and, in any event, has not historically had a significant impact on the operation of, or charges set by, the airport. In this sense, an MLPC approach could be viewed as a way of continuing to enable charges to be set by commercial pressure, albeit that the methodology used to reach the price cap differ significantly from that previously adopted.
- 10.24 It appears to the CAA that there are two main arguments for supporting some form of transitional arrangements. First, airlines are likely to face higher switching costs in the short-term, reducing their ability to exert competitive pressure on Stansted over this period⁸⁷. Introducing a transition to an MLPC would enable airlines to respond to the new price control approach and, if appropriate, adjust their use of the airport in response to any potential increase in the level of charges paid. The transitional period would also allow the airlines and airport operator to negotiate future access terms.
- 10.25 Second, BAA's current plans for a second runway at Stansted involve the new runway becoming operational during 2015, following planning consent around 2010. This suggests that while it is important to ensure that the price caps that are expected to apply to the investment are such that they will not distort this investment decision, the level of the price cap in the early years of Q5 is less likely to distort this investment decision. However, it might also be important to ensure that earlier – albeit less significant – investment decisions and/or competition between airports are not distorted. Further, in order to establish a reasonable expectation that the price cap will eventually rise to the level suggested by the MLPC it might be necessary to limit the duration of the transitional arrangements.

Illustration of a market-led price cap

- 10.26 This section sets out the CAA's proposed methodology for establishing an MLPC for Stansted, and presents an illustration of how this methodology might be applied to reach an MLPC in practice⁸⁸. The intention here is not to present estimates of the price caps or for the illustrative values included within this document to constrain the values that might be proposed under this approach following more detailed analysis.
- 10.27 As noted above, it is important to recognise that setting the level for an MLPC is not a purely quantitative exercise; the MLPC would be set by reference to a range of quantitative evidence, qualitative considerations and, ultimately, rely on an assessment of the balance of this evidence. The CAA has not sought to present a definitive proposal, but rather the results of its initial

⁸⁷ The nature of airline switching costs and their relationship with airport market power is discussed in 'De-designation of Manchester and Stansted airports for price control regulation - The CAA's advice to the Secretary of State', CAA, July 2007.

⁸⁸ Reflecting the preliminary stage of this consultation, these ranges are only indicative and reflect the information currently available to the CAA. For the avoidance of doubt, the CAA is not indicating that, should it set an MLPC, the price cap would necessarily lie within the indicative ranges set out in this chapter.

analysis in order to set out a range within which the MLPC might be expected to fall.

10.28 However, the MLPC is not intended to be the principal determinant of the actual level of airport charges set by the airport. Instead, competitive pressure and commercial interaction between the airport and its users would be expected to determine the actual level of charges paid. The degree of precision that is likely to be appropriate for the MLPC is, therefore, somewhat less than that which would be required under a 'standard' building-block, where the level of the price cap is much more likely to determine the actual level of charges faced by airlines.

10.29 There are two key elements in setting an MLPC:

- the level of prices that remove the risk of significant distortions to investment decisions; and
- the level of prices that remove the risk of significant distortions to competition between airports.

These are discussed below.

Prices that remove the risk of significant distortions to investment

10.30 As discussed in chapter 4, an airport operator will undertake investment if the present value of the expected revenues exceeds the present value of the expected costs⁸⁹. Investment decisions are, therefore, dependent upon forward-looking costs and forward-looking revenues.

10.31 This implies that prices should be permitted to rise to a level that reflects the efficient cost of capacity expansion. Further, consideration should be given to the cost of expansion at both Stansted and at other airports operating in Stansted's market – in order to gain sufficient comfort that the price cap on Stansted does not unduly discourage investment at competing airports.

10.32 However, an investment project competing with potential investment at Stansted would be expected to succeed if its costs are lower than those at Stansted, and would be unlikely to succeed if the reverse were true.⁹⁰ Setting the MLPC by reference to Stansted's investment costs would, therefore, facilitate any more-efficient investment at competing airports, whilst only risking undermining the profitability of less efficient investment.

10.33 Against this background, a key element of the assessment of the MLPC is the level of incremental cost. The following section sets out some initial estimates of incremental cost.

⁸⁹ Suitably adjusted for risk.

⁹⁰ This assumes that the competing projects deliver capacity that has similar quality characteristics. More precisely, the net value delivered by the competing project should be greater than the value delivered by Stansted.

Evidence – incremental costs

- 10.34 For the purpose of establishing an MLPC, it is necessary to estimate long-run average incremental costs (LRAIC) and to express this as a cost per passenger. The focus on long-run costs reflects the fact that investment decisions will be based on long-term demand prospects and the cost of investment over this period. This analysis assumes that the demand will continue to grow over the medium and long-term.
- 10.35 The CAA has adopted a two-stage approach for this assessment: first establishing a range of estimates for the relevant incremental capital cost; and, second, converting these costs into an implied per-passenger charge, to aid comparison with the illustrative numbers included for Option 1 and 2.
- 10.36 In relation to the first, in order for the CAA to present an illustration of the appropriate LRAIC the CAA has considered three sources of potential evidence to provide an indication of the cost of expanding capacity in the market in which Stansted operates. In each case the CAA has sought to focus on significant expansions of capacity, where additional terminal and runway assets are required, rather than the costs of incremental investment that enables an airport to make better use of its existing maximum capacity. This reflects the focus of this analysis on the long-term cost of capacity expansion. Against this background, the CAA has drawn on the following sources:
- **the costs contemplated or incurred by airports across Europe for significant increases in capacity**
Annex D sets out some recent examples of the cost of expanding capacity at a number of airports across Europe. This suggests that, whilst there are practical barriers to comparing the expansion costs at different airports, the cost of expanding airport capacity can be very significant, particularly where expansion requires the construction of an additional terminal and/or runway. For example, the cost of a number of projects that involve additional runway and terminal assets exceeds £2bn.
 - **the costs contemplated or incurred by other UK airports for significant increases in capacity**
A number of UK airports have either contemplated or undertaken capacity expansion. However, in respect of a number of these, there are reasons why it is difficult to draw meaningful comparisons. For example, the infrastructure costs associated with expansion at Heathrow are currently forecast to be between £6.8 billion and £8.3 billion⁹¹, but these costs reflect the particular challenges of expanding a constrained site which requires significant surface access infrastructure. By contrast, the second runway at Manchester Airport cost £172 million in 2001. However, this expansion was intended to

⁹¹ Table 1, Annex B, 'Impact Assessment' of 'Adding capacity at Heathrow', DfT, December 2007.

provide additional peak runway capacity and did not, at that time, include substantial terminal, apron or surface access infrastructure that would be required to make full use of an additional runway.

A further example, perhaps more relevant to the Stansted market, is the plan announced, but subsequently withdrawn, by Luton Airport to construct a full-length, replacement runway and associated facilities. The original estimates of the cost of such a project were reported to be in the order of £1.5 billion.

- **the current costs contemplated by BAA to expand Stansted**
BAA has announced plans that currently contemplate providing a new runway, terminal building and surface access infrastructure to take the airport from an annual capacity of around 35 million passengers to 68 million passengers. In 2007 BAA estimated that this project would cost £2.5 billion including possible contributions to road and rail schemes (or £2.3 billion excluding these contributions), with the first phase of expansion up to 50 million passengers costing £1.4 billion (in Q2 2005 prices).⁹²

10.37 It should be noted that the cost of capacity expansion will depend, to some degree, on the exact specifications of the facilities. These facilities could, in principle, be provided to 'high' or 'low' quality specifications. However, a significant proportion of the costs associated with efficient capacity expansion are likely to be independent of the nature of the terminal facilities provided. For example, BAA's proposals for Stansted indicate that around one quarter of the total project cost relates to the terminal facilities – an area where the exact specification might be expected to have the greatest impact on costs.

10.38 Reflecting the above evidence, it appears reasonable at this early stage to adopt a range of capital cost assumptions of: £1.5, £2 and £2.5 billion.

10.39 In relation to the second aspect of the LRAIC calculation – converting a capital cost into a per passenger charge – it is necessary to make a number of simplifying assumptions. These enable a capital cost to be converted into a constant per passenger charge that would, over the lifetime of the assets, allow the airport to recoup its initial costs in present value terms.

10.40 For the purposes of this illustration, the following simplifying assumptions have been adopted:

- operating costs are met by income from non-aeronautical charges;
- the project delivers 35mppa of additional capacity;
- there is no ongoing capital expenditure (i.e. no replacement capex);
and

⁹² 'Stansted Generation 2 – Development proposal', BAA, January 2007.

- the assets have an average life of 35 years⁹³.

10.41 The first of these assumptions adopts a ‘single-till’ approach to calculating the appropriate price cap. Whilst this assumption could be relaxed and a dual-till approach adopted, the underlying rationale behind the LRAIC is to reflect the revenues that would need to be generated, over the long term, to remunerate investment. As the decision to invest would be based on expected costs and revenues from both aeronautical and non-aeronautical activities it seems appropriate to mirror this approach in the calculation of LRAIC.

10.42 In addition, the following assumptions have been made and varied to reach a number of scenarios:

- project cost: £1.5bn, £2bn and £2.5bn;
- passenger growth rate: 4 and 6 per cent; and
- cost of capital: 7, 8 and 9 per cent.

10.43 Table 10-1 presents the results of this analysis.

Table 10-1 Initial estimates of long-run average incremental costs (all figures rounded to nearest £0.5/pax, real)

		Cost of capital		
		7%	8%	9%
4 per cent passenger growth rate at opening				
	1,500	6.5	7.5	8.5
Project cost (£m)	2,000	8.5	10.0	11.5
	2,500	10.5	12.5	14.5
6 per cent passenger growth rate at opening				
	1,500	5.0	6.0	7.0
Project cost (£m)	2,000	7.0	8.0	9.0
	2,500	8.5	10.0	11.5

Source: CAA analysis

10.44 It is also possible to undertake further sensitivity analysis on these figures, varying the average asset life. For example, if the scenario with a project cost of £2 billion, a 4 per cent passenger growth rate and 8 per cent cost of capital are repeated with 25, 35 and 45 year average asset life, giving an LRAIC of 12.0, 10.0 and 9.5.

10.45 The results of these illustrative calculations suggest that, if the assumptions made prove to be appropriate, under most of the more likely scenarios the LRAIC falls within the range £8.50 to £12.50.

