

APPENDIX J

Evidence and analysis on Test C

Introduction

- J1 Test C requires the assessment of whether for users of air transport services the benefits of regulation are likely to outweigh the adverse effects.
- J2 This appendix provides:
- the framework for the assessment of Test C;
 - a summary of the minded to assessment of Test C;
 - responses to the Consultation;
 - the CAA's analysis; and
 - the CAA's conclusion on whether Test C is met.

Assessment framework

- J3 Test C of the market power test requires "that, for users of air transport services, the benefits of regulating the relevant operator by means of a licence are likely to outweigh the adverse effects"¹
- J4 The relevant operator is "the person who is the operator of the airport area at the time the test is applied."²
- J5 Users of air transport services are defined in the CA Act as passengers, or those with a right in cargo and includes future users of such services.³
- J6 Test C forms part of the market power test that must be met before the CAA can grant a licence, and if so on what conditions, pursuant

¹ Section 6(3) of the Civil Aviation Act 2012 (CA Act).

² Section 6(2) of the CA Act.

³ Sections 69(1) and (2) of the CA Act.

to sections 15-21 of the CA Act. Test C requires the CAA to assess whether the benefits of regulating the relevant operator by means of a licence are likely to outweigh the adverse effects. Test C does not expressly require the CAA to apply this test by reference to a specific set of licence conditions (regulatory obligations). Such a requirement would reverse the logical structure of the CA Act, and would require the determination of individual licence conditions before the decision of whether to grant a licence is made.

- J7 However, in the present case, due to the logistical timetable of implementing the CA Act in time, the market power assessment has had to be undertaken in parallel to the CAA's Q6 review of the possible forms of regulation for Gatwick Airport Limited (GAL) after April 2014.⁴ In those circumstances, the CAA has considered Test C by reference to the form of licence regulation which it considers to be most appropriate for GAL. As further explained below, in the present case, that is GAL's proposed commitments to airlines backed by a licence and a monitoring framework (referred to in this determination as licence-backed commitments or the LBC Licence).
- J8 The CAA notes that the CA Act does not dictate a particular method of impact assessment and as a result such assessment may be qualitative or quantitative or a combination of both depending upon the availability of the relevant data. Where it has been reasonably practicable to quantify the respective benefits and costs, the CAA has done so. Nevertheless, it has also assessed qualitative factors. It has then exercised its regulatory judgement in weighing those factors in order to apply Test C.

⁴ CAA, Economic regulation at Gatwick from April 2014: Initial proposals, April 2013, available from:

<http://www.caa.co.uk/docs/33/CAP%201029%20Economic%20regulation%20at%20Gatwick%20from%20April%202014%20initial%20proposals.pdf>.

CAA, Economic regulation at Gatwick from April 2014: Final proposals, October 2013, available from:

<http://www.caa.co.uk/docs/33/CAP1102.pdf>.

CAA, Economic regulation at Gatwick: notice of the proposed licence, January 2014, available from:

<http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=15152>.

Other documents relating to the CAA's Q6 review for GAL are available from:

<http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=15152>.

- J9 As required by the CA Act, when assessing the benefits of imposing licence regulation on the relevant operator, the CAA has carried out its functions in a manner which will further the interests of users of air transport services as defined by the CA Act (passengers and cargo owners) and, where appropriate, to do this by promoting competition, having regard to certain specified matters.⁵ As part of the assessment the CAA must consider the extent to which any likely net benefits are transposed into users' benefits.
- J10 Under section 1(5) of the CA Act if the CAA considers that there is a conflict between the interests of different classes of user or between the interests of users in different matters its duty is to carry out the functions in a manner which it considers will further such of those interests as it thinks best. The CAA's approach to balancing these different needs is set out in paragraph 10.27 of the CAA's Q6 final proposals.
- "When balancing the needs of passengers' interests the CAA is conscious of the need to protect against the risk of abuse of SMP. Consequently where an airport operator has SMP over all passengers (as identified in the minded to assessment), albeit the requirements of different groups of passengers differ, the CAA has focused regulation where the risk of abuse of market power and potential detriment to passengers is greatest. (...) The CAA recognises that this is likely to benefit some passengers more than others, although the CAA considers it will minimise distortions by focusing this protection on the cost of a minimum bundle of common services. This approach allows passengers that have higher service quality requirements to purchase this additional quality, rather than impose these higher costs and quality on all passengers. The CAA considers where an airport operator has SMP over all passengers, and there are trade-offs between different groups, the CAA should seek the outcome that provides the greatest overall benefit."
- J11 The CA Act also sets out the provisions for granting a licence and what a licence may contain.⁶ A licence may include such conditions as the CAA considers necessary or expedient in relation to the risks

⁵ Sections 1(3) and (4) of the CA Act.

⁶ Sections 15 to 21 of the CA Act.

of abuse of market power and any other conditions the CAA considers necessary or expedient having regard to the its duties.⁷

- J12 The CAA also has to have regard to the regulatory principles in section 1(4) of the CA Act and the duty not to impose or maintain unnecessary regulatory burdens.⁸ These provisions, in essence, build in a proportionality exercise to Test C to ensure that ex ante regulation via a licence is only imposed where it is suitable, necessary and proportionate.

Commitments in lieu of a licence

- J13 As an alternative to licence regulation, GAL has put forward proposals for airport commitments to airlines. These commitments, which GAL is proposing to include in its Conditions of Use (CoU), set out seven year limits on airport charges, a service quality scheme and commitments on consultation, investment and operational and financial resilience.
- J14 The CA Act does not provide a statutory scheme for the CAA to accept and enforce commitments as part of carrying out its functions in relation to the regulation of airport operators with substantial market power (SMP).⁹ Under section 6(5) of the CA Act, Test C requires a balancing exercise, whereby the benefits of a licence have to be considered against the adverse effects of regulation. As a result of its section 1 duties, including the need to further the interests of users, to promote competition and to have regard to the better regulation principles, the CAA needs to ensure that it acts proportionately when conducting the risk/benefit exercise required by Test C.
- J15 Where voluntary commitments are put forward, the CAA considers that it is entitled to take account of them as part of the counterfactual to the assessment of licence regulation under Test C. The CAA's discretion is not, however, unlimited but has to be exercised within

⁷ Section 18(1) of the CA Act.

⁸ Section 73(2A)(b) of the Regulatory Enforcement and Sanctions Act 2008 as amended by section 104 of the CA Act.

⁹ This contrasts with the Competition Act 1998 (CA98) and the Enterprise Act 2002, both of which explicitly provide for the acceptance of commitments in lieu of further regulatory action.

the confines of the CA Act, its general duties and the wider EU and national regulatory framework.

The relevant factual scenarios

- J16 The CAA's consideration of the benefits and costs of a licence regime under Test C has focused on a form of regulation based on GAL's proposed commitments backed by a licence and monitoring framework, referred to in this determination as 'LBC Licence. This is the form of regulation that the CAA has set out in its notice of the proposed licence and associated licence conditions, which is published at the same time as this document.¹⁰ The notice also sets out the reasons for the choice of this form of regulation and the proposed licence conditions.
- J17 By 'licence-backed commitments' the CAA means that the commitments offered by GAL will be incorporated into a basic licence along with other conditions that the CAA considers necessary and expedient to secure compliance with its regulatory duties and objectives. As part of this licensing approach, the CAA will apply a monitoring regime. This will, amongst other things, compare the actual average blended price applied by GAL under the CoU and any bilaterals with the CAA's fair price benchmark that it has calculated on the basis of its standard regulatory asset base (RAB) building block assessment. If prices are above the benchmark then the CAA will consider further action including introducing licence conditions to restrain prices. Further details of the terms of the LBC Licence are set out in paragraphs J94 and J95 below and are set out in full in the Gatwick Q6: notice of the proposed licence.
- J18 For completeness, the CAA has also considered the costs and benefits of regulation by means of licensing in general, that is a licence that is not in the form of an LBC Licence. The CAA refers to this below as Licensing Generally.
- J19 It is also necessary for the CAA to form a view of the counterfactual to a licence regime i.e. the situation that would exist in the absence of a licence.

¹⁰ CAA, Economic regulation at Gatwick: notice of the proposed licence, January 2014 ("Gatwick Q6: notice of the proposed licence"), opcit.

- J20 GAL has stated in its response to Q6 final proposals¹¹:
- "As we have previously made clear, Gatwick is committed to its proposed [Commitments] framework whatever the outcome of the CAA's market power assessment."
- J21 In the circumstances, the CAA has assessed the costs and benefits of regulation against the counterfactual situation in which, in the absence of a licence, GAL maintained the commitments framework it has put forward. The CAA refers to this as the "Commitments Counterfactual".
- J22 That counterfactual situation also includes other forms of regulation that currently exist, irrespective of any licence, most notably the Airport Charges Regulations 2011 (ACRs) and Airports (Groundhandling) Regulations 1997 (AGRs) as well as competition law. That regulatory framework is referred to below as "Existing Regulation".
- J23 For completeness, the CAA has also briefly considered the counterfactual situation in which GAL does not maintain the commitments and there is no licence in place. The CAA refers to this as the "No Commitments Counterfactual."
- J24 Lastly, to ensure the proportionality of the form of licence regulation in contemplation, when assessing the respective costs of licence regulation, the CAA has conducted a comparison between a LBC Licence and other possible forms of regulation, including full RAB licensing. The CAA's conclusions on that matter are set out in the Gatwick Q6: notice of the proposed licence but in the course of its assessment of Test C it has drawn comparisons between a LBC Licence and a RAB-based licence in respect of specific impacts.

¹¹ GAL, Economic regulation at Gatwick from April 2014: CAA's final proposals: Response from Gatwick Airport Limited, page 6, 4 November 2013, Final Airport Commitments, available from:
<http://www.caa.co.uk/docs/78/PUBLIC%20%20Gatwick%20response%20to%20CAA%20final%20proposals%20-%204%20Nov%2013.pdf>.