10.46 If the CAA were to pursue the MLPC approach, it would expect to revisit this analysis and, in particular, the assumptions used to derive the LRAIC estimate. The CAA invites comments from stakeholders on the illustrative analysis of LRAIC set out in this section, and invites evidence on the

⁹³ It should be noted that whilst this asset life assumption might appear to be relatively short, it is also assumed that there is no ongoing capital expenditure.

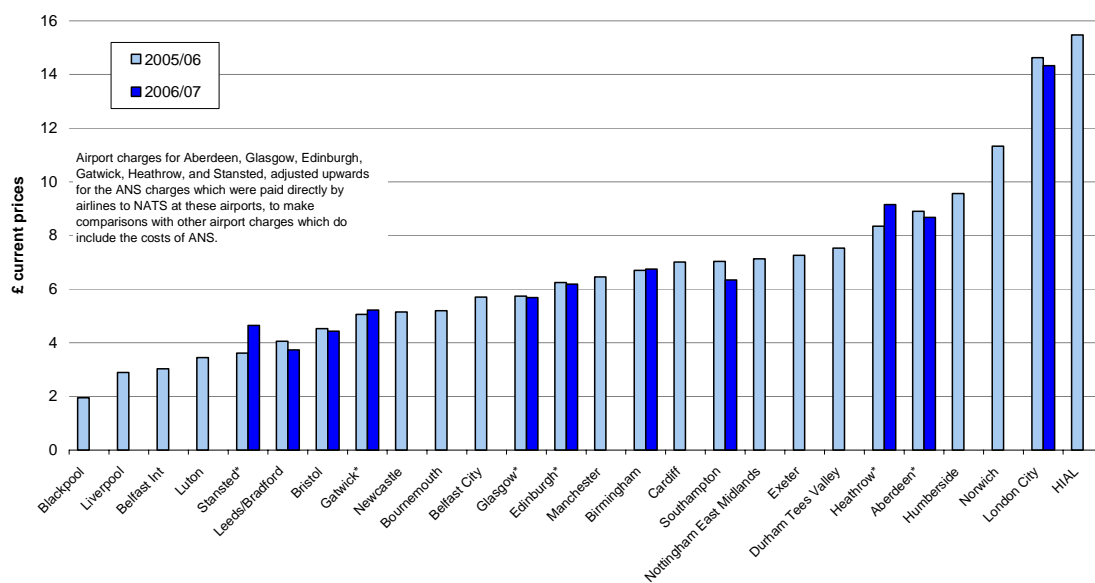
potential relevant cost of airport expansion and the appropriate assumptions to use in the calculation of LRAIC.

Prices that remove the risk of significant distortion to competition

- 10.47 In order to identify whether a certain price cap is likely to distort competition between airports it is useful to consider three pieces of evidence.
- 10.48 First, the level of airport charges at other UK airports can provide some useful context for considering the Stansted price cap, including whether the current level of charges is high relative to other airports. Were the Stansted price cap be below the level of charges set – or that might reasonably be set in the future – by potentially competing, non-designated airports this might raise concerns that the competition between airports would be distorted.
- 10.49 Second, the replacement cost of airport capacity can provide an indication of the level of prices that might risk unduly undermining the profitability of competing airports and the development of competition. Measures of the replacement cost of assets remove the potential distortions caused by the accounting and/or regulatory treatment of the cost of airport assets. By contrast, the historical cost base of Stansted reflects the costs incurred at the airport, but is also affected by a range of factors including the accounting policies adopted and the regulatory treatment of the airport. It is far from certain – and, in fact, rather unlikely – that the historical accounting costs at Stansted reflect the efficient costs faced by its competitors. As a result, capping prices to the level of historical costs incurred at Stansted would risk undermining the profitability of competing airports and the prospects for investment at these competing airports.
- 10.50 The third source of evidence relates to the potential for airport charges to vary, in response to short-term changes in supply and/or demand conditions. This was discussed in more detail in chapter 4. If the MLPC does not reflect these variations, there is a risk that the pattern of charging at competing airports could be distorted, as during periods where the supply-demand balance is relatively tight the price cap would be more likely to restrain prices at Stansted, potentially limiting the ability of other airports to remunerate their investment and/or discourage them from undertaking additional investment.

Evidence – relative prices

- 10.51 The CAA routinely collects accounting data from a selection of UK airports, including the income from aeronautical charges. In order to enable a more meaningful comparison, the CAA wrote to these airports requesting that they set out their main accounting policies.
- 10.52 The results of this analysis are set out in Figure 10-1.

Figure 10-1 Comparison of airport charges and revenue per passenger

Source: CAA analysis of airport statutory accounts

- 10.53 This analysis suggests that the current level of airport charges at Stansted have been low relative to other airports and, whilst they have increased in the latest year, remain significantly below those at other airports. In addition, it appears that airport charges across the UK currently lie in the region of £5/pax to £10 per passenger⁹⁴.
- 10.54 It should, however, be noted that this analysis takes no account of the differences in the value of the product supplied by the airports, or the differing quality of service delivered. The proximity of Stansted to a large, affluent demand centre and major destination for inbound passengers (both business and leisure) might suggest that the level of charges would be expected to be higher than average. Conversely, it could be argued that the nature of the airline business models at Stansted might affect the nature of the service provided by the airport and the expected level of charges.
- 10.55 Further, the markets in which these airports operate are likely to have differing supply-demand balances. As described in Chapter 4, there is a link between the prevailing supply-demand balance and the likely level of airport charges in a competitive airport market – with a tighter supply position tending to be accompanied by charges that are above the long-term average level. In this respect, it is notable that airport charges at Stansted are somewhat below the level set by airports operating in markets with more scarce capacity.
- 10.56 It should also be noted that these prices include charges for air navigation services.

⁹⁴ Including charges for ANS services.

Evidence – replacement cost

10.57 The ‘standard’ building-block price cap calculation is based on a measure of historical costs incurred, rather than necessarily reflecting the replacement cost of the airport’s assets. Indeed, there are a number of factors that might be expected to lead to a divergence between the historical costs incurred – as measured by the Regulatory Asset Base – and the relevant measure of replacement cost, including:

- the depreciation profile adopted;
- the impact of system regulation and the extent to which the costs of remunerating the Stansted RAB were met by revenues generated at other airports;
- whether the capital expenditure was efficiently incurred; and
- the price index applied to the RAB and whether this accurately reflects the increase in cost of airport expansion.

10.58 The CAA has not undertaken any detailed analysis of the replacement cost of Stansted Airport. However, as discussed above the costs of investment projects of a similar size to that of the current Stansted operations are somewhat above the current accounting value of the Stansted RAB – currently estimated as being £969 million in the airports 2006/7 regulatory accounts.

10.59 In order to illustrate the potential impact of adopting a replacement cost basis for valuing the RAB the CAA has repeated the ‘standard’ building-block calculation with a £1 billion uplift to the current Stansted RAB. The results of this analysis are presented in Table 10-2 **Error! Reference source not found.**, alongside the results from the comparable ‘standard’ building-block calculation.

Table 10-2 Illustration of the impact of a higher RAB on the building-block calculation

	2009/10	2010/11	2011/12	2012/13	2013/14
‘Standard’ building-block calculation – forecast RAB	6.69	7.23	7.69	8.17	8.69
Revalued RAB: +£1bn	7.48	8.78	10.28	12.04	14.10

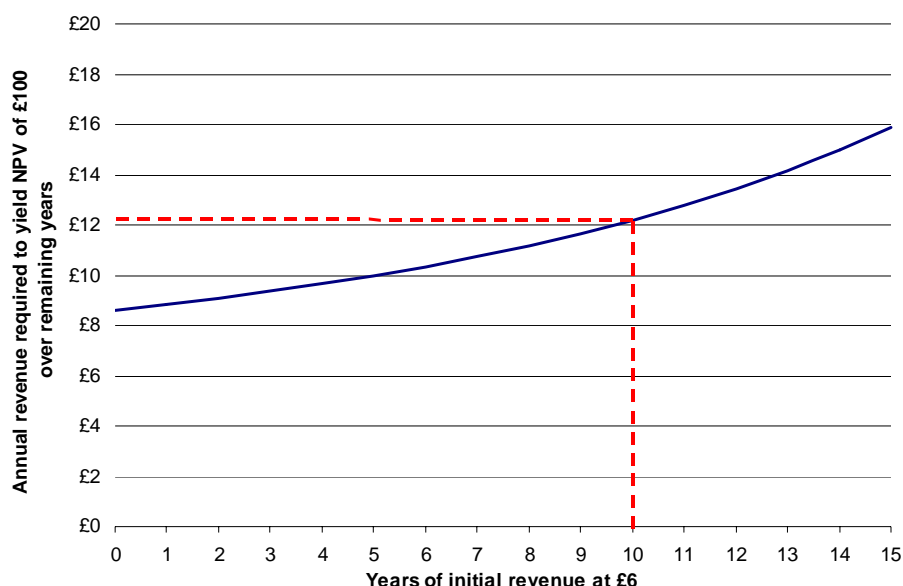
Source: CAA analysis

10.60 The CAA intends to develop this analysis further. In principle, this analysis could take one of two forms. First, a ‘bottom-up’ approach could be taken, whereby the current book values in BAA’s asset register are inflated using an appropriate construction price index in order to estimate their current (depreciated) replacement cost. Second, a ‘top-down’ approach could be taken, whereby a consultancy study is undertaken into the current cost of replacing the airport’s assets.

Evidence – short-term variation in prices

- 10.61 As discussed in chapter 4, a well-functioning airport market is likely to exhibit some variation in short-term prices around a long-term trend. When there is relative capacity scarcity there is likely to be upward pressure on airport charges, and when capacity is less scarce there is likely to be downward pressure on airport charges. In setting an MLPC it is important to take this into account.
- 10.62 It is possible to undertake some analysis to understand the relationship between the magnitude of any below-average pricing and the degree of above-average pricing required to leave the airport neutral in present value terms. Figure 10-2 sets out an example of the results of the CAA's illustrative analysis.

Figure 10-2 Illustration of the link between initial below-average charging and later above-average charging, to achieve a constant NPV



Source: CAA analysis

- 10.63 This analysis considers the profile of prices that will deliver an NPV of £100, with an annual discount rate of 8 per cent⁹⁵. A constant revenue of approximately £8.50 per annum for 35 years has an NPV of £100. This is then compared to a profile of revenues that commence with 'x' years of £6 per annum, followed by a constant revenue for the remaining (30-x) years, keeping the NPV constant. For example, if revenue is £6 per annum for 10 years then the airport would need to generate a £12 per annum revenue in each of the remaining 25 years to achieve an NPV of £100 (this point is shown with a red dashed line in the figure).
- 10.64 Thus, in this example, a revenue shortfall experienced for ten years would need to be accompanied by a later revenue surplus that was 40 per cent

⁹⁵ These values have been chosen to maintain consistency with the central assumption adopted in the earlier illustration of the calculation of long-run average incremental cost, and are not intended to indicate the CAA's views on the appropriate cost of capital or asset life for Stansted Airport.

greater, to leave the airport neutral in present value terms. This illustrates the familiar concept that revenue received in earlier periods has a greater value than an equal amount received in later periods. However, it should be noted that this analysis considers revenues, not the level of airport charges, and ignores the potential impact of growing passenger numbers.

- 10.65 Furthermore, this analysis focuses on the required variation in prices, assuming that airports do not enter into longer-term contractual relationships with airlines. In practice, the potential variation in short-term prices tends to provide airports and airlines with an incentive to contract in a way that reduces this volatility.
- 10.66 It might not, therefore, be necessary for the CAA to make any significant adjustment to the level of the price cap to reflect this variation in short-term prices, as the airport and airlines can agree longer-term prices under contract. It should be noted, however, that without the possibility that short-term prices might rise the incentive to enter into longer-term contracts would diminish.

An illustrative market-led price cap

- 10.67 The above analysis results in three illustrative ranges for the MLPC, based on incremental cost, replacement cost and relative prices. These are summarised in Table 10-2.

Table 10-2 Summary of illustrative evidence for the MLPC

	Lower bound	Upper bound
Incremental costs	8.5	12.5
Replacement costs	7.0	14.0
Relative prices	5.0	10.0

Source: CAA analysis

- 10.68 This evidence (albeit in the form of illustrative numbers) suggests that to ensure that competition between airports is not distorted the price cap should be set somewhat above £5 per passenger and, based on the evidence of replacement cost estimates, no lower than £7 per passenger. Similarly, if the assumptions made turn out to be appropriate this would suggest that, in order to ensure that investment at designated and non-designated airports is not distorted the price cap should be set no lower than £8.50 and that there is evidence to support a cap as high as £12.50.
- 10.69 As noted above, there might be a case for applying transitional arrangements, to take the price cap from its current level to the level suggested by the MLPC approach. Actual prices charged would, however, tend to be set in response to commercial pressures and would not be expected to be at the level of the price cap.
- 10.70 In general, to establish the path of this transition requires two additional variables: the initial price level and the date at which the transitional price cap should reach the MLPC level.

10.71 The CAA has identified four candidates for this initial price level:

- the 'headline' price cap applied in 2008/09, increased by inflation (but without any uplift for under-recovery within Q4);
- the actual price cap applied in 2008/09, increased by inflation (this would include an amount reflecting the previous under-recovery of revenue within Q4);
- the current average level of charges, increased by inflation; and
- the level implied by the building-block price cap.

10.72 On the face of it, there appear to be no strong arguments for any one of these options. However, for presentation purposes, the CAA has adopted the first of these alternatives, which amounts to £5.88 in 2008/09 (nominal prices).

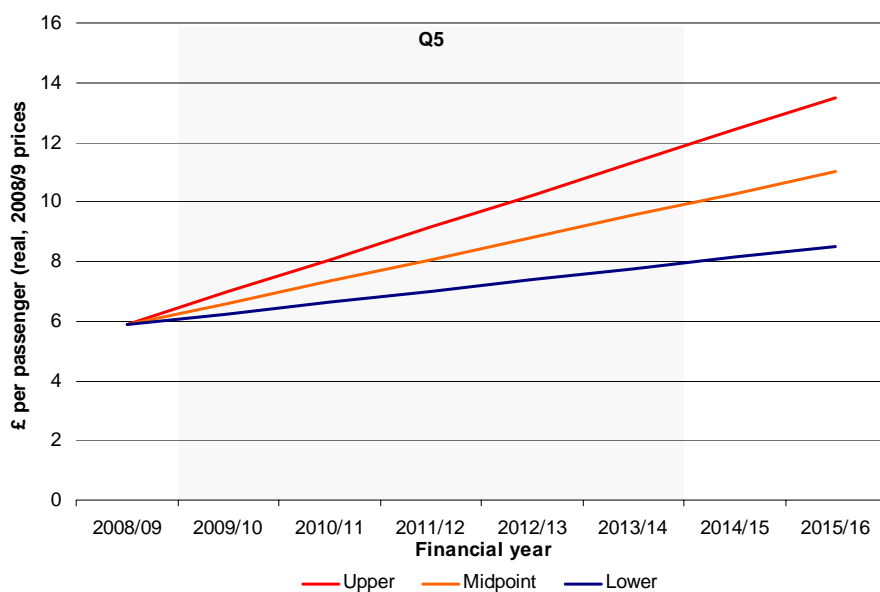
10.73 The CAA has identified three candidates for the date by which the transitional arrangements should end, namely when BAA is expected to⁹⁶:

- secure the necessary planning consents (estimated to be 2010);
- enter into agreements to commence construction; or
- bring the new runway into operational use (estimated to be 2015).

10.74 Again, the CAA has not identified any strong arguments for any of these dates. In particular, so long as the CAA's commitment to phase out the transitional arrangements before the runway comes into use is seen as credible by BAA, this should significantly reduce the magnitude of any distortions to its investment decisions. However, an earlier end to the transitional arrangements would have the benefit of removing the risk of distortions to other, albeit less significant, investment projects and would improve the credibility of the transition to an MLPC.

10.75 The CAA has brought together the above inputs to illustrate the potential path of the price cap. This illustration, set out in Figure 10-3, applies a transition from a price cap of £5.88 in 2008/09 to the range of values suggested for the MLPC by 2015/16.

⁹⁶ All of these dates are based on the assumption that BAA successfully secures the required planning permissions.

Figure 10-3 Illustration of price cap, including a transitional period

10.76 As the transitional arrangements extend to cover the whole of Q5, the average price cap during this period is somewhat below the longer-term level of the MLPC. In the illustration presented above, the price cap under the upper, midpoint and lower scenario would average £9, £8 and £7 per passenger during Q5.

Comparing a market-led price cap to the CAA's statutory duties

10.77 In this section the CAA sets out an initial consideration of the MLPC against its statutory duties.

Reasonable interests of users

10.78 The degree to which an MLPC represents an appropriate response to the circumstances at Stansted depends upon the view taken of the strength of the competitive constraints faced by the airport.

10.79 The main distinguishing feature of the MLPC approach is that it seeks to establish the lowest price cap that will not unduly distort investment or competition between airports. This approach would also have regard to the degree of risk faced by users that the airport might abuse its market position. A consequence of this is that the level of the MLPC would tend to be somewhat below the level at which prices would risk being judged to be excessive under competition legislation.

10.80 The CAA's initial view is that it is important to ensure that the future decisions taken by airports, airlines and passengers are not distorted and that investment decisions and competition are not unduly distorted. Such an approach will support the development of a competitive and efficient UK airports market, ultimately to the benefit of airport users.

- 10.81 In addition, as set out in Chapter 4, prices in well-functioning markets tend to reflect current and future market circumstances, rather than historical costs incurred. This questions whether it is reasonable for airport users to expect that prices should be held below a level that would be viewed as normal in other sectors of the economy.
- 10.82 Further, it should also be noted that an increase in the price cap does not necessarily imply that there will be an increase in the prices paid by end consumers (i.e. passengers and cargo shippers). Indeed, the principal impact of keeping airport charges below the level implied by the balance between supply and demand is likely to be to distribute income from the airport towards airlines. Reflecting its duties towards both airport users and airports, the CAA does not consider that there is a strong case for adopting a price cap approach in order simply to increase the profitability of airlines and reduce the profitability of airports (or, indeed, vice versa).
- 10.83 The MLPC involves not placing reliance on the 'standard' RAB-based approach to setting price caps and adopting an approach that places greater reliance on the assessments made by the CAA as to the appropriate level of the price cap. This could increase the regulatory risk faced by users, but this needs to be balanced against the other adverse effects likely to arise from adopting other approaches. Moreover, the use of a Regulatory Policy Statement provides one way of mitigating the adverse effects that might arise from this uncertainty.

Efficient, economic and profitable operation of airports

- 10.84 The MLPC approach should set the price cap at a level that should remove any undue distortions to investment and competition. One benefit of this approach is, therefore, the beneficial effects on the operation of competing airports and on the investment performance of Stansted.
- 10.85 However, the MLPC approach places significant reliance on the competitive constraints faced by Stansted to ensure that the airport operates in an efficient manner and delivers appropriate service quality to its users. A distinction could be drawn between these two aspects. In respect of the efficiency of operating and capital expenditure, it appears likely that the combination of competition and the incentives faced by the owners of Stansted will provide an appropriate impetus to control these costs
- 10.86 It could, however, be argued that there is more uncertainty about the degree to which Stansted would deliver appropriate service quality under an MLPC approach. The strength of competitive constraints would provide the principal incentive for the airport owners to invest in service quality, due to the potential impact of inappropriate service quality on passenger numbers and the returns generated from airlines – the MLPC approach would not

apply additional incentives on the airport in respect of service quality.⁹⁷ It is, however, important to note that an MLPC would not, in itself, provide the airport with an incentive to reduce its investment in service quality - a potential risk associated with the 'standard' building-block approach.

- 10.87 However, recent operational experience at UK airports highlights that poor service quality can have a significant impact on passenger throughput in the short-term and cause significant harm to the reputation and value of an airport in the longer-term. In addition, the periodic review of whether the airport has acted against the public interest does provide a source of scrutiny for service quality issues.

Investment in time

- 10.88 A key feature of the MLPC approach is a decoupling of the level of the price cap from the investment undertaken by the airport. This removes the potential for the airport to over-specify or bring forward premature investment in order to raise the price cap. In fact, the price cap is set with the specific goal of minimising any distortions to investment decisions (both at Stansted and at other airports).
- 10.89 Further, the MLPC approach is likely to alter the incentives faced by the airport operator and the airport users and encourage more effective supplier-customer interaction, to the ultimate benefit of end users. For example, airlines and the airport operator might be more willing to enter into more normal contractual relations covering price, quality and capacity. This would provide important information about willingness to pay for quality and capacity, reduce project risk and potentially encourage the development of more efficient proposals.
- 10.90 However, whilst the MLPC might enable investment, it does not guarantee that it takes place. This lack of investment could be a result of factors outside of the control of the airport operator (such as an adverse planning decision) or, in principle, the result of abusive behaviour, should the airport acquire a position of dominance. The MLPC approach relies to some degree on the sufficiency of competitive pressure and the deterrent effect of competition and Airports Act legislation to mitigate the risks that investment is delayed.