Minded to Consultation

CAA's minded to position

- J25 The Consultation was published in May 2013 and was based on the initial version of the commitments GAL provided as part of its Revised Business Plan in January 2013. GAL has subsequently substantially revised its commitment proposals several times in response to the CAA's consultations, most recently on 5 December 2013.
- J26 In the Consultation, the CAA was minded to consider that, given the level of market power identified in relation to Gatwick, the ACRs or AGRs would not necessarily provide sufficient protection for passengers.
- J27 The CAA considered that licence regulation was likely to provide a better method of enforcement than relying on the commitments alone. In particular the commitments would be enforced by airlines and so would not provide the same protection to passengers as a licence which could be enforced by the CAA which has a statutory obligation to further their interests. A licence would also offer a more credible and quicker enforcement route by avoiding the requirement to refer the matter through a dispute resolution process and would also reduce the time taken to re-introduce tighter controls should they be required. A licence would also avoid some of the additional problems created by the inclusion of the commitments in the CoU, for example the potential for GAL to make unilateral changes to the CoU.
- J28 The minded to assessment compared the protection provided by GAL's commitments with that under licence regulation against the topics most commonly addressed by economic regulation. A summary of the CAA's minded to views and the responses to the Consultation are set out in more detail below.
- J29 **Price.** As GAL was pricing at its regulatory cap for the vast majority of traffic, there was a reasonable expectation that if the price cap were removed then charges would rise. GAL's commitments price cap of retail price index (RPI)+4 per cent per year was above the CAA's view of a fair price of RPI+0 per cent per year and it allowed

the full pass through of security costs, taxation changes and the development costs of a second runway, which were not typically included under licence regulation. While the CAA acknowledged that there were risks from a licensing regime, for example from the potential impact on agreeing bilateral contracts, the CAA considered these risks were outweighed by the potential benefits.

- J30 **Efficiency, which impacts on future prices.** There was little evidence to suggest that competition has, so far, driven improved efficiency and so market pressure alone was unlikely to lead to an improvement in efficiency. While commitments would offer benefits from retaining the benefits from efficiency for longer (at least seven years), licence regulation was likely to provide stronger efficiency incentives due to the tighter price cap and the removal of the full cost pass through of security costs and the development costs of a second runway.
- J31 **Service quality, in terms of the range and level of services.** GAL's service quality performance improved during Q5 although it was difficult to judge whether this reflected the impact of regulation or competitive pressure. GAL's proposed commitments included a similar service quality regime as used for Q5, however, the extension and increased money at risk for bonuses could provide windfall gains to GAL and may not provide sufficient protection against repeated service quality failures. Potentially partially offsetting this would be the increased likelihood of bilateral contracts which could allow greater tailoring of the service quality offer to individual airlines and their customers.
- J32 **Investment, which can affect future levels of service quality.** The CAA acknowledged that regulation could distort investment incentives, with a potential bias of RAB-based regulation towards capital spend. However, although such a distortion may exist in principle, the CAA did not find evidence that it had had a significant impact on GAL's recent behaviour. Some distortive effects (e.g. fixing investment too far in advance and disincentivising investment for new customers) could be addressed by modifying the detail of licence regulation. Nevertheless, licence regulation was likely to lead to some costs in terms of rigidity, particularly in terms of investment consultation. The commitments included a commitment to consult in

line with the requirements of the ACRs and publish a rolling five-year capital investment programme and airport master plan. While this may save costs and speed processes, given GAL's SMP position, the CAA considered that there was a risk that beneficial enhancements would not be taken forwards and passengers' interests would not be taken into account.

- J33 The CAA also considered that there would be additional benefits from licence regulation in terms of the ability to introduce conditions to strengthen operational and financial resilience (above that provided for in the commitments themselves).
- J34 The CAA considered that commitments would have some benefits over a licence, in that they would avoid the **direct costs** of staff and consultancy associated with a regulatory review. However, a commitments regime would not be costless and the CAA considered that the potential cost savings from the commitments would be significantly reduced if there was not effective partnership working between GAL and the airlines.
- J35 The CAA considered that commitments would also have some benefits in terms of **avoiding management distraction**, as the enforcement of the commitments would be linked to commercial negotiations; and removing some **perverse incentives** that may occur under a regulatory regime, for example potential distortions to capital expenditure (capex) incentives under a RAB-based regime, or the potential for regulatory gaming.
- J36 Overall the CAA welcomed GAL's commitment proposals in the Consultation. However, the CAA was not sufficiently convinced that the enforceability of and the terms within the commitments' proposals provided sufficient protection to passengers' interests. Consequently, the CAA was minded to consider that the benefits of licence regulation were likely to outweigh the adverse effects and that, as Test C was met, some form of licence regulation should apply to GAL.

Responses to the Consultation

- J37 The CAA received five responses to the Consultation.
- J38 GAL has substantially revised its commitment proposals subsequent to the Consultation in response to comments from airlines and the CAA. GAL considered that the CAA had set the bar too high by requiring that a commitments framework would better protect passengers' interest than licence regulation and provide sufficient protection for passengers' interest. GAL considered that its revised commitments would provide passengers with certainty over the range, availability, continuity, cost and quality of airport operation services without the requirement for additional regulatory back-up. GAL emphasised the protections to passengers in the commitments on price, service quality, investment consultation, transparency and operational and financial resilience. GAL also emphasised the benefits of the commitments over licence regulation from passengers benefiting from a more appropriate service proposition, an increase in competition and greater flexibility over capex, which better reflected normal commercial practice. GAL made some further points on the approach to Test C in its response to the Stansted minded to market power assessment. The CAA has also addressed these points in this document.
- J39 The Gatwick Airport Consultative Committee (GACC) considered that Test C did not require the CAA to define precisely the form of regulation and considered that it was not clear that GAL's proposed commitments would have occurred if there was no regulation. The GACC stated that the appropriate counterfactual was the commitments without a licence and this should be compared in general terms to the benefits and costs to passengers of licence regulation. The GACC considered that there were benefits of licence regulation over commitments in terms of price, efficiency, service quality and investment. The GACC stated that the costs of licence regulation were overstated and non licence approaches could be very costly as they were new and subject to uncertainties and ambiguities. Overall the GACC considered that Test C was met and some form of licence regulation should apply to GAL.

- J40 easyJet plc (easyJet) fully supported the GACC's position.
- J41 Virgin Atlantic Airways Limited (VAA) raised similar concerns to the GACC over the commitments and the benefits of licence regulation. VAA also considered that licence regulation would have additional benefits as it would provide a better method of enforcement in that it would allow quicker and more efficient resolutions to be reached. VAA notes that the benefit of the regulatory system has already resulted in GAL downwardly revising its proposed prices under the commitments and finding further efficiencies.
- J42 British Airways plc (BA) supported the GACC's position and raised a number of additional points. BA stated that the terms in the commitments did not adequately address GAL's market power and did not further passengers' interests. BA considered that it was not the intention of Parliament that price controls are implemented in a way that renders obsolete processes and protections provided by the CA Act. BA considered that if the commitments were not included in the licence: the CAA would forgo its enforcement powers under the CA Act; and the process for varying the terms of the commitments differed from those under the CA Act, in particular by removing the airlines' right of appeal. BA considered that incorporating the commitments in a licence was necessary to ensure an oversight role of the CAA. BA considered that for the commitments price to be comparable to a RAB-based approach then the duration, obligations and key terms would need to be similar. Based on GAL's approach at that time, BA also did not think it was more likely that the commitments approach would lead to bilateral contracts.

Subsequent development of the commitments

- J43 The market power consultation was based on GAL's January 2013 version of the commitments. Since then GAL has issued a number of further versions of the commitments. In June 2013, in response to the CAA's Q6 initial proposals and following feedback from airlines, GAL reduced the commitments price to RPI+2.5 per cent per year for published charges and RPI+1.5 per cent based on the blended rate of the published charges and bilateral contracts. This was the version of the commitments seen by the airlines when responding to the Consultation.

- J44 In September 2013¹², following further feedback from the CAA and airlines, GAL put forward a revised set of commitments which included a price of RPI+1.5 per cent per year based on published charges and RPI+0.5 per cent per year based on the blended rate, and made amendments to a number of terms in the commitments for example around treatment of second runway costs.
- J45 In October 2013, the CAA issued its Q6 final proposals for the regulation of GAL. The CAA assessed GAL's revised commitments proposals. The CAA considered that the price in the commitments was reasonable compared to the CAA's fair price which was based on a RAB-based calculation. While the CAA considered that the commitments could have benefits, it highlighted concerns with the enforceability and terms of the commitments and based its final proposals on commitments and a LBC Licence.
- J46 On 4 November 2013¹³, in response to CAA and airline concerns, GAL put forward a further revised set of commitments. GAL considered that these revised commitments proposals also addressed previous CAA and airline concerns around second runway costs, premium services, the security cost pass through and consultation with the passenger advisory group.

Subsequent responses

- J47 In its response of 25 November 2013, the GACC set out its remaining concerns with GAL's revised November 2013 commitments. The GACC continued to consider that the commitments price was too high, the fair price calculation was too high and the CAA had wrongly concluded that the commitments price was comparable to the fair price. While the GACC acknowledged progress on the terms of the commitments it had the following outstanding concerns:

- the lack of mutual waiver/indemnity;

¹² GAL, Heads of terms of Airport Commitments in relation to Airport Services & Charges beyond Q5, September 2013, available from:
<http://www.caa.co.uk/docs/78/20SeptemberFinalCommitmentsProposals.pdf>.

¹³ GAL, Economic regulation at Gatwick from April 2014: CAA's final proposals: Response from Gatwick Airport Limited, Appendix 1, opcit.

- the lack of simultaneous alternative recourse to the courts in addition to the proposed dispute resolution mechanism;
- the lack of detail on the consultation on operational resilience, with a need for at least two consultations a year on operational resilience;
- GAL should not require airlines to undertake actions allocated to them during disruption;
- unclear definition of core service and premium charges;
- definitions are required of RPI, master plan and tollgates;
- pass through of security compares to previous year rather than base year;
- amendment of price needs to be based on a higher proportion of airline agreement;
- given their potential scale second runway costs should be subject to a full re-opener requiring a licence change;
- all airlines should have access to the service quality rebate (SQR) scheme, whether they have agreed a bilateral agreement or not;
- airline standards are anti-competitive and should be removed;
- pier service should be 95 per cent with reductions by agreement for major works;
- the service quality measurement manual should include the new metric on aerodrome congestion and a daily outbound baggage measure and should be agreed with the airlines and included with the commitments; and
- there should be a stronger commitment from GAL to consult on capex.

J48 BA stated that the November 2013 commitments had not addressed its concerns, including the lack of capex commitments and excessive prices.

GAL's final commitment proposals

- J49 On 5 December 2013 GAL published its final commitments proposals. This reduced the price to RPI+1 per cent per year (published charges) and RPI+0 per cent per year (average blended rate based on bilaterals and published charges in the CoU). GAL also revised a number of terms in the commitments in response to airline concerns. It:
- removed the GAL indemnity from the commitments;
 - allowed simultaneous alternative recourse to the courts in addition to the proposed dispute resolution mechanism;
 - provided two consultations a year on operational resilience and stated it would consult in a fair and timely manner with relevant information;
 - accepted airlines were to use best endeavours during periods of disruption and were not required to undertake actions allocated to GAL during disruption;
 - improved the definition of core service charges;
 - provided definitions of RPI, master plan and tollgates; and
 - provided airlines with access to the SQR scheme under bilateral agreements.
- J50 GAL did not seek to further address airline concerns on second runway costs, capex and consultation, level of airline agreement required to change prices and airline service quality standards. GAL considered that it had already made extensive revisions of these in the earlier versions of commitments but acknowledged that some airline concerns remained. GAL has also made progress with agreeing the service quality measurement manual with airlines, although no agreement has been reached on pier service levels.
- J51 GAL has also made some progress with bilateral contracts and has signed contracts with [redacted] airlines (Norwegian, Emirates, [redacted], Thomson) and heads of terms (HoT) agreed with [redacted]. GAL has stated it has had advanced discussions with a number of other airlines (including [redacted], [redacted]).

Additional airline views on market power

J52 On 27 November 2013, the CAA asked whether airlines' views on market power or the need for a licence had changed following recent bilateral negotiations.

- [redacted].
- easyJet stated that it has been trying to negotiate with GAL for over 1.5 years but until October 2013 there had been no meaningful engagement. easyJet considered that GAL negotiating did not indicate a change in GAL's market power or that GAL did not have SMP. easyJet stated that the aim of the licence-backed commitments was to provide room within the regulatory regime for the airline and airport operator to negotiate more commercially and prevent the airport operator charging excessive prices. GAL's refusal to negotiate a price relative to a final commitments price was an example that GAL was negotiating within a regulatory structure.
- [redacted] had concerns with the negotiations that illustrated GAL has SMP.
- Thomson/TUI did not consider that a possible bilateral agreement altered their previous representations made as part of the GACC response to the Consultation.
- VAA raised concerns that the proposed form of regulation did not offer as much protection as a RAB regime and removed the protection for airlines and passengers, that the commitments did not constitute a 'fair' price or support the CAA's primary duty, that those not signing up to bilateral deals would be punished by paying the maximum price, [redacted] and VAA continued to consider GAL held SMP. [redacted].

The CAA's analysis

- J53 In light of the representations from stakeholders as part of the Consultation, and additional evidence, the CAA has re-evaluated its assessment. The evidence and reasons for its conclusions are set out on an issue by issue basis. The CAA also sets out its response to the arguments raised during the Consultation on each issue and the reasons for rejecting or accepting stakeholders' views.
- J54 This section is structured as follows:
- a review of the assessment framework;
 - Commitments Counterfactual: costs and benefits analysis of the impact of the LBC Licence versus commitments plus Existing Regulation against the following specific impacts:
 - enforceability,
 - price,
 - efficiency,
 - service quality,
 - investment,
 - other potential benefits of licence regulation,
 - direct costs, and
 - other adverse effects;
 - Commitments Counterfactual: costs and benefit analysis of the impact of Licensing Generally versus commitments plus Existing Regulation by reference to the above regulatory impacts;
 - No-commitments Counterfactual: an assessment of the costs and benefits of a LBC Licence and Licensing Generally compared to the situation under Existing Regulation;
 - an overall conclusion of whether the benefits of licence regulation are likely to outweigh the adverse effects.

- J55 The assessment focuses on the potential impact on passengers, but also, where relevant considers the impact on cargo, in particular in the consideration of excessive prices. There are virtually no cargo-only operations at Gatwick¹⁴ and cargo is carried belly-hold in passenger airlines. Accordingly, there is a degree of overlap between the interests of passengers and cargo owners.

Assessment framework

Responses from the Consultation

- J56 GAL stated that the CAA had set the bar too high by requiring that a commitments framework would better protect passengers' interest than licence regulation and provide sufficient protection for passengers' interest. In particular GAL stated that the CAA wrongly took regulation as its starting point and focused on an item-by-item analysis rather than providing a holistic view on whether the benefits of regulation are likely to outweigh the adverse effects.
- J57 The GACC considered that Test C did not require the CAA to define precisely the form of regulation and considered that it was not clear that GAL's proposed commitments would have occurred if there was no regulation. The GACC stated that the appropriate counterfactual was the commitments without a licence and this should be compared in general terms to the benefits and costs to passengers of licence regulation.
- J58 On the assessment of Stansted Airport Limited (STAL), Starkie and Yarrow stated that the CAA's assessment failed to take proper account of the dynamic aspects of competition in particular the impact of regulation (and regulatory uncertainty) on innovation incentives.¹⁵

¹⁴ According to CAA Airport Statistics, there were only 5 commercial cargo-only flights at Gatwick in the first nine months of 2013.

¹⁵ MAG included a paper from Starkie and Yarrow in its response to STAL's Consultation. The CAA considered issues raised by Starkie and Yarrow applied to GAL as well and where appropriate included them in this document.

CAA's response

- J59 The assessment of Test C has contrasted licence regulation with two counterfactuals, namely the Commitments Counterfactual and the No-commitments Counterfactual. While the CAA has specifically examined these scenarios against different headline issues, the CAA has considered the benefits and costs of licence regulation as a whole.
- J60 The CAA does not consider that it has set the bar too high for the assessment of the suitability and effectiveness of the commitments. It continues to consider that, before exercising any discretion to accept commitments in lieu of licence regulation, it should exercise some caution and would need to be satisfied that the regime created by the commitments is reasonable and confers effective protection for passengers' interests (inter alia) in the range, price and quality of airport operation services. The net benefits of the commitments regime must be such that comparable benefits of licence regulation are no longer justified and are out of proportion with the adverse effects.
- J61 In its response on the STAL market power assessment, GAL made comments emphasising the need for the assessment to be forward-looking and to take account of the impact of increasing competition. The assessment of Test C, as with the other elements of the market power test has assessed the current situation and how that is likely to change over the next regulatory period. To inform this assessment the CAA has considered past performance, as this can provide an indication of future behaviour, and also the changes that are likely to take place in the future, with the change in ownership of STAL and the increasing capacity constraints over the Q6 period. The CAA notes that under Test A the CAA considers that GAL will have SMP throughout the relevant period. In considering the costs and benefits the CAA has had regard to its statutory duty to further the interests of passengers and, where appropriate, promote competition.
- J62 GAL also stated that the CAA should have estimated the magnitude of the indirect effects of regulation. The CAA notes that the previous assessments of market power by the CAA and Department for Transport (DfT) did not manage to quantify all impacts, particularly

indirect effects, which by their nature are somewhat uncertain and no stakeholders have provided values for the scale of the impact. The CAA also notes that GAL has not quantified the indirect effects of regulation. The CAA has therefore quantified impacts where possible. Where it is not possible to quantify impacts, the CAA has provided indications of the magnitude of impacts, for example in terms of the potential impact of removing price controls, although this has not been possible in all circumstances, for example in terms of the values attached to indirect impacts and the CAA has focused on whether these impacts are likely to apply and the potential issues that might apply.

- J63 In relation to STAL, Starkie and Yarrow stated that the assessment failed to take proper account of the dynamic aspects of competition in particular the impact of regulation (and regulatory uncertainty) on innovation incentives. Starkie and Yarrow stated that innovation encompassed product and service innovation including improvements in service quality. The CAA has taken account of the impact of regulation on innovation incentives in particular on service quality and the impact on bilateral contracts.

Test C analysis of the LBC Licence

- J64 In this section, the CAA assesses the incremental benefits and adverse effects of imposing regulation on GAL in the form of a LBC Licence as compared to the Commitments Counterfactual.
- J65 In what follows, the CAA considers:
- Existing Regulation;
 - the nature of GAL's proposed commitments;
 - the LBC Licence; and
 - assessment against specific impacts (in terms of the incremental benefits and adverse effects of the LBC Licence).

Existing Regulation

- J66 As part of the Commitments Counterfactual, the CAA has considered the constraints upon GAL's behaviour arising from Existing Regulation.

Airport Charges Regulations

CAA's minded to position

- J67 All three of the currently designated airports will remain subject to the ACRs regardless of whether they are removed from the licensing regime under the CA Act^{16,17}. The ACRs came into effect in November 2011 and transposed into UK law Directive 2009/12/EC of the European Parliament and of the Council of 11 March 2009 on airport charges. The ACRs provide airlines (but not directly passengers) with a number of protections, which include the following requirements:
- airport operators must consult annually with airlines on airport charges and service quality;

¹⁶ The Airport Charges Directive can be found at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:070:0011:0016:EN:PDF>.

¹⁷ The ACRs can be found at: http://www.legislation.gov.uk/uksi/2011/2491/pdfs/ukxi_20112491_en.pdf.