Minimum restrictions

- 10.91 The underlying rationale of the MLPC is to set the price cap at a level that balances the risks associated with the price cap being too high with those associated with it being too low. In doing so, the MLPC should only constrain prices in certain circumstances, making best use of the competitive pressure that exists between Stansted and other airports and placing some reliance on

⁹⁷ Indeed, it would be difficult for the MLPC (or PPC) approach to implement such incentives, as the price cap is not expected to be the principal determinant of the actual charges paid to – and, therefore, the revenue received by – the airport operator.

existing regulatory tools, including UK and EC competition law and section 41 of the Airports Act.

- 10.92 However, the MLPC approach could constrain prices to a level significantly below the level at which they would become illegal under competition law. This could detract from the CAA's duty to impose the minimum restrictions necessary.

Initial CAA view: market-led price cap

- 10.93 This chapter has set out the key features of a market-led price cap (MLPC), the level of the price caps that might be implied by such an approach and an initial assessment of this approach against the CAA's statutory duties
- 10.94 Overall, the CAA sees considerable merit in the MLPC approach. It makes use of the competitive constraints that apply to Stansted, ensures that investment decisions and competition are not unduly distorted and provides some protection for users against high prices.
- 10.95 However, as with all of the options identified, there are disadvantages. In particular, the MLPC approach focuses on price and investment outcomes, placing considerable reliance on the impact of competition to ensure that service quality outcomes are reasonable. In the CAA's view, the available evidence on the strength of competitive constraints is sufficient to justify such an approach. The CAA acknowledges that others may take a different view.

Questions for consultation

- Q.15 Do you agree that long-run average incremental costs (LRAIC) and/or replacement costs are an important element of the evidence base for setting an MLPC? What evidence and/or approach should the CAA draw upon when assessing these values, including the appropriate assumptions in respect of asset lives, cost of capital, etc?**
- Q.16 If a transitional period were to be adopted, what price level should be used for the first year and over what period should this transition take place? In both cases, please explain the rationale for the values suggested.**
- Q.17 Has the CAA correctly identified the key effects arising from an MLPC?**
- Q.18 Do you agree with the comments made by the CAA on the degree to which the MLPC might meet its statutory duties?**

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11. Option 5: precautionary price cap

Introduction

- 11.1 In December 2006 the CAA raised the prospect of applying a market-led price cap to Stansted.⁹⁸ This chapter considers another similar approach, in that it does not place reliance on the building-block calculation of historical average costs.
- 11.2 Reflecting the potential for significant competitive constraints to protect the interests of users and to ensure that the airport operates and develops in an appropriate way, it is possible to develop a price control that places considerable reliance on the existence of these constraints. In this context, the CAA's duties to impose the minimum restrictions necessary would imply that the price cap should only be a precautionary measure. For this reason, the CAA has referred to this approach as the precautionary price cap (PPC).
- 11.3 This chapter sets out the key features of such a precautionary price cap, the level of the price caps that might be implied by such an approach and an initial assessment of this approach against the CAA's statutory duties.

Key features of a precautionary price cap

- 11.4 A PPC would be set at a level that provides the maximum degree of freedom for prices to vary, but applies a maximum limit on charges that would prevent excessive pricing. The actual level of airport charges would be determined by the competitive interaction of airlines with the airport.
- 11.5 The main focus of the PPC is, therefore, the prevention of any abuse of market dominance during the five-year price control period, as far as possible, consistent with the approach that the CAA would expect to be taken in any assessment of prices under UK and/or EC competition law. In this way, the PPC could be viewed as a response to the risk that Stansted might acquire a position of market dominance and that airlines and/or consumers were unable to identify and/or take action against movements in prices during a price control period due to the difficulty in either identifying whether prices were abusive or in exercising their legal rights in court.
- 11.6 In common with the MLPC, the PPC would not seek to reflect the short-term balance between supply and demand in such a way as to "second guess" what the (maximum permitted) market price should be. Rather, the PPC would be set for five years, based on a forward-looking assessment of the level at which the prices might be viewed as being excessive.
- 11.7 However, there are a number of features of a PPC that would need to be determined, including the:
- form of the regulatory policy statement; and

⁹⁸ 'Initial Proposals for Heathrow, Gatwick and Stansted', CAA, December 2006.

- need for any transitional arrangements

These are discussed below.

Regulatory policy statement

- 11.8 The CAA is required, and only able, to set a price cap for the five-year period from 1 April 2009 to 31 March 2014. However, airport investments typically have asset lives well in excess of this five-year period. In response, the CAA's price control proposals have typically been accompanied by a Regulatory Policy Statement (RPS).
- 11.9 An RPS is intended to give guidance on how the CAA might apply the price control framework in future regulatory periods and what factors might lead to the CAA considering within-period adjustments to the price caps. It is, therefore, a tool to manage within-period uncertainty and to reduce the degree of uncertainty associated with its approach to future price control reviews, whilst recognising that the CAA is unable to fetter its future decisions. A PPC is intended to provide a protection against within-period exploitative pricing. The CAA would not, therefore, envisage that it would change the (real) level of the PPC unless there was a very substantial change in circumstances⁹⁹.
- 11.10 However, consistent with the approach set out above, at subsequent price control reviews the CAA would expect to assess whether there is a continued justification for the PPC approach and, if so, review the evidence base used to establish the PPC. For example, should the CAA identify that there had been a material reduction in the costs of expanding capacity in the market this might lead to a reduction in the assessment of the level at which prices might become excessive and, therefore, the appropriate level of the PPC.

Transitional arrangements

- 11.11 The underlying rationale for the PPC approach is that there is evidence that there will be significant competitive constraints on the conduct of Stansted over the Q5 period, but that some additional protection is justified in order to address any perceived practical difficulty associated with applying competition legislation to short-term movements in prices, should the airport acquire a dominant position, whilst giving the airport the freedom to set prices that reflect the underlying balance between demand and supply. This would remove the risk of significant distortion to competition between airports and would facilitate the airport bringing forward timely investment in new capacity.
- 11.12 In the event that there was evidence of significant competitive constraints in the near term this would suggest that a transitional period was not necessary under the PPC approach.

⁹⁹ It is important to distinguish between an increase in the nominal level of the price cap from an increase in the real level of the price cap. This section considers the latter. Under the PPC, it would appear appropriate to specify the price cap in such a way as to ensure that, over time, it increased in line with a suitable price index (as is the case under the RPI-X formulation of the price cap).

- 11.13 An alternative view is that airlines are likely to face higher switching costs in the short-term, reducing their ability to exert competitive pressure on Stansted over this period. This could leave them more vulnerable to exploitation in the short-term, justifying a short transitional period (such as a year). However, the CAA has seen limited evidence that the airlines at Stansted face significant switching costs. Indeed, the Government's decision on the designation status of Stansted recognised that these airlines enjoyed a significant degree of operational flexibility.
- 11.14 The CAA would invite views on the justification for transitional arrangements within the context of a PPC approach. For ease of exposition, the illustration of the PPC presented later in this chapter does not include a transitional period.

Illustration of a precautionary price cap

- 11.15 This section sets out the CAA's proposed approach for establishing a PPC for Stansted, and presents an illustration of how this approach might be applied to reach a PPC in practice¹⁰⁰.
- 11.16 There are three elements of the calculation of a PPC. These individual elements are similar to those used to reach a view on the level of the MLPC. However, the way in which these pieces of evidence are used differs, resulting in a different price control proposal.

Evidence – incremental costs

- 11.17 The CAA's approach to estimating incremental cost is set out in Chapter 10. Table 11-1 reproduces the results of this analysis.

Table 11-1 Initial estimates of long-run average incremental costs (all figures rounded to nearest £0.5/pax)

		Cost of capital		
		7%	8%	9%
4 per cent passenger growth rate at opening				
	1,500	6.5	7.5	8.5
Project cost (£m)	2,000	8.5	10.0	11.5
	2,500	10.5	12.5	14.5
6 per cent passenger growth rate at opening				
	1,500	5.0	6.0	7.0
Project cost (£m)	2,000	7.0	8.0	9.0
	2,500	8.5	10.0	11.5

Source: CAA analysis

- 11.18 If the CAA were to pursue the PPC approach, it would expect to revisit this analysis. The CAA invites comments from stakeholders on its approach to estimating LRAIC.

¹⁰⁰ Reflecting the preliminary stage of this consultation, these ranges are only indicative and reflect the information currently available to the CAA. For the avoidance of doubt, the CAA is not indicating that, should it set a PPC, the price cap would necessarily lie within the indicative ranges set out in this chapter.

Evidence – replacement costs

11.19 The CAA's illustration of the potential impact of a replacement cost calculation on the level of the price cap is set out in Chapter 10. Table 11-2 reproduces a summary of this analysis.

Table 11-2 Illustration of the impact of a higher RAB on the building-block calculation

	2009/10	2010/11	2011/12	2012/13	2013/14
'Standard' building-block calculation – forecast RAB	6.69	7.23	7.69	8.17	8.69
Revalued RAB: +£1bn	7.48	8.78	10.28	12.04	14.10

Source: CAA analysis

Evidence – short-term variation in prices

11.20 Chapter 4 explained why prices in airport markets might be expected to vary above and below long-run average levels, in response to the balance between supply and demand.

11.21 The CAA's approach to assessing the potential magnitude of these variations in short-term prices was set out in Chapter 10. This analysis suggested that if new capacity puts downward pressure on prices and they fall below the long-term average level in the short term, then prices might be expected to rise significantly above the level of long-run average incremental cost (LRAIC) in order to enable an airport operator to recover its investment costs.

11.22 The CAA also presented analysis that illustrated that a revenue shortfall experienced for ten years would need to be accompanied by a later revenue surplus that was 40 per cent greater, to leave the airport neutral in present value terms. This illustrates the familiar concept that revenue received in earlier periods has a greater value than an equal amount received in later periods.

An illustrative precautionary price cap

11.23 The estimates of incremental cost and replacement cost set out in this paper give an indicative range of long-run price levels of £8.50 to £12.50 per passenger.

11.24 However, an important feature of the PPC is that it enables prices to increase in the short-term, in response to demand and supply conditions, whilst providing protection against prices reaching excessive levels. This suggests applying an uplift to this range – or, at least, avoiding setting the price cap at the bottom of the range – in order to allow prices to vary around their long-term average level.

11.25 As discussed above, the CAA does not consider that there is a strong case for a significant transitional period under the PPC approach.