- airport operators have to provide airlines with information about the overall cost structure and revenues relevant to charges;
- four months' notice of changes to the system or level of airport charges or to the quality of service associated with an airport charge;
- airport charges must not discriminate between airlines except on relevant, objective, and transparent criteria, which can include cost and the quality and scope of services; and
- airport operators must consult airlines on major infrastructure projects.

J68 If an airline considers that an airport operator has breached one of these requirements, it can take action in the courts to recover loss or damage, or complain to the CAA. If the CAA receives such a complaint it must investigate and can give a compliance order on the airport operator and order any damage or loss be remedied.

J69 In the Consultation, the CAA considered that, given the level of market power identified in relation to Gatwick, the ACRs would not necessarily provide sufficient protection for passengers' interests as:

- the ACRs do not require charges to be cost reflective and do not seek to control the overall level of charges and hence are unlikely to provide sufficient protection against excessive prices;
- the ACRs are likely to provide limited incentives for the airport operator to be efficient and although they require the airport operator to provide information on the overall costs structure and costs associated with different airport charges, this information is unlikely to be sufficiently detailed to allow airlines to robustly challenge the efficiency of airport costs to gain assurance where an airport operator has SMP, like GAL;
- the ACRs are likely to provide limited incentives to provide an efficient level of service quality where an airport operator has SMP, as negotiations on service quality level held under the ACRs may not approximate to those that would be conducted in a competitive market;

- although the ACRs require the airport operator to consult on investment it does not require the airport operator to undertake an efficient level of investment and in case of an airport operator with SMP there is risk that it may undertake investment inefficiently (as costs can be passed on to users) or delay the required investments, reducing future service quality;
- the ACRs impose a duty on the CAA to investigate whether any of obligations in the ACRs have been breached only where there has been a complaint by an airline or another airport operator; and
- although the CAA can give a compliance order and take action to enforce such an order, it is likely to be difficult to make an order aimed directly at any losses sustained by end users because of the challenge of indentifying those affected and quantifying their losses.

Responses from the Consultation

J70 The CAA did not receive any responses that directly mentioned the protection from the abuse of SMP from the ACRs.

CAA position

J71 For the reasons given above and in the Consultation document, the CAA continues to consider that the ACRs would not provide sufficient protection against the risk of abuse of SMP to be in passengers' interests.

Airports (Groundhandling) Regulations

CAA's minded to position

J72 The AGRs transpose the European groundhandling directive into UK law. Groundhandling covers a multitude of activities including check-in, handling baggage, cargo and mail, re-fuelling aircraft, and transporting passengers and crew to aircraft.

J73 Under the AGRs, operators of airports with more than 2 million annual passengers cannot restrict the number of self handling airlines or third-party groundhandlers that operate at the airport without a determination from the CAA. There are currently no restrictions on the number of handlers in the UK.

- J74 Where handlers use aircraft facilities, such as check-in desks, baggage belts and fuel hydrant systems, the airport operator must set its charges according to relevant, objective, transparent and non-discriminatory criteria. The CAA can investigate alleged breaches of the AGRs.
- J75 The CAA considered that, given the level of market power identified in relation to Gatwick, the AGRs would not provide sufficient protection for passengers.

Responses from consultation

- J76 The CAA did not receive any responses that directly mentioned the protection from the potential abuse of SMP from the AGRs.

CAA's position

- J77 For the reasons given in the Consultation document, the CAA continues to consider that the AGRs would not provide sufficient protection against the risk of abuse of SMP to be in passengers' interests.

Competition law

- J78 As discussed in appendix I, dealing with Test B, the CAA considers that competition law alone, will not provide sufficient protection against the risk of GAL engaging in conduct that amounts to an abuse of its SMP.

Conclusion

- J79 As the foregoing makes clear, the CAA considers that Existing Regulation and competition law offers limited protection for users where an airport operator has SMP. The CAA has taken into account the impact of Existing Regulation as part of its assessment of Test C. It has also considered the additional protection offered by the commitments themselves.

GAL's proposed commitments

- J80 The CAA has based its assessment on GAL's December 2013 commitments, which are included within its CoU. These provided a number of protections on price, service quality, consultation and operational and financial resilience. The key features of GAL's proposed commitments are set out in figure J.1.
- J81 The CAA considers that, to some extent, the downward revision of the price and improvement of the terms in the commitments has occurred as a result of the CAA's regulatory process and would not have occurred if there was no realistic possibility of licence regulation.

Figure J.1: GAL's commitments proposal

Issue	Commitments proposal
Contractual basis	GAL commits to include the commitments in the Conditions of Use
Duration	7 years, with GAL providing 2 years' notice of its intention with regards to the continuation of the commitments
Change mechanism	Ability to change price path profile and service quality regime following consultation and if agreed by GAL and airlines carrying at least 67 per cent of passengers (and paying by reference to published charges) and 51 per cent of airlines responding to the consultation
Price	No price cap but the average revenue yield limited to RPI+1.0 per cent per year based on published charges and RPI+0.0 per cent per year based on average charges over the duration of the commitments, with a limit on over or under recovery in any one year. Variations to price cap to pass through changes in security costs and the costs of the second runway and hold baggage screening
Capital consultation	Publish rolling five yearly capital plan, consult on major projects and report on annual expenditure. Consultation with airlines and the Passenger Advisory Group
Service quality regime	Similar rebate scheme as Q5, with introduction of new outbound baggage measure and reweighting of attributes (both agreed with airlines). Monthly rebates the same as Q5 and would be increased by 25 per cent if service quality failures persist for more than six months (although there are no rebates if there are more than six failures in a financial year). Airline service quality penalties on check-in and arrivals bag performance, which would be

Issue	Commitments proposal
	funded by netting off airport rebates. There is no bonus for outperformance. Rebates on passenger-facing measures are capped at 2.85 per cent of charges
Investment	Minimum capex spend of £100m and explain material differences between the latest forecast, the prior year forecast and the forecast included in the CAA's price review
Operational resilience	Develop, maintain and consult on an operational resilience plan and so far as reasonable and practical coordinate and cooperate with all relevant parties to deliver the operational resilience plan
Financial resilience	Provide an annual confirmation of adequate financial resilience, prepare and maintain a continuity of service plan, and not to amend, vary or supplement any of its finance documents in respect of credit rating requirements unless it has given prior written notice to the CAA
Accounts	Publish same information as in the 2011/12 statutory accounts

Source: GAL and CAA analysis

Benefits of the commitments versus licensing

J82 GAL has proposed that these commitments should facilitate a normal commercial relationship based on bilateral contracts with individual airlines, while providing assurance to non-contracted airlines. GAL considers that the conclusion of bilateral contracts will be more likely with the airport operator's commitments in place than under a traditional price cap. Also the commitments will apply the rates over a longer term (7 years compared to a traditional 5 year price cap) providing greater certainty for airlines. The CAA agrees with GAL that bilateral contracts are more likely under commitments than a traditional 5 year RAB-based price cap, in particular as the commitments would:

- include a specific average price cap relating to the blended price, which is the below the average published price cap, thereby providing a financial incentive to both GAL and airlines to enter into bilateral contracts;
- reduce the risk for GAL and the airlines concerned that the terms offered in a typical 10 year bilateral might not be consistent with regulation over more than one control period;

- provide a longer period for an early sacrifice of margin to be compensated later; and
- enable a more flexible capital plan which would support differentiated services under bilateral contracts.

J83 The CAA considers that bilateral contracts are likely to enable price/volume deals which would facilitate growth, increasing choice and value for passengers.

J84 Airlines and passengers at Gatwick are more diverse than at other airports subject to economic regulation. It is therefore unlikely that "one size would fit all" and the commitments may provide benefits over a licence in the form of additional flexibility which would allow better tailoring to the needs of individual airlines and their passengers.

J85 A combination of airport commitments and bilateral contracts could therefore better further the interests of passengers as it could better be tailored to the business needs of individual airlines and their passengers, providing greater flexibility while still providing protection to all passengers. There could also be advantages from a reduction in complexity and a refocus of relationships towards airlines and away from the CAA.

Impact of bilateral contracts on the CAA's assessment

J86 GAL provided the CAA with information on the bilateral contracts being discussed with airlines. GAL has stated that if all bilateral contracts being discussed are agreed then it would deliver a blended price of between [£<] per year. [£<] bilateral contracts have so far been signed (Norwegian, Emirates, Thomson, [£<] and [£<]). Other bilateral agreements are under discussion. There is no guarantee that all bilateral contracts being discussed would be agreed going forwards. The CAA cannot therefore rely on the terms that are currently being discussed being implemented.

J87 The CAA considers that the bilateral contracts appear to be a function of the commitments regime rather than something that GAL has pursued separately for four reasons.

- Under the commitments framework, if GAL does not agree bilateral contracts then the published yield will need to be set at the same as the average yield to meet the requirements for the blended yield profile under the commitments (which is RPI+0 per cent). Consequently, GAL will have an incentive to agree bilateral contracts as this is more likely to deliver traffic growth and higher overall revenues. Airlines will also have an incentive to agree bilateral contracts as GAL only needs some airlines to agree bilateral contracts, with other airlines paying the higher published tariff.
- GAL appears to have actively pursued bilateral contracts only since the CAA published its final proposals which supported a commitments framework. The CAA notes that GAL indicated at the start of 2011 that it wanted to agree bilateral contracts in that year. The CAA subsequently structured its process so as to allow time for these negotiations to take place. Over two years elapsed and no bilateral contracts were concluded which contrasted with the rapid progress that Manchester Airports Group has made in reaching agreement with easyJet and Ryanair at Stansted since it took over STAL in February 2013. GAL stated that progress in agreeing long term contracts was made after the CAA published its final proposals and airlines became substantially more engaged.¹⁸ Airline responses have indicated that it is only since the publication of the CAA's final proposals that GAL has actively pursued bilateral contracts. Regardless of whether GAL or airlines became more involved in bilateral contract discussions after the CAA published its final proposals for licence backed commitments, this indicates that the discussions were strongly linked to the CAA's final proposals.
- The bilateral contracts are conditional upon the CAA's acceptance of the commitments. If the CAA's final proposals for a commitments and licensing approach change, or if the price in the commitments change, then the bilateral agreements do not stand.

¹⁸ Correspondence from GAL, 23 December 2013.

- A number of terms in the bilateral contracts are explicitly linked to the commitments, both in terms of price and service offering (for example in relation to airport charges, charges for ancillary services, airport service quality standards etc).

- J88 The bilateral contracts grant effective discounts (or financial incentives) in two forms: discounts to airport charges and marketing support. Discounts to airport charges make up the majority of the discounts to airlines, [redacted]. Discounts to airport charges are generally on discounts on winter charges [redacted]. The other main form of discount provided under the bilateral contract is in the form of marketing support, for example the provision of marketing support of £0.10 per passenger for passenger numbers above a certain threshold. [redacted].
- J89 GAL stated that the contracts include agreements for tailored service quality, [redacted].
- J90 The CAA understands from GAL that heads of terms for bilateral contracts have been agreed with airlines carrying 56% of GAL's passengers, Norwegian, Thomson, Emirates, [redacted],[redacted].¹⁹. Under the commitments-only framework GAL will only need to agree contracts to achieve a blended price of RPI+0 per cent and so all bilateral contracts currently under discussion may not be subsequently be agreed.
- J91 For the reasons set out above the CAA considers that the main protection to passengers is therefore via the commitments rather than via the bilateral contracts.
- J92 Given the limited additional protections conferred on users through the bilateral contracts, the uncertainty what terms might eventually be agreed via the contracts, and the fact that all the contracts are predicated on the commitments (and the CAA's acceptance of this approach for Q6) the CAA has focused its assessment on the benefits provided by the commitments themselves.

Summary of the LBC Licence

- J93 As mentioned earlier the CAA considers that the unique circumstances surrounding the implementation of the new CA Act

¹⁹ [redacted].

allow it to assess Test C based on a specific form of licence, i.e. the LBC Licence.

J94 The CAA's notice of the licence issued at the same time as this document sets out the specific licence conditions and other regulatory measures it intends to include which form the basis for the assessment of the Commitments Counterfactual. The notice includes the following proposed licence conditions:

- general conditions relating to the payment of fees and revocation;
- a condition that incorporates the commitments and requires them to be included in the Gatwick Airport CoU;
- a condition requiring GAL to comply with the commitments in a manner designed to further the interests of passengers, so far as reasonably practicable;
- a condition allowing GAL to make changes to the commitments only in line with the modification provisions in the commitments;
- a condition requiring GAL to seek a licence amendment if it wants to pass through more than £10 million per year from the costs of a second runway; and
- financial resilience conditions which set out requirements to provide an annual certificate of adequate resources, a restriction on business activity, an ultimate holding company undertaking and an obligation to report changes in the banking ring fence.

J95 In addition the CAA would introduce a monitoring regime encompassing:

- monitoring to assess whether prices are above the fair price benchmark of RPI-1.6 per cent per year and if prices are above the relevant benchmark the CAA will consider action, which includes considering introducing additional licence conditions to restrain prices;
- monitoring of service quality performance to identify whether any individual metric is failed for more than six months, where the CAA would expect to undertake an investigation into the failure to identify whether any enforcement action is required;

- require GAL to undertake a shadow RAB calculation throughout the commitments period in case the commitments regime breaks down and tighter regulation is required; and
- in 2016 ask stakeholders for views and undertake a short and focused assessment of the performance of the commitments to identify whether the commitments, licensing and monitoring regime are operating in passengers' interests and to publish its findings.

Assessment of specific impacts

- J96 The CAA has considered a series of specific impacts, in terms of the likely benefits and adverse effects, that the CAA considers are important for furthering passengers' interests, promoting competition and complying with its general regulatory duties.
- J97 Although, for presentational purposes, the CAA lists these issues separately and deals with them in turn, its assessment has looked at the impact of licence regulation in aggregate.

Impact 1: Enforcement

CAA's minded to position

- J98 In the Consultation, the CAA raised a number of concerns with the enforceability of the commitments on their own, including:
- the balance of obligations, in particular as there was nothing in the commitments to define the facilities that GAL would deliver;
 - the ability of GAL to make unilateral variations to the commitments through the CoU;
 - the ability of GAL to contract out of the commitments;
 - the commitments would be enforced by airlines in circumstances where airlines' and passengers' interests may not always align, and so would not adequately protect passengers' interests compared to a licence overseen by a regulator that has a statutory duty to further their interests;

- the commitments do not provide sufficient protection against repeated breaches of service quality standards;
- the dispute resolution procedures could unnecessarily delay urgent intervention from the courts; and
- the process of re-introducing a price control could take at least two years including appeals, which could mean that abuses could go unchecked for some time, allowing significant passenger detriment to occur.

Responses from consultation

- J99 GAL considered that the CoU were an enforceable contractual agreement between GAL and its airline customers with any variation subject to approval of the (specified) majority of airlines. Airlines would be able to exercise normal contractual remedies available through the courts, or through the CAA or the courts in relation to the ACRs or competition law. The commitments also included an independent dispute resolution process to allow the speedy and efficient resolution of disputes. GAL also highlighted the paper it had commissioned from Stephen Littlechild.²⁰ Littlechild proposed that the CAA should take the commitments as undertakings from GAL and so avoid the need for a licence.²¹
- J100 BA considered that it was not the intention of Parliament that price controls should be implemented in a way that renders obsolete processes and protections provided by the CA Act. For example, if the commitments were not included in the licence, the CAA might forgo some of its enforcement powers under the CA Act and the process for varying the terms of the commitments differed from those under the CA Act, in particular by removing the airlines' right of appeal.

²⁰ Stephen Littlechild, Regulation of an increasingly competitive airport sector (May 2013) and A further note on regulation of an increasingly competitive sector (September 2013), available from: <http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=14279>.

²¹ GAL has stated that it does not support commitments being taken as undertakings as the commitments can stand on their own.

J101 VAA considered that a licence would provide a better method of enforcement than relying on commitments alone as it would lead to a quicker and more efficient resolution of issues.

CAA's position

J102 Even though there is no statutory scheme for the CAA to accept and enforce commitments in lieu of regulation, the CAA has nevertheless taken them into account as part of the Commitments Counterfactual.

J103 The CAA considers that GAL's latest commitment proposals address some of its previous concerns over the enforceability of the commitments in passengers' interests.

- The CoU are in principle capable of amounting to a contract and if this is the case then the commitments were enforceable to the extent permitted under normal contract law, although the CAA notes that there are still risks, for example if the ownership of GAL changes.
- The CAA considers that the inclusion of the commitments in the CoU go some way to addressing the issue of enforcement.
- As to the issue of unilateral variation or contracting out, and the particular concerns expressed over the scope of GAL's ability to introduce new or alter existing terms, the CAA considers that this has been addressed by the inclusion of an obligation in the latest commitments that prevents changes to the commitments obligations that are included in the CoU (although the CAA notes that the commitments may need to be amended to reflect legislative or regulatory decisions). While the commitments allow contracting out, the CAA considers that if the terms in the commitments are reasonable then this should provide a reasonable benchmark against which airlines can seek to negotiate bilateral contracts. In addition the inclusion of commitments to both an average revenue yield and an average yield from published charges should moderate the potential differences between bilateral contracts and the commitments, reducing the potential for discrimination.

- Dispute resolution, where the commitments require parties to follow a dispute resolution mechanism: the CAA considers that this issue has been addressed as the findings of the dispute resolution process are now binding until determined by legal proceedings or agreement and do not prevent either party from seeking urgent relief from the court.

J104 However, in the absence of a licence the CAA continues to have concerns in a number of areas.

- The commitments are **enforced by airlines**. While the interests of airlines generally align with those of passengers, this may not always be the case. For example, while GAL stated in relation to CAA's Q6 proposals that it has included a provision to consult the capital plan with Passenger Advisory Group, this does not address enforcement concerns for passengers for example in relation to the service quality. Consequently, commitments would not offer the same level of protection to passengers and cargo owners compared to a licence enforceable by the CAA, which has a statutory duty to further their interests.
- The commitments do not provide **adequate protection against repeated service quality failures**. The commitments include a requirement to increase service quality rebates by 25 per cent if failures continue for more than six months and to develop an improvement plan. The CAA continues to have concerns in this area, for example as the increased rebates would only apply if failures are spread across two financial years and that rebates reduce to zero if there are six consecutive months' of failure in one financial year. This does not appear to be in passengers' interests unless, as with Q5, there was a backstop of a CAA investigation if failures persist for more than six months.
- The commitments do not include **sufficient protection** in certain areas, for example in terms of the pass through of second runway costs and financial resilience, and if problems arose in these areas then significant consumer detriment could occur before issues could be rectified.

- The commitments have been put forward by GAL following discussions with the CAA and airlines. If airlines do not agree with the terms in the commitments, then there is no mechanism (similar to that for licence conditions) for them to appeal the conditions in the commitments to the Competition and Markets Authority (CMA), **removing important protections in the CA Act**. This could work against passengers' interests and be detrimental to passengers as it would make the process both more expensive and lengthy.
- In the absence of a licence there are concerns over the **speed of regulatory intervention** which can only take place once abuse against passengers' interests has occurred. The commitments provide GAL with considerable flexibility, for example in terms of the capital plan. If GAL uses this flexibility to abuse its market power then, in the absence of a licence, the CAA may need to undertake a full market power assessment to introduce potential controls in the form of new licence conditions (the CAA has no ability to amend the commitments directly). The whole process of introducing a licence is likely to take two years including appeals. A long period to re-introduce controls could allow abuse to go unchecked for some time with potentially significant user detriment.