Comparing a precautionary price cap to the CAA's statutory duties

- 11.26 In this section the CAA sets out an initial consideration of the PPC against its statutory duties. Many of the relevant considerations are similar to those set out in the discussion of the MLPC approach. For this reason, the CAA has not repeated that material here.
- 11.27 However, the PPC approach places more reliance than the MLPC approach on competitive constraints to protect the reasonable interests of users. As such, greater confidence as to the strength of these constraints would increase the relative benefits associated with a PPC. The PPC also requires the CAA to apply less judgement to establish the appropriate level of the price cap than under the MLPC approach. The PPC might, therefore, benefit from less regulatory uncertainty.

Initial CAA view: precautionary price cap

- 11.28 This chapter set out the key features of a precautionary price cap (PPC), the level of the price caps that might be implied by such an approach and an initial assessment of this approach against the CAA's statutory duties.
- 11.29 Overall, the CAA sees considerable merit in the PPC approach. It places considerable reliance on the competitive constraints that apply to Stansted, and applies a price cap that is focussed on mitigating the risk of excessive prices within the forthcoming five-year period. This approach would provide supplementary protection against abuse over the timescales when competition legislation might not adequately protect users' interests. Relative to the MLPC approach, the PPC might also benefit from less regulatory uncertainty.
- 11.30 However, as with all of the options identified, there are disadvantages. In particular, the PPC places considerable reliance on the impact of competition to ensure that service quality outcomes are reasonable. In the CAA's view, the available evidence on the strength of competitive constraints is sufficient to justify such an approach.

Questions for consultation

- Q.19 Has the CAA correctly identified the key effects arising from a PPC?**
- Q.20 Do you agree with the comments made by the CAA on the relative degree to which the PPC might meet its statutory duties, when compared to the MLPC approach?**

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12. Comparing the options

- 12.1 This chapter presents a high-level summary of the main advantages and disadvantages of the various options, in order to assist interested parties when making comparisons between them.
- 12.2 These advantages and disadvantages are organised against the factors highlighted in Chapter 6 as being of particular relevance to the CAA's assessment of options against its statutory duties.
- 12.3 The CAA would stress that this is a brief summary and is not an attempt to capture all of the potential effects. Interested parties are asked not to limit their consultation responses to the material set out below.

Table 12-1 Comparison of the advantages and disadvantages of the current options

		1 Augmented Building Block	2 Legacy Price Cap	Options 3 Terminal Development Tendering	4 Market-led Price Cap	5 Precautionary Price Cap
Reasonable interests of users						
Protection against excessive prices	+	<ul style="list-style-type: none"> Prevents prices from exceeding average historical cost. 	<ul style="list-style-type: none"> Prevents prices to existing airlines from exceeding average historical cost. 	<ul style="list-style-type: none"> Prevents prices from exceeding average historical cost (if no investment occurs). Prevents prices to existing airlines from exceeding costs of new assets (if investment occurs). 	<ul style="list-style-type: none"> Avoids duplicating competitive constraints Additional protection limits prices below “excessive” levels 	<ul style="list-style-type: none"> Avoids duplicating competitive constraints
	-	<ul style="list-style-type: none"> Can encourage investment in capex to boost price caps. 	<ul style="list-style-type: none"> As for option 1, for existing airlines Might only have a limited impact on prices to passengers and other end users. New airlines provided with little protection, and less than incumbents 	<ul style="list-style-type: none"> As for option 1, for existing assets 		<ul style="list-style-type: none"> Prices could rise towards (but not above) “excessive” price levels within Q5
Delivery of service quality	+	<ul style="list-style-type: none"> Can link price cap to service quality outcomes to provide service quality incentives. 	<ul style="list-style-type: none"> As for option 1, for existing airlines 	<ul style="list-style-type: none"> As for option 1, for existing airlines 	<ul style="list-style-type: none"> Avoids duplicating competitive constraints 	<ul style="list-style-type: none"> Avoids duplicating competitive constraints
	-	<ul style="list-style-type: none"> Could distort decisions in favour of capex, rather than opex. 	<ul style="list-style-type: none"> As for option 1, for existing airlines New airlines provided with little protection, and less than incumbents 	<ul style="list-style-type: none"> As for option 1, for existing airlines New airlines provided with little protection, and less than incumbents 	<ul style="list-style-type: none"> Reliance placed on competitive constraints 	<ul style="list-style-type: none"> Reliance placed on competitive constraints
Impact of uncertainty	+	<ul style="list-style-type: none"> Well-understood calculation. 	<ul style="list-style-type: none"> As for option 1, for existing airlines 	<ul style="list-style-type: none"> As for option 1, for existing airlines 		
	-		<ul style="list-style-type: none"> New airlines operate within a different regulatory approach. 	<ul style="list-style-type: none"> New airlines operate within a different regulatory approach. 	<ul style="list-style-type: none"> CAA discretion in setting the level of the price cap 	<ul style="list-style-type: none"> CAA discretion in setting the level of the price cap

		Options				
		1 Augmented Building Block	2 Legacy Price Cap	3 Terminal Development Tendering	4 Market-led Price Cap	5 Precautionary Price Cap
Efficient, economic and profitable operation of airports						
Encouraging efficiency	+	<ul style="list-style-type: none"> Strong incentives to reduce within-period costs. 	<ul style="list-style-type: none"> As for option 1, for existing airlines 	<ul style="list-style-type: none"> Introduces terminal competition, following expansion 	<ul style="list-style-type: none"> Avoids duplicating competitive constraints 	<ul style="list-style-type: none"> Avoids duplicating competitive constraints
	-	<ul style="list-style-type: none"> Could be incentives to reduce outputs and service to deliver cost savings. Incentives to boost end-of period costs, to boost future cost projections. 	<ul style="list-style-type: none"> As for option 1, for existing airlines Might distort airline competition Might distort the operation of the airport, reducing the flexibility and efficiency of airport operations 	<ul style="list-style-type: none"> Interface between new and old airport assets and operation may introduce complexity Airport design will need to facilitate separately owned terminals 	<ul style="list-style-type: none"> Reliance placed on competitive constraints 	<ul style="list-style-type: none"> Reliance placed on competitive constraints
Impact on the profitability of airports	+		<ul style="list-style-type: none"> Removes the airport's incentive to invest too early and to over-specify new infrastructure, preventing harm to competitors. 	<ul style="list-style-type: none"> CAA specification and terminal tender might prevent inefficient investment. 	<ul style="list-style-type: none"> Removes the airport's incentive to invest too early and to over-specify new infrastructure, preventing harm to competitors. 	<ul style="list-style-type: none"> Removes the airport's incentive to invest too early and to over-specify new infrastructure, preventing harm to competitors.
	-	<ul style="list-style-type: none"> Price cap may be below market levels, and undermine profitability of competing airports. Potential for distortions to investment, or other conduct, and harm to other airport operators. 	<ul style="list-style-type: none"> As for option 1, for existing airline operations (by encouraging existing airlines to expand into the legacy assets) 	<ul style="list-style-type: none"> Investment decisions could still be distorted (see below), and may unduly harm other airport operators. 		

		Options				
		1 Augmented Building Block	2 Legacy Price Cap	3 Terminal Development Tendering	4 Market-led Price Cap	5 Precautionary Price Cap
Investment in time						
Investment at Stansted	+			<ul style="list-style-type: none"> Introduces a form of 'market testing' to the funding of investment 		
	-	<ul style="list-style-type: none"> Can distort the timing, extent and nature of investment decisions. Discourages effective interaction between airport and airlines. CAA may need to decide on a range of design features, to resolve airport-airline disagreements. 	<ul style="list-style-type: none"> Can distort the timing, extent and nature of investment decisions relating to the legacy airport assets 	<ul style="list-style-type: none"> Runway investment decisions might be distorted, as terminal demand does not guarantee sufficient runway demand Terminal and runway investment decisions could be distorted by the pricing of runway assets CAA determines key features of runway investment and some features of the terminal investment. 		
Investment at non-designated airports	+		<ul style="list-style-type: none"> Removes the airport's incentive to invest too early and to over-specify new infrastructure, preventing harm to competitors. 	<ul style="list-style-type: none"> 'Market testing' might prevent worst extremes of over-investment. 	<ul style="list-style-type: none"> Removes the airport's incentive to invest too early and to over-specify new infrastructure, preventing harm to competitors. 	<ul style="list-style-type: none"> Removes the airport's incentive to invest too early and to over-specify new infrastructure, preventing harm to competitors.
	-	<ul style="list-style-type: none"> Can adversely affect the prospects for investment at non-designated airports. Can harm the development of the UK airports market. 		<ul style="list-style-type: none"> Distorted investment could adversely affect the prospects for investment at non-designated airports and harm the development of the UK airports market. 		
Impact of uncertainty	+	<ul style="list-style-type: none"> Well-understood calculation. 	<ul style="list-style-type: none"> Well-understood calculation. 			

		Options				
		1 Augmented Building Block	2 Legacy Price Cap	3 Terminal Development Tendering	4 Market-led Price Cap	5 Precautionary Price Cap
	-		<ul style="list-style-type: none"> New airlines subject to a different approach, and greater risk than incumbents. 	<ul style="list-style-type: none"> Complex process, involving considerable regulatory intervention, followed by 'market testing' 	<ul style="list-style-type: none"> CAA discretion in setting the level of the price cap 	<ul style="list-style-type: none"> CAA discretion in setting the level of the price cap
Minimum restrictions necessary						
	+		<ul style="list-style-type: none"> New investment is 'free' from cost-based price caps. 	<ul style="list-style-type: none"> New terminal investment 'free' from price controls 	<ul style="list-style-type: none"> Avoids duplicating competitive constraints 	<ul style="list-style-type: none"> Avoids duplicating competitive constraints
	-	<ul style="list-style-type: none"> Potentially limits prices to levels below that which might be expected in a competitive airport market. Requires CAA scrutiny and approval of investment plans. 	<ul style="list-style-type: none"> The legacy price cap might just distribute profit from the airport to the legacy airlines, without any benefits to passengers and other end users. 	<ul style="list-style-type: none"> Airport operator prevented from providing new terminals CAA determines key features of runway investment and some features of the terminal investment The price cap on the old assets might just distribute profit from the airport to the legacy airlines, without any benefits to passengers and other end users. 		