- In contrast, by incorporating the terms of the commitments within the statutory licensing framework, the CAA would have a range of **regulatory and enforcement measures**, for example by either enforcing the commitments as a condition of the licence itself or modifying and/or introducing new licence conditions as required (subject to the safeguard of appeals). In appropriate cases, the CAA would be entitled to proceed with interim remedies or to impose penalties for breach. A licence is therefore likely to lead to a quicker, more efficient resolution of issues. Importantly, a breach of a condition of the LBC Licence could lead to a directly actionable right of damages for any person affected by the breach (including passengers and cargo owners as well as airlines).²² Accordingly, there are real benefits from the licence framework in terms of enforcement and deterrence that are not provided by the contractual commitments on their own.

J105 Based on the above the CAA does not consider that, in the absence of a licence, the commitments on their own offer sufficient protection in terms of enforceability to be able to operate in passengers' interests.

Impact 2: Protection against excessive prices

CAA's minded to position

J106 In the Consultation the CAA stated that, as GAL was pricing at its regulatory cap for the vast majority of traffic, there was a reasonable expectation that if the price cap was removed then charges would rise. GAL's initial commitments proposed a 7-year price cap of RPI+4 per cent per year, which was above the CAA's initial view of a 7-year fair price of RPI+0 per cent per year and allowed the full pass through of security costs, taxation changes and the development costs of a second runway, which were not typically included under licence regulation. While the CAA acknowledged that there were risks from a licensing regime, for example from the potential impact on agreeing bilateral contracts, the CAA considered these risks were outweighed by the potential benefits over GAL's proposed

²² Civil proceedings can be brought following a breach of a CAA enforcement order or urgent enforcement order.

commitments in terms of ensuring that prices charged are in passengers' interests.

Consultation responses and further stakeholder views

Responses to the Consultation

- J107 GAL revised its initial set of commitments in June 2013. In addition to a 'core yield' price path of RPI+2.5 per cent per year which applied to charges under the published tariff, GAL introduced a 'blended yield' price path of RPI+1.5 per cent per year to apply to the combination (or blend) of charges under both the published tariff and bilateral contracts. To the extent that GAL was unable to conclude contracts with airlines, then the blended yield price path would apply to the published airport tariff.
- J108 GAL stated that the core yield price path provided assurance on prices to those airlines that do not contract and provided safeguards to ensure bilateral contracts were not struck at the expense of airlines remaining on the published tariff.
- J109 The airlines' responses to the Consultation were based on the June 2013 version of GAL's commitments.
- The GACC considered that prices would increase more under a non-licence approach than under a licence approach. It also believed that the reduction in GAL's price forecasts from RPI+7 per cent per year in the January 2013 Business Plan to RPI+4 per cent per year for commitments and then to RPI+2.5 per cent per year in June 2013 was only done as part of the airport operator's negotiation to try and secure deregulation. The GACC considered that the airport operator's prime motivations in seeking a non-licence approach (full deregulation or commitments) were to increase prices at the airport. The GACC agreed with the CAA that the current price cap was not significantly below the competitive price, the GACC pointed out it did not endorse the current price cap as being competitive. The GACC stated it believed a licence-based approach was likely to deliver significant price benefits, which would be passed to consumers in the form of lower air fares and a greater choice of air transport services. The GACC further considered that, based on GAL's view that prices are currently too

low, any potential benefits from lower regulatory costs under a non-licence approach would accrue to GAL's shareholders and not to passengers in the form of lower prices.

- BA stated its view was reflected in the GACC response. BA also considered the commitments price was excessive and the benefits of a licence-based approach were likely to outweigh the adverse effects as GAL had clearly stated its intention to increase prices even above the CAA's assessment of a fair price. BA considered the CAA's fair price was too high and proposed a price cap of RPI-10 per cent per year (consistent with the GACC's forecast of RPI-9 per cent per year but reflecting minor changes in the capital programme and a slightly different approach to the weighted average cost of capital (WACC) and operating expenditure). BA raised concerns that GAL's proposed pricing formula did not include all specified activity charges and excluded 'premium service charges'. BA felt this gave the airport operator scope to create new uncapped charges. BA also raised concerns over the considerable scope with which GAL could vary charges from year to year and between different types of charges. Furthermore, BA considered GAL's proposal of a cumulative revenues difference mechanism gave GAL the flexibility to alter prices during the 7-year period, which would come at the expense of airlines which would face greater uncertainty in pricing.
- VAA considered GAL's intention to increase prices would be at the detriment of passengers and it would be in excess of the CAA's assessment and airlines' view of a fair price. It therefore considered a licence-based approach was likely to deliver significant savings to the passenger resulting in reduced prices and an increased level of services at the airport.
- The GACC, and individually BA and VAA, all raised concerns about the difference between GAL's proposed price and the CAA's initial estimates of a fair price. Concerns were also raised about the comparability of the commitments price and the CAA's fair price.

- J110 GAL also raised two concerns with the assessment of excessive prices at STAL:
- that the CAA should take into account the constraining effect of competition law on pricing practices; and
 - that while the CAA has considered a number of factors that have changed since its assessment in 2007, it failed to acknowledge the increase in competition from the break-up of BAA, or the substantial increase in spare capacity in the South East since 2007.

Further comments made in relation to the Q6 process

- J111 In response to the CAA's consultation of the draft licence and after the revision of GAL's commitments in June 2013, the airlines raised the following additional concerns in July 2013;²³
- a difficulty in monitoring the blended price;
 - the modification process for price and service standards based on the 51 per cent of airlines' threshold was too low, given the diverse airline base;
 - a lack of pricing principles in GAL's commitments;
 - the loss of existing protection on non-regulated charges;
 - the airlines remain the insurer of last resort of the commitments;
 - the inappropriateness of the pass through costs of the second runway; and
 - there was no commitment to publish the value of the RAB.

Subsequent development

- J112 In September 2013 GAL published revised commitments which included a reduced price of RPI+1.5 per cent per year based on published charges and RPI+0.5 per cent per year based on the blended published rate and bilateral contracts. The September 2013 commitments also addressed some of the airlines' concerns by:

²³ These were based on the June 2013 version of commitments.

- removing service quality bonuses;
- including a requirement to have regard to the CAA policy on the financing of new runway costs;
- increasing the threshold of modifications to airlines representing 67 per cent of passengers on published charges; and
- including its pricing principles as an annex to the commitments.

J113 In November 2013, in response to the CAA's Q6 final proposals, GAL provided an amended set of commitments in which GAL addressed some of the airlines' and the CAA's concerns by:

- including an obligation to follow the CAA's guidance relating to second runway costs;
- revising the drafting to improve understanding of what was a core service and what was a premium service and including a definition of the core service charge which will apply for all services covered by airport charges as at April 2013; and
- making the pass through of costs of required changes in security standards bidirectional as previous version of commitments included only a pass through of increases in such costs.

Further comments made in the Q6 process

J114 The GACC raised a number of further concerns in the November 2013 commitments. The GACC continued to consider that the commitments price was too high, the fair price calculation was too high and the CAA had wrongly concluded that the commitments price was comparable to the fair price. While the GACC acknowledged progress on the terms of the commitments it had the following outstanding concerns related to the price in the commitments:

- the lack of mutual waiver/indemnity;
- the lack of simultaneous alternative recourse to the courts in addition to the proposed dispute resolution mechanism;
- unclear definition of core service and premium charges;

- pass through of security compares to previous year rather than base year;
- amendment of price needs to be based on a higher proportion of airline agreement; and
- given their potential scale second runway costs should be subject to a full re-opener requiring a licence change.

J115 BA stated that the November 2013 commitments had not addressed its concern over the lack of capex commitments.

Subsequent development

J116 In December 2013, GAL provided a further amendment of its commitments to airlines which now included a reduced price of RPI+1.0 per cent per year based on published charges and RPI+0.0 per cent based on the blended published rate and bilateral contracts and addressed a number of the airlines' concerns for example around the definition of core services and the indemnity in the commitments. GAL did not seek to address the airlines' concerns around second runway costs, the pass through of security costs and capex commitments.

CAA's position

Introduction

J117 GAL has been pricing up to the cap from at least the start of the Q4 period (1 April 2003 to 31 March 2008) until 2011/12. In 2011/12 GAL offered unpublished discounts to new long haul routes subject to certain criteria. Despite this, GAL has been pricing to the cap for the vast majority of traffic. At the start of the Q6 consultation process, as part of its Revised Business Plan, GAL proposed to increase charges above the level of the current regulatory cap by RPI+6.9 per cent. For the reasons set out in Test A and B, the CAA maintains its view that there is reasonable expectation that, if the price cap was removed and there were no commitments or licence in place, GAL's charges would increase above the level that the CAA considers to be within the reasonable range of the competitive price.

- J118 GAL has stated that the CAA should take into account the constraining effect of competition law. For the reasons in Test B, the CAA does not consider that competition law would provide adequate protection to users on pricing matters. As to Test C, the CAA considers that there are significant benefits for users arising out of the LBC Licence as compared to the Commitments Counterfactual.
- J119 In relation to GAL's comments regarding the increasing conditions of competition since the break-up of BAA, the CAA notes that as set out in Test A that while the separation of ownership of Heathrow, Gatwick and Stansted is likely to increase competition, this is likely to be more than offset by the increasing capacity constraints over time. The CAA considers that the increasing capacity constraints are likely to decrease rather than increase competitive pressure over the next control period.
- J120 In the Gatwick Q6: notice of the proposed licence, notifying the CAA's proposals to grant a LBC Licence for Q6, the CAA has stated that it would monitor prices against a fair price benchmark of RPI-1.6 per cent per year and if prices are above the benchmark the CAA will consider action under the licence, including introducing licence conditions to restrict prices or to place conditions on GAL's ability to alter the structure of charges (as discounts are generally on winter charges). The CAA calculated the fair price to reflect the maximum average level of airport charges based on a single till RAB calculation.
- J121 As part of the Q6 consultation process, both GAL and the airlines have submitted detailed representations regarding the calculation of the fair price and whether it translates into benefits for passengers. Both the airport operator and airlines have put forward their own calculations of a 5-year RAB-based approach. Figure J.2 below presents a comparison of the airport operator's and airlines' RAB calculations together with the CAA's own estimates and GAL's commitment proposals.

Figure J.2: Comparison of price cap proposals (change in each year relative to RPI)

	5 years	7 years
GAL RAB (Revised Business Plan)	+6.9%	
GAL commitments January 2013		+4.0%
GAL commitments June 2013		+2.5% core yield +1.5% blended yield
GAL commitments September/November 2013		+1.5% core yield +0.5% blended yield
GAL commitments December 2013		+1.0% core yield +0.0% blended yield
easyJet Q6 response to initial proposals	-8.5%	
GACC RAB Q6 response to initial proposals	-9%	
BA RAB Q6 response to initial proposals	-10%	
CAA fair price in Q6 initial proposals April 2013	+1.0%	+0.0%
CAA fair price in Q6 final proposals October 2013	+1.6%	+0.3%
CAA fair price in Q6 notice of the proposed licence January 2013 ²⁴	-1.6%	-2.0%

Source: GAL, easyJet, GACC, BA, CAA

²⁴ The CAA's final fair price is lower than its previous assessments in the Q6 initial and final proposals. This is due to a lowering in GAL's WACC due to the lower cost of equity as well as increased traffic forecasts, leading to changes in operating expenditure (opex) efficiency assumptions, increases in overall total commercial revenues and other revenues and changes to capex - see Gatwick Q6: notice of the proposed licence appendices B to H, opcit, for further details.

CAA's position

- J122 The CAA's final view of the fair price is RPI-1.6 per cent per year over five years and RPI-2.0 per cent per year over seven years. The CAA's consideration of the airlines' and GAL's concerns over the individual building blocks of the CAA's fair price calculation are set out in appendices B to H of the Gatwick Q6: notice of the proposed licence.
- J123 It is not within the remit of Test C to replicate all the details and arguments concerning the calculation of the fair price. Details of stakeholders' representations and the CAA's response to them are set out in the Gatwick Q6: notice of the proposed licence.²⁵ For the reasons set out in the Q6 notice, the CAA considers that its calculation of the fair price is consistent with its statutory duties in particular to further current and future passengers' interests and would mimic what would happen in a fully functioning competitive market as prices would be set in relation to costs. Test C accordingly starts from the premise that the proposed form of regulation, including the calculation of the fair price, is reasonable.
- J124 In the light of this, the CAA here concentrates on stakeholders' arguments that have a bearing on the methodology conducted as part of the assessment of the LBC Licence against the Commitments Counterfactual. Both GAL and the GACC have raised criticisms, as part of the Q6 consultation process, with comparing the fair price (which is based on a 5-year RAB calculation) with the price in the commitments which is calculated over a 7-year period. GAL, in particular, argues that the fair price did not encompass the full value generated by the commitments, which extended benefits to airlines for an extended time period beyond the duration of the fair price. The GACC raised concerns about comparing differing time periods and a different basket of price components. It also objected to the use of the blended price which includes charges agreed under bilateral agreements. A detailed explanation of these arguments and the

²⁵ See Gatwick Q6: notice of the proposed licence, Appendix I "Form of regulation", *opcit.*

CAA's position is set out in the Gatwick Q6: notice of the proposed licence.²⁶

- J125 The CAA notes that its 5-year fair price is based on a detailed bottom up assessment of the individual building blocks. The 7-year fair price was developed for comparison with the commitments and took into account changes forecast by GAL in the two years following a traditional 5-year control period (2019/20 and 2020/21). For the reasons set out in the Gatwick Q6: notice of the proposed licence²⁷, the CAA considers that it is relevant to take account of both 5-year and 7- year prices for comparison, but places the greatest weight on the 5-year commitment price as this is the effective RAB alternative.
- J126 The CAA also considers that the blended price, which is the average price under the commitments, is the most appropriate comparison with the fair price, as the latter is the average charge paid by airlines and their passengers. As explained in more detail in the Gatwick Q6: notice of the proposed licence²⁸, the blended price takes into account the prices under bilateral contracts, which may be lower as the result of volume discounts. Although the commitments price is calculated on a different basis and includes certain ancillary services, the CAA does not consider that those differences materially affect the comparison since, in the absence of the commitments, passengers would still have to pay for ancillary services but would do so outside the fair price cap.
- J127 For the above reasons, the CAA considers that the fair price and the blended average price in the commitments are comparable and it is reasonable to compare them as part of the assessment of Test C.

Benefits from licence regulation that imposes controls on airport charges

- J128 There is a difference between the latest price in GAL's commitments (RPI+0 per cent) and the fair price benchmark in the LBC Licence (RPI-1.6 per cent). Under the LBC Licence the CAA will monitor outturn prices under the commitments. If the average blended prices are above the CAA's fair price benchmark then the CAA will consider

²⁶ *ibid.*

²⁷ *ibid.*

²⁸ *ibid.*

action, including the introduction of licence conditions to restrain prices.

- J129 The CAA's final view of the fair price benchmark is an average of £7.88 per year over five years and, at the end of seven years, the fair price is expected to be £7.42 per passenger in 2020/2021, which is approximately 12 per cent lower than the blended price in GAL's commitments.²⁹
- J130 The difference between the blended price commitment and the fair price is 1.6 per cent per year. Over seven years this is equivalent to a average price difference of around £21 million per year.
- J131 In addition, if the difference in capex commitments is taken into account, with a commitment to £100 million of capex per year under the commitments compared to an average of around £160 million per year under the 5-year fair price calculation, this difference increases to 3.6 per cent per year, or £33 million per year over five years.
- J132 For the reasons set out in the Gatwick Q6: notice of the proposed licence, the CAA considers that higher costs of airport operation services will either be passed onto passengers by airlines or, if absorbed by airlines instead, could have knock-on effects for passengers in the form of reduced route offerings, reduced investment in fleet renewals and lower quality air transport services.³⁰
- J133 For these reasons, a LBC Licence presents concrete benefits for passengers in terms of furthering their interests in the range, availability, cost and quality of airport operation services and thereby in promoting competition.

²⁹ Gatwick Q6: notice of the proposed licence, paragraph 1.13, opcit. The 7 year price has assumed a constant price change of RPI-1.6% per year over the seven year period. The revenue impacts do not take account of any traffic impacts from a change in airport charges.

³⁰ Gatwick Q6: notice of the proposed licence, opcit. While GAL contests this view and has submitted evidence from Compass Lexicon in support, BA, supported by RBB Economics, argues that airport charges are likely to be passed on. The CAA has commissioned independent research from SLG Economics which concluded that an increase in airport charges would lead, to some extent, to higher ticket prices. Details of the stakeholders' arguments and the CAA's position in this respect are set out in the Gatwick Q6: notice of the proposed licence.

Other price-related benefits from licence regulation

J134 The CAA notes that while GAL's commitments provide a degree of protection in the form of an upper limit on prices, they do not ensure that prices are cost reflective. The CAA maintains several concerns in relation to GAL's commitments.³¹

- GAL's previous version of commitments allowed for the pass through of the **second runway costs** following the support of the Airports Commission only. The CAA noted that although the Airports Commission will make its recommendations to the Government this will not constitute a Government decision, and if the Government decides against the second runway it will not be in passengers' interests to pay for nugatory expenditure.
- GAL's December 2013 commitments caveat the pass through in that it would follow Government support and would follow any policy guidance issued by the CAA in relation to the financing of new runway developments. The CAA continues to have concerns as, this could still mean the actual costs that GAL plans to pass through to airlines and their passengers will not be assessed by the CAA. The airlines would also have a limited ability to challenge GAL's interpretation of the CAA guidance through dispute resolution/enforcement (and the CAA's guidance itself). Since there would be no authorisation by the CAA there will be no possibility of an appeal. The potential impact of this pass through could be significant given GAL's estimate of costs of up to £9 billion. The CAA remains concerned that when engaging in this project GAL's primary focus is likely to be the profitability and value of the company and consequently there could be significant risks to passengers in this area. A LBC Licence which limits the pass through of second runway costs to £10 million in the absence of a licence modification will therefore provide incremental benefits to passengers.

³¹ This is also discussed in chapter 10 of the CAA's Q6 final proposals, opcit.

- GAL's ability to **profile the yield** across seven years subject to overall neutrality and a maximum variation in any one year, even now that the maximum variation of £10 million has been specified, could potentially lead to some variations in the price paid by airlines and their customers in individual years. A LBC Licence will allow the CAA to monitor prices and should GAL's ability to profile yields not be operating in passengers' interests, the CAA will have the ability to intervene.
- The CAA notes that the commitments include a requirement to publish the value of the asset base and the underlying assumptions and calculations. This, however, does not constitute the calculation of the **RAB**, which could be different to the asset base for a variety of reasons. As part of its response to the final proposals GAL stated that, although it does not consider it necessary, GAL will prepare a shadow RAB and maintain such calculation for the benefit of the CAA as part of its ongoing monitoring regime, up to the review scheduled for late 2016. This provision does not appear in the CoU. The CAA continues to consider that a shadow RAB calculation is required throughout the period should any subsequent tighter regulation be required. Under the monitoring regime of a LBC Licence, the CAA is requiring GAL to undertake a shadow RAB calculation. This will facilitate the monitoring and enforcement regime, providing benefits to passengers should tighter regulation be required.

Other pricing and non-pricing concerns raised by the airlines

J135 In their responses to the initial and final proposals, the airlines have raised a number of other concerns about the commitments. However, most of these have been addressed by the December 2013 commitments and the CAA does not consider that the issues identified by airlines remain valid.³²

³² This is discussed in chapter 10 of the CAA's Q6 final proposals, opcit.