		Options				
		1 Augmented Building Block	2 Legacy Price Cap	3 Terminal Development Tendering	4 Market-led Price Cap	5 Precautionary Price Cap
Other legal or practical issues						
	+		<ul style="list-style-type: none"> • Might encourage or require airport to discriminate between airlines – might be incompatible with UK and/or EC competition legislation • Might encourage or require airport to breach UK’s international obligations. • Appears complex to implement – requiring the boundary between the old and new assets and operations to be defined. Associated risk of unintended consequences. 	<ul style="list-style-type: none"> • Appears complex to implement – requiring the boundary between the old and new assets and operations to be defined. Associated risk of unintended consequences. • Unclear whether CAA has legal vires to prevent BAA from delivering terminal capacity 		
	-					

Annex A. Questions for consultation

- A.1 Interested parties are invited to comment on any issues raised in this document, and to provide any such evidence and/or analysis that they consider to be relevant to the function to be carried out by the CAA.
- A.2 This Annex sets out, for ease of reference, the specific consultation questions asked in this document. The CAA requests that, for ease of reference, respondents arrange their comments following the structure of this document and, where possible, against these consultation questions.

Chapter 1 – Introduction

- A.3 No consultation questions were posed in Chapter 1.

Chapter 2 – Recent developments

- Q.1 Do you agree that the CAA has accurately summarised the relevant regulatory and market developments?**

Chapter 3 – Legal Framework

- Q.2 Do you agree that the CAA has accurately summarised the relevant legal framework?**
- Q.3 Has Stansted Airport, since the last reference on 28 February 2002, pursued a course of conduct which has operated or might be expected to operate against the public interest? If so, could you provide supporting evidence?**

Chapter 4 – Key challenges in setting price controls at Stansted

- Q.4 Do you agree with the summary of the general issues faced in regulating airports? If not, what other issues should be considered?**
- Q.5 Do you agree with the summary of the specific issues faced in regulating Stansted? If not, what other issues should be considered?**

Chapter 5 – Identifying price control options

- Q.6 Do you agree that the circumstances faced by Stansted Airport mean that the 'standard' approach to setting price caps is unlikely to be appropriate for the airport?**
- Q.7 Has the CAA identified all of the relevant potential options for setting a price cap at Stansted Airport? If not, what are the key features of any alternative proposals and how would these proposals be consistent with the CAA's statutory duties?**

Chapter 6 – Framework for assessing the options: the CAA’s statutory duties

Q.8 Do you agree with the CAA’s interpretation of its statutory duties? If not, how should the CAA interpret these duties, and on what basis?

Chapter 7 – Option 1: the augmented building-block approach

Q.9 Has the CAA correctly identified the key effects arising from an augmented building-block approach?

Q.10 Do you agree with the comments made by the CAA on the degree to which the augmented building-block approach might meet its statutory duties?

Chapter 8 – Option 2: legacy price caps

Q.11 Has the CAA correctly identified the key effects arising from an LPC?

Q.12 Do you agree with the comments made by the CAA on the degree to which the LPC might meet its statutory duties?

Chapter 9 – Option 3: terminal development tendering

Q.13 Has the CAA correctly identified the key effects arising from a TDT approach?

Q.14 Do you agree with the comments made by the CAA on the degree to which the TDT approach might meet its statutory duties?

Chapter 10 – Option 4: market-led approach

Q.15 Do you agree that long-run average incremental costs (LRAIC) and/or replacement costs are an important element of the evidence base for setting an MLPC? What evidence and/or approach should the CAA draw upon when assessing these values, including the appropriate assumptions in respect of asset lives, cost of capital, etc?

Q.16 If a transitional period were to be adopted, what price level should be used for the first year and over what period should this transition take place? In both cases, please explain the rationale for the values suggested.

Q.17 Has the CAA correctly identified the key effects arising from an MLPC?

Q.18 Do you agree with the comments made by the CAA on the degree to which the MLPC might meet its statutory duties?

Chapter 11 – Option 5: precautionary price cap

Q.19 Has the CAA correctly identified the key effects arising from a PPC?

Q.20 Do you agree with the comments made by the CAA on the relative degree to which the PPC might meet its statutory duties, when compared to the MLPC approach?

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Annex B. Stansted's recent financial and operating performance

Introduction

B.1 This annex provides an overview of Stansted's performance to date against the assumptions of the Q4 price control. In particular:

- it outlines performance against the key individual building blocks that make up the price control;
- it shows the movement of the airport's price cap during the quinquennium and highlights recovery against them; and
- it provides a calculation of aggregate performance against the price control at each of BAA's designated airports.

Performance against individual building blocks

B.2 This section outlines emerging trends on the key drivers of the building block calculation for the first four years of the Q4 price control. It focuses on the following categories:

- volumes (terminal passenger numbers);
- operating expenditure;
- capital expenditure;
- commercial revenues.

B.3 The following sections deal with these categories in turn. Each section details the levels forecast when the price control was set, outlines outturn performance in the first four years of the quinquennium and provides BAA's most recent forecasts for the remainder of the control period.

Volumes

B.4 Table B-1 compares volume projections, made at the time of the last price control review, against outturn volumes to date and the latest available BAA forecasts for the final year of Q4. This indicates that volumes at Stansted have been in excess of the levels forecast in the Q4 determination.

Table B-1 Volumes at Stansted in Q4 (mppa)

	2003/04	2004/05	2005/06	2006/07	2007/08	Total
Determination	17,500	19,300	20,300	21,100	22,300	100,500
Outturn/forecast	19,409	21,169	22,237	23,845	24,700	111,360
Variance	1,909	1,869	1,937	2,745	2,400	10,860

Sources: BAA regulatory accounts, BAA regulatory submission, CAA decision

Operating expenditure

B.5 Table B-2 displays outturn operating expenditure for Stansted airport against the levels assumed by the CAA in its final decision. This shows that spend at Stansted was slightly lower than the level assumed by the price cap during the early years of the control period. However, this trend has reversed in the final two years, with spend projected to be significantly above forecast levels in 2007/08. BAA states that the key factors driving this increase in expenditure are:

- increased security staffing levels in response to increased traffic and to maintain service levels; and
- higher accounting pensions costs.

Table B-2 Operating expenditure at Stansted airport in Q4 (£m, 2006/07 prices)

	2003/04	2004/05	2005/06	2006/07	2007/08	Total
Determination	90.3	98.7	105.6	108.0	112.1	514.8
Outturn/forecast	89.3	96.3	104.2	114.7	133.9	538.5
Variance	-1.0	-2.4	-1.4	6.7	21.8	23.7

Sources: BAA regulatory accounts, BAA regulatory submission, CAA decision

Capital expenditure

B.6 Table B-3 shows the outturn capital expenditure for Stansted airport and the latest forecast spend against the assumptions of the last review for Q4. This shows that spend was well below determination in the early years of Q4. Whilst this trend is reversing in the final two years of Q4, spend in aggregate is forecast to be less than the determination. This, taken together with the significant asset disposal undertaken in 2004/05, means that the Stansted RAB will be somewhat lower than the level it was expected to reach at the end of Q4.

Table B-3 Capital expenditure at Stansted airport in Q4 (£m, 2006/07 prices)

	2003/04	2004/05	2005/06	2006/07	2007/08	Total
Determination	37.7	79.7	79.6	91.7	95.2	383.8
Outturn/forecast	21.3	54.7	68.4	111.4	114.7	370.5
Variance	-16.4	-25.0	-11.2	19.7	19.6	-13.3

Sources: BAA regulatory accounts, BAA regulatory submission, CAA decision

Other revenues

B.7 Table B-4 shows the 'other revenues' earned at Stansted airport against the level projected at the time of the last review. This shows that revenues at Stansted have been consistently below the level projected in the Q4 determination despite significantly greater numbers of passengers.

Table B-4 Other revenues at Stansted airport in Q4 (£m, 2006/07 prices)

	2003/04	2004/05	2005/06	2006/07	2007/08	Total
Determination	107.6	115.4	118.2	121.8	127.6	590.6
Outturn/forecast	102.6	108.2	106.9	108.2	108.5	534.4
Variance	-5.0	-7.2	-11.2	-13.6	-19.1	-56.2

Sources: BAA regulatory accounts, BAA regulatory submission, CAA decision

Note: These figures do not include revenues from non-passenger flights

Tracking the price cap during Q4

B.8 At the last review, the CAA set a price cap for Stansted airport for Q4, that limited prices to £4.89 followed by RPI-0%. This represented the baseline cap. There are a number of further factors, such as the security pass-through and the correction factor that can potentially affect the path of prices. Table B-5 shows the calculation of the maximum allowable yields at Stansted airport across Q4 against the published charges. Table B-6 provides, for comparative purposes, the same information against the revenues from actual charges. This shows that Stansted has under-recovered significantly in each of the first four years of Q4 due to unpublished discounts provided to airlines. It should be noted that the correction factor only applies to shortfalls on published charges.

Table B-5 Application of the pricing formula at Stansted (published charges)

	2003/04	2004/05	2005/06	2006/07	2007/08
Allowable yield per pax, before adjustments (£)	4.89	4.89	5.03	5.18	5.32
S factor	-	-	-	-	-
K factor	-	-	-0.46	-0.50	-0.93
RPI	-	2.8	3.1	2.7	3.4
X factor	-	-	-	-	-
Allowable yield per pax, after adjustments (£)	4.89	5.03	5.64	5.83	6.44
Revenue from airport charges (£m)	87.2	97.1	106.9	122.8	
Passenger numbers	19.5	21.3	22.3	23.9	
Average yield per pax (£)	4.47	4.57	4.79	5.14	
Difference	0.42	0.46	0.85	0.69	

Source: CAA analysis

Table B-6 Application of the pricing formula at Stansted (actual charges)

	2003/04	2004/05	2005/06	2006/07	2007/08
Allowable yield per pax, before adjustments (£)	4.89	4.89	5.03	5.18	5.32
S factor	-	-	-	-	-
K factor	-	-	-0.46	-0.50	-0.93
RPI	-	2.8	3.1	2.7	3.4
X factor	-	-	-	-	-
Allowable yield per pax, after adjustments (£)	4.89	5.03	5.64	5.83	6.44
Revenue from airport charges (£m)	48.0	55.5	65.7	74.3	
Passenger numbers	19.5	21.3	22.3	23.9	
Average yield per pax (£)	2.46	2.61	2.94	3.11	
Difference	2.43	2.42	2.70	2.72	

Source: CAA analysis

Overall performance against the price cap

B.9 The section above highlighted that Stansted airport has significantly under-recovered in terms of the outturn yields against the allowed yields under the price caps for all years of Q4 to date. This will have a considerable impact on the overall performance of the airport against the price cap. However, a number of other factors beyond simply the recovery of airport charge revenue will impact upon the overall returns generated at the airport.

B.10 The first section of this annex showed performance against the key regulatory building blocks. This indicated that:

- operating expenditure had been marginally below the determination in the early years of Q4;
- passenger numbers have been well above the projected level; and
- capital expenditure has been lower than forecast.

B.11 Each of these factors in isolation might be expected to have a positive impact on the regulatory return generated by Stansted airport. Table B-7 combines these factors with the opening RAB value and depreciation assumptions to calculate the aggregate performance to date against the Q4 price cap.

Table B-7 Stansted's Q4 performance

	2003/04		2004/05		2005/06		2006/07	
	Outturn	Determ.	Outturn	Determ.	Outturn	Determ.	Outturn	Determ.
Passenger numbers	19,409	17,500	21,169	19,300	22,237	20,300	23,845	21,100
Revenues								
Airport charge revenue	54.3	70.6	62.4	83.2	72.5	92.0	80.7	100.7
Other revenue	93.5	98.1	101.7	108.4	103.1	113.9	108.2	121.8
Total revenues	147.8	168.7	164.1	191.6	175.6	205.9	188.9	222.5
Costs								
Opex	81.4	82.3	90.5	92.8	100.5	101.8	114.7	108.1
Depreciation	31.7	31.7	31.8	31.8	36.4	36.4	40.5	40.5
Total costs	113.1	114.0	122.3	124.6	136.9	138.2	155.2	148.6
Regulatory return	34.7	54.7	41.8	67.0	38.7	67.7	33.7	73.9
Weighted av. RAB	868.6	876.0	868.0	924.1	886.6	991.8	969.1	1,074.0
Return on the RAB	4.0%	6.2%	4.8%	7.3%	4.4%	6.8%	3.5%	6.9%

Service quality performance

B.12 BAA has provided the performance quarterly data in Table B-8 relating to 2006 and the first three quarters of 2007 based on the percentage availability of facilities. With the exception of the availability of jetties in September 2007 each group of facilities had an availability of over 99% in each quarter.

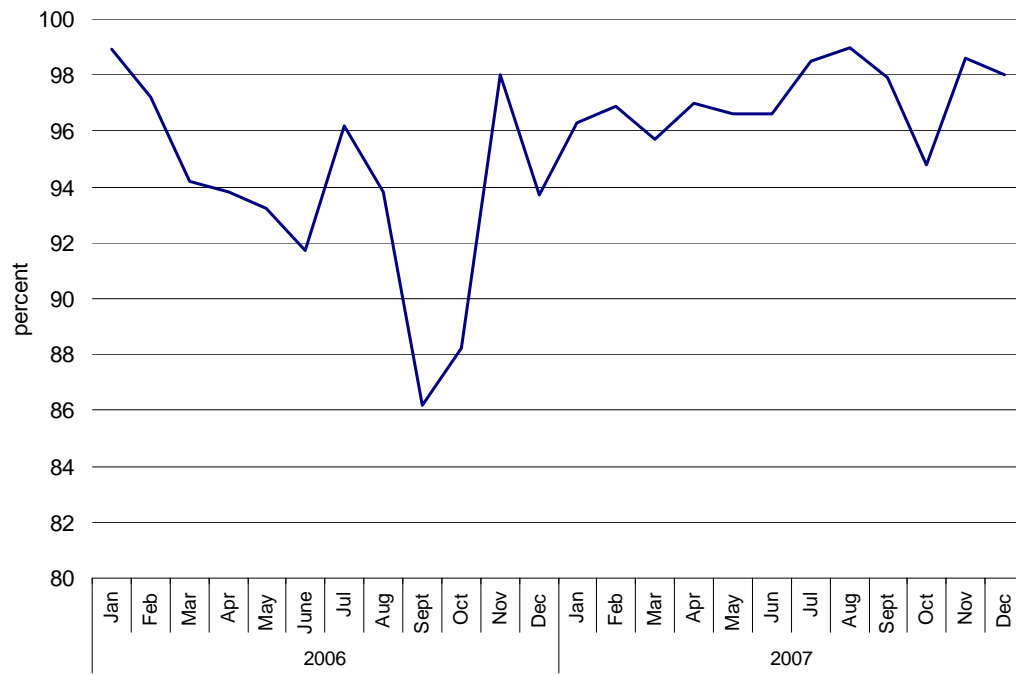
Table B-8 Availability of facilities by quarter.

	Mar 06	Jun 06	Sep 06	Dec 06	Mar 07	Jun 07	Sep 07
Jetties	99.98	99.52	99.55	100.00	100.00	99.80	86.50
Passenger lifts	99.89	99.76	99.73	99.99	99.80	99.60	99.75
Goods lifts	99.91	99.76	99.78	99.99	99.70	99.90	99.10
Transits	99.84	99.96	99.97	99.98	99.70	99.70	99.98
Auto walks & escalators	99.62	99.91	99.92	99.99	99.90	100.00	99.90

Source: BAA data

B.13 BAA has also provided data for security queues based on the percentage of occasions when queue time was less than ten minutes measured over three agreed peak periods (0500 to 0700, 1200 to 1400, 1730 to 1930) which is set out in Figure B-1 below. This appears to show that queuing performance fell substantially following the imposition of more stringent security standards in August 2006 but has been above 95% for each month in 2007 with the exception of October.

Figure B-1 Percentage of occasions when queue length is less than 10 minutes



Source: BAA data

Annex C. Cost of new entry and expansion

Introduction

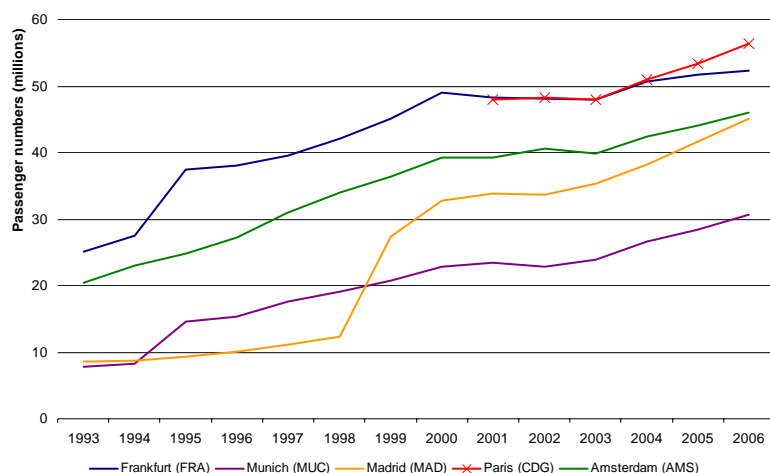
- C.1 This annex sets out evidence on the potential costs of significant expansion of airport capacity, of a similar order of magnitude to that being contemplated in the South East of England to cater for projected increase in passenger demand in the coming decades.
- C.2 The CAA commissioned consultants Scott Wilson to conduct a short review of the capital costs of airport expansion. The study was approached in three phases:
- identification of airports that should be assessed as being appropriate study subjects;
 - identification of potential sources of information and collection thereof; and
 - analysis of the collected data.
- C.3 The study considered European airports that had grown from approximately 20 to 40 millions of passengers per annum (mppa). Relatively few airports have achieved this level of throughput as shown in Table C-1 below, which lists only the thirteen airports exceeding 20 mppa throughput.

Table C-1 European airport passenger throughput, 2005

Airport	Pax (mppa)
London Heathrow	67.7
Paris Charles de Gaulle	53.4
Frankfurt Main	51.8
Amsterdam Schiphol	44.1
Madrid Barajas	41.7
London Gatwick	32.7
Munchen	28.4
Roma Fiumicino	27.8
Barcelona	27.0
Paris Orly	24.9
Manchester	22.1
London Stansted	22.0
Palma de Mallorca	21.2

Source: Eurostat, 2006

- C.4 Excluding the BAA owned airports, the following airports were considered: Paris Charles de Gaulle (CDG), Frankfurt Main (FRA), Amsterdam Schiphol (AMS), Madrid Barajas (MAD) and Munchen (MUC), which had increased its throughput to 30.8 mppa by 2006. Only the largest three of these airports had grown to a throughput above 40 mppa. Growth profiles, including 2006, of these five airports are shown in Figure C-1.

Figure C-1: Growth in passenger throughput at selected airports

Source: Eurostat

C.5 Following a review of the available literature relating to the five comparable airports (AMS, CDG, FRA, MAD, MUC), the study concluded as follows:

- the airports saw two phases of consistent growth, firstly during the 1990's up to 2001 and again from 2003 after the levelling of throughput following the terrorists attacks of 11 September 2001;
- data for both periods of growth are not readily evident in the literature;
- the potential use of data from the early 1990's may not be readily useable given uncertainties of inflating costs with accuracy;
- data from 2003 are available in the literature, but are more journalistic in nature and not of sufficient completeness to enable a constructive analysis;
- reliable data may be available from the airports directly.

C.6 Although no firm conclusions can be drawn from the available data, the study does provide, at the broadest level of estimation, some indication of the order of magnitude of costs associated with major capacity expansions at major European airports. Among the data, those set out in Table C-2 (which are both historical and future forecasts) appear to be closest in terms of scale of capacity to the sorts of capacity increments which are being contemplated in the south-east of England.

Table C-2 Summary of data on the cost of a selection of airport expansion projects

Project Description		Year of Completion	Reported Cost	Capacity Increase	Previous Capacity	New Capacity
CDG	New satellite		US \$ 868m	8.5 mppa, 26 ATM/hr, inc 6 A380	47mppa	
FRA	Terminal 3	2015		25 mppa		56 mppa
	New Runway	2011		37 ATM	83 ATM	120 ATM/hr; 520,000 ATM/yr
	Land purchase		€ 650m			
	Investment in new runway, pax handling facilities & other operating facilities including purchase of site and inflation adjustments	2020	> € 4bn			
	New terminal and runway	2014	US\$ 4.9bn			
AMS	5 th runway	2003	€ 340m			
MAD	Terminal	2006/10	€ 670m			
	Satellite	2006/10	€ 400m			
MUC	Terminal 2 incl. infrastructure facilities	2003	€ 1.5bn	25 mppa	25 mppa	50 mppa
	3 rd runway					120 ATM/hr

C.7 In addition, Table C-3 sets out a summary of the remaining potential comparator projects.

Table C-3 Summary of data on reported costs of European airport expansion

Project Description		Year of Completion	Reported Cost	Capacity Increase	Previous Capacity	New Capacity
CDG	Terminal 1 renovation	2006	€ 220m		7/8mppa	
	Terminal 2E (104,000m ²)	2003	€ 750m	10 mppa		
	Terminal S3	2007				
	Terminal 2E roof repair and expansion	2005	€ 980m			
	New Runway	2000				110 ATM/hr
	Terminal 2E	2003		9 mppa		
	Terminal 2E-2F, extension of boarding satellite	2003				
	New satellite		US \$ 868m	8.5 mppa, 26 ATM/hr, inc 6 A380	47mppa	
	Investment programme announced in 2006		€ 2.7bn			

	Project Description	Year of Completion	Reported Cost	Capacity Increase	Previous Capacity	New Capacity
FRA	Expansion Project		>€ 3.3bn			80 mppa
	New landing runway	2009		40 ATM/hr	80 ATM/hr	120 ATM/hr
	Terminal 3	2015	€ 1.1bn	25 mppa		56 mppa
	New Maintenance Hangar for A380		€ 150m			
	Terminal 1 Expansion	2007	€ 115m	4 mppa		
	4 th runway	2006				
	Construction of additional Terminal (3) and apron area	2007				
	Terminal 3	2015		25 mppa		56 mppa
	New Runway	2011		37 ATM	83 ATM	120 ATM/hr; 520,000 ATM/yr
	Land purchase		€ 650m			
	Investment in new runway, pax handling facilities & other operating facilities including purchase of site and inflation adjustments	2020	> € 4 bn			
	Expansion investments 2000-2006		€ 405.7m			
New terminal and runway	2014	US\$ 4.9bn				
AMS	5 th runway	2003	€ 340m			
	Renovation and expansion of Departure Lounge 1	2005	€ 165m	15 mppa	45mppa	60 mppa
	People mover over to new pier	2005	US\$ 50m			
	New J-Pier (west extension)	2005	US\$ 100			
	Western terminal extension	2005	US\$ 200			
	Apron extension	2006	US\$ 50m			
	Southern A pier extension and people mover	2006	US\$ 200m			

	Project Description	Year of Completion	Reported Cost	Capacity Increase	Previous Capacity	New Capacity
MAD	Expansion inc. new terminal and satellite building	2004	€ 2.91bn			
	Terminal 4 and satellite building			35 mppa		70 mppa
	Satellite Building			15 mppa		
	2 new runways					120 ATM/hr
	Parking and Access	2004	US\$ 142m			
	Automated baggage handling system	2004	US\$ 265m			
	Satellite Terminal	2004	US\$ 280m			
	Electric power modifications	2004	US\$ 102m			
	Apron expansion	2004	US\$ 260m			
	Runway 15L-33R	2004	US\$ 255m			
	Runway 18L-36R	2004	US\$ 220m			
	New air terminal	2004	US\$ 545m			
	Terminal	2006/10	€ 670m			
	Satellite	2006/10	€ 400m			
	Car Park	2006/10	€ 168m			
	Relocation of residents	2007	€ 6.6m			
	Soundproofing houses		€ 130m			
MUC	Baggage Handling system	2000	€ 93m	100,000 items/day		
	Terminal 2	2003	€ 56m	25 mppa		
	Apron 2	2003	US\$ 160m			
	Terminal 2	2003	US\$ 1.15bn			
	Apron 3	2003	US\$ 115m			
	Terminal 2 incl. infrastructure facilities	2003	€ 1.5bn	25 mppa	25 mppa	50 mppa
	3 rd runway					120 ATM/hr
	Maglev Link	2014	€ 1.85bn			

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Annex D. Information on relative prices

Introduction

D.1 This annex sets out the results of the CAA's recent survey of UK airport charges, for the purposes of collating information which could be relevant to the setting of price controls at Stansted Airport. The annex reports the following:

- CAA survey methodology;
- Airport charge definitions
- Airport charge revenue per passenger on a normalised basis
- Factors affecting the setting of airport charges

Survey methodology

D.2 The CAA wrote in September 2007 to those UK airports which handled in excess of 0.5 million terminal passengers in 2006. These 29 airports are:

Aberdeen, Belfast City, Belfast International, Birmingham, Blackpool, Bournemouth, Bristol, Cardiff, Coventry, Doncaster Sheffield, Durham Tees Valley, East Midlands, Edinburgh, Exeter, Gatwick, Glasgow, Heathrow, Humberside, Inverness, Leeds Bradford, Liverpool, London City, Luton, Manchester, Newcastle, Norwich, Prestwick, Southampton, Stansted.

D.3 The CAA requested responses to the following questions from each airport:

- Total revenue from airport charges for the year ending 31 March 2006, or the nearest equivalent year if the airport used a different financial year;
- What charges are included in airport charges revenue figures?
- Do the charges cover the provision of air navigation services?
- Do the charges cover any elements of ground handling, such as for the provision of check-in or baggage handling facilities?
- How does each airport account for discounts and rebates? Do the figures reflect the actual charges paid by airlines or are they calculated as if airlines had paid the published charges?
- Is there any account taken in the figures for any marketing support that the airport provides to airlines?
- Are there any other factors or contractual conditions covering airport charges that the CAA should take into account when comparing airport

charges across airports (e.g. long-term contracts, volume discounts or revenue sharing agreements)?

(In asking these questions the CAA noted that it was not attempting to change accounting practices to achieve uniformity in reporting, but was seeking to avoid making misleading comparisons.)

D.4 As at early December 2007, the CAA had received responses from 22 airports, a response rate of around 75 per cent in terms of numbers of airports, and a much higher percentage in terms of the proportion of passengers covered by responding airports.

Airport charges - definitions

D.5 A summary of the responses from the airports on the questions relating to definition of airport charges is as follows:

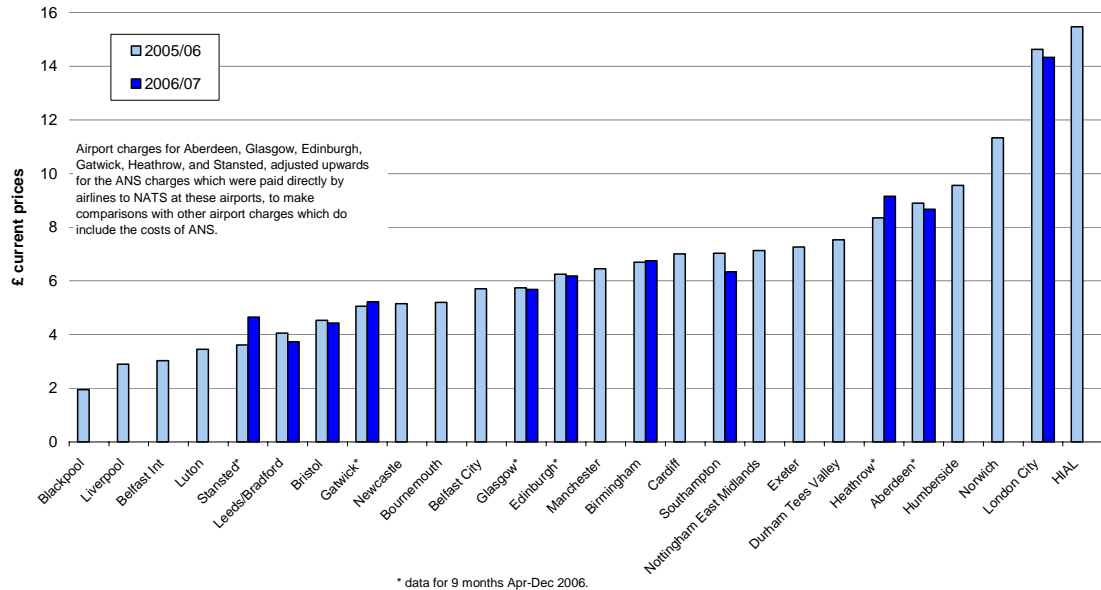
- Airport charges encompass the core of aircraft landing, parking, and passenger processing at all of the airports. Several other services and facilities (such as baggage handling, check-in desks, airfield air navigation services) are also included in airport charges at several airports.
- All airports, apart from six owned and operated by BAA, include airfield air navigation services (ANS) within airport charges¹⁰¹.
- Any discounts and rebates on published airport charges are generally included within the total amount of airport charges reported in the accounts, i.e. this total is net of any such discounts.
- By contrast, any marketing support payments from the airport to pay for the promotion of airline services is generally recorded as an operating cost, and not netted off airport charge revenue.
- Many airports observed that the actual level of charges was driven by the degree of competition which that particular airport faced, and by the strength of 'buyer power' which individual airlines possessed.
- Many airports also observed that as a result of individual contracts with airlines, often in return for airline commitments to providing traffic for that airport, and/or the incentive structures within the published tariff, the average charge per passenger would be lower than the basic published tariff.

¹⁰¹ Aberdeen, Edinburgh, Gatwick, Glasgow, Heathrow and Stansted are currently designated by the Secretary of State for Transport under section 77(3) of the Transport Act 2000 for the so-called 'direct charging' of aerodrome ANS. The DfT has announced a policy decision to end direct charging, although the timing of this may vary between these airports.

Airport charges – levels

- D.6 As part of its regulatory functions, the CAA receives accounts information on annual basis from a number of UK airports. From these data and the CAA's own statistics on airport passenger traffic, the CAA has derived airport charge per passenger statistics for all of those airports for which data had been reported by end November 2007, for the financial years 2005/06 and 2006/07.
- D.7 To produce comparable data, it was necessary to make an adjustment for the fact that in the year's in question the airfield ANS charge was paid directly by airlines to NATS (NSL) at six airports, whereas this cost was covered by airport charges at all other airports. The basic airport charge per passenger results for each BAA airport has therefore been adjusted upwards to include an estimate of the ANS charge per passenger at the relevant airport. However, it should be noted that there are a number of other factors that could affect this data. For example, where an airport has a high proportion of non-passenger traffic the following analysis will tend to overstate the actual level of charges paid by passenger aircraft.
- D.8 The resulting comparisons of (adjusted) airport charges per passenger at each airport are illustrated in Figure D-1 below. In summary, in 2006/07:
- The maximum charge per passenger was £14.33 at London City, the minimum was £3.73 at Leeds Bradford, with a range of £10.59 around a midpoint of £9.03.
 - The median charge was £6.18 at Edinburgh. The simple arithmetic mean was £6.95.
 - There are no clear trends or patterns which emerge in comparing 2006/07 data with those for the previous year – at different airports, charges per passenger increase, decrease or remain broadly constant between these two years.

Figure D-1 Airport charge revenue per passenger



Source: CAA survey of airports, adjusted for direct charging of ANS at BAA's airports