- The CAA considers that it will be possible for airlines to **monitor prices**, as the overall revenue from airport and other traffic charges will be available in GAL's statutory accounts. GAL is also committing to publish the cumulative revenue difference (including underlying actual data) for both the blended and published charge basis as part of the annual airport charges consultation. The CAA considers that this, together with reporting requirements under the ACRs, will provide airlines with sufficient information to challenge GAL's calculations should they wish to do so.
- The earlier version of commitments allowed for a change in the price cap if there was agreement from airlines representing 51 per cent of passengers operating on the published price list. This gave GAL some flexibility to pass on additional costs and to some extent increased the level of uncertainty for airlines. The December 2013 commitments increased this threshold to 67 per cent, hence reducing this flexibility. The CAA considers that the increase in the **threshold for airline support** to 67 per cent for making changes to the price and service quality regimes would be sufficient to prevent a single airline or one or two airlines being able to push through changes to the regime that would not be in the interests of passengers in general and from making changes unilaterally. The CAA considers that the modification provision should therefore not act against passengers' interests and should take away some of GAL's flexibility to make changes to commitments without airlines' support representing the interests of their passengers.
- The CAA does not consider that the **pricing principles** need to be included in the commitments, as GAL is required to set out its pricing principles as part of setting its structure of charges under the ACRs. In addition if the pricing principles were to be included in the commitments within a licence it could be seen as the CAA standing over those principles where it would be the appeal body.

- The CAA has considered the airlines' concerns that GAL could introduce additional **premium charges**. The CAA considered that for most airport operation services any premium charges would be covered by the non-discrimination provisions in the ACRs and the AGRs or the fair, reasonable and non-discriminatory provisions for ancillary services under the commitments as well as general competition law (which the CAA identified as insufficient in case of GAL under Test B). However, based on the September 2013 commitments the CAA acknowledged that the scope of premium service was unclear and in the absence of a licence there may be potential for GAL to introduce charges that act against passengers' interests. The December 2013 commitments did not include premium service charges and stated that the core service charge would apply for all services covered by airport charges as at April 2013. The CAA considers that this addresses the concerns in this area.

Conclusion

- J136 Whilst there are benefits from the commitments in terms of flexibility for GAL in setting its charging structure and recouping shortfalls over a 7-year period and increased certainty for airlines from locking in lower prices for seven years and into the subsequent Q7 control period, the concerns identified by the CAA above suggest that the commitments in themselves may not be able to provide adequate protection to passengers' interests. There is still a risk that GAL may raise the prices above the fair level.
- J137 The CAA acknowledges the airlines' point that GAL has decreased its initial price cap of RPI+6.9 per cent per year under a RAB-based approach to an average price of RPI+4 per cent per year for commitments and then to RPI+2.5 per cent per year and further to RPI+1.5 per cent per year (core yield) and RPI+0.5 per cent (blended yield) in response to the CAA's Q6 initial proposals. It has since proposed RPI+1.0 per cent per year (core yield) and RPI+0.0 per cent (blended yield) in response to the CAA's final proposals. The CAA considers that these repeated changes suggest that the prospect of licence regulation alone has already worked towards lowering the price as a form of negotiation towards deregulation.

GAL's initial commitments price of RPI+4 per cent was well above the CAA's consideration of a fair price.

- J138 The price in the commitments at RPI+0 per cent (blended yield) and RPI+1 per cent per year (core yield) is above what the CAA considers to be a fair price of RPI-1.6 per cent per year over five years and RPI-2.0 per cent per year over seven years. The difference between the commitments blended price and the 5-year RAB-based price is 1.6 per cent per year. This is equivalent to an average of £15 million per year over five years and £21 million per year over seven years.
- J139 In addition, if the difference in capex commitments is taken into account, with a commitment to £100 million of capex per year under the commitments compared to an average of £158 million per year under the 5-year fair price calculation, this difference increases to RPI+3.6 per cent or £33 million per year over five years.
- J140 GAL takes issue with the need for the CAA to intervene in the event of pricing above the level of the fair price. It argues that, in the presence of price regulation, airlines will retain most, if not all, of the difference between the fair price and the market price. Any benefit in constraining charges will not be passed onto users. Further a licensing regime tied to a RAB-based price will not deliver the outcomes in a competitive market in terms of investment, innovation and price differentiation. The main thrust of GAL's argument seems to be that the CAA should allow prices to rise to market clearing levels. However, given Government control over the supply of additional airport capacity in the South East and the ensuing barriers to entry and capacity constraints, the relevant market does not appear to have the characteristics of a properly functioning market. In such a situation, any removal of price controls on airport charges is likely to lead to increased profits to the airport operator, with no discernible benefit to end users.
- J141 The CAA's use of the fair price tries to mimic what would happen in a fully functioning competitive market where there were no constraints on new capacity. This would produce lower charges for airlines, which through competition in the downstream air transport markets, would to some extent be passed on to passengers in the form of

lower air fares. The CAA's approach ensures that a substantial part of the benefit will flow through to passengers rather than to GAL's shareholders. The CAA considers that this is more consistent with its general statutory duties.

- J142 There is no prejudice to GAL as the calculation of a fair price builds in an allowance to enable GAL to recover its efficiently incurred costs and to make a reasonable profit, whilst at the same time ensuring that GAL can finance its provision of airport operation services.
- J143 One of the concerns considered in the Consultation was whether under a licence the CAA would set prices too low. The CAA considers that it has better information on the competitive price (than at Stansted in 2007) and so the risk of setting prices too low is reduced. In addition under Test A the CAA considers that Gatwick is in a market on its own. Even if Stansted and Heathrow were included in the market, the uncertainty over the level of the price at Gatwick has not stopped either airport (or Gatwick) from advancing plans for additional runways to the Airports Commission, nor has it prevented investment plans being taken forwards, for example the Terminal Transformation project at Stansted. The CAA also notes that it is proposing to monitor prices rather than set an explicit price cap.
- J144 In the Consultation the CAA stated that price monitoring was most appropriate where the risks of abuse were low, which the CAA does not consider was the case for GAL. The CAA still considers that the risks of abuse by GAL are unchanged, however it considers that the explicit price control in the commitments, coupled with a monitoring regime with an explicit threat of re-regulation if prices delivered are not consistent with the fair price should provide adequate protection to users.
- J145 The CAA does not consider that the presence of the price monitoring regime should prevent GAL from agreeing bilateral contracts, as the CAA's final proposals for a LBC Licence encouraged rather than prevented the discussion of bilateral contracts and the monitoring is simply setting out what the CAA would expect to be delivered from contracts and commitments. As such it could be a further spur to both airlines and GAL to agree contracts.

- J146 Under a LBC Licence the CAA can monitor prices to ensure that GAL sets prices that are consistent with the fair price. The CAA can also monitor capex to ensure that GAL undertakes expenditure that is in users' interests. A licence would also allow the CAA to introduce additional licence conditions if the CAA identified issues with the operation of the commitments, for example in relation to prices and capex, to minimise the potential detriment to users. A licence would also provide benefits from the regulatory processes that could be placed on the pass through of the costs of a second runway.
- J147 In terms of proportionality, a LBC Licence would also avoid the more significant adverse effects and distortions that come from a typical RAB price cap regulation discussed in the Consultation.
- J148 For the above reasons, the CAA therefore considers that licence regulation in form of a LBC Licence will provide incremental pricing benefits to users rather than relying on commitments alone.

Impact 3: Efficiency

CAA's minded to position

- J149 The CAA's minded to position was that it considered that impact of regulation on efficiency was difficult to judge. An initial analysis of GAL's opex in Q6 led the CAA to suggest that following the change in ownership in 2009 GAL initially reduced its opex, although this could have been due to greater management focus rather than an increase in competition. The CAA also pointed to the scope for further improvements in both opex and capex efficiency identified in its initial proposals. The CAA acknowledged possible distortions of incentives in a RAB-based regulation in particular. However, given the potentially tighter price cap and the removal of full cost pass through elements, the CAA believed that licence regulation was likely to provide stronger efficiency incentives than those in GAL's proposed commitments.

Responses to the consultation

- J150 Several comments were made specifically in relation to efficiency-related issues.
- GAL raised concerns that the assessment assumed that the regulated company should be the most efficient in its benchmark group in their response to STAL's consultation document. The CAA notes that GAL has made substantial submissions on its analysis of efficiency in response to the Q6 review. As mentioned earlier, these are set out along with the CAA's position in the Gatwick Q6: notice of the proposed licence.
 - BA considered that GAL should not automatically be able to pass through the whole of the charges as previously set out in the commitments, for example the pass through of an unlimited sum to secure planning permission for a second runway spread over a ten year period. BA considered that more efficiency incentives should be imposed on GAL to incentivise greater efficiency. BA did not accept the commitments provided strong enough efficiency incentives in a way that benefited passengers. To the extent that the commitments delivered efficiency, BA considered this would not result in lower prices, but the benefits would accrue to GAL's shareholders.
 - VAA considered that while a non-licence approach might in principle provide an incentive for efficiency in both capex and opex, in practice it would be the airport operator's stakeholders rather than the passengers who would benefit. VAA also considered that efficiencies would be less likely to be made by the airport operator under a non-licence based approach due to the ability to raise prices far above a level that would be in the best interest of the passengers.

- The GACC considered that while a non-licence approach might lead to the airport operator becoming more efficient, because the airport operator would be able to retain efficiency savings, it would be the airport operator's stakeholders rather than the passengers who would benefit. Even so, the GACC considered that GAL might be less likely to pursue efficiencies under the commitments as it would be easier to make profits by increasing prices. The GACC considered that a licence would give the CAA a direct tool to incentivise efficiency as price controls are designed to pass through efficiency benefits to users through lower prices.
- In relation to STAL, Starkie and Yarrow raised concerns that licence regulation distorted incentives on non-aeronautical revenues and removed the benefits from innovation and investment.

CAA's position

J151 In the calculation of the fair price as part of the Q6 review, the CAA undertook a detailed assessment of GAL's operating and capital efficiency as well as comments made by stakeholders in response to Q6 related documents.³³ Contrary to GAL's statement, this assessment was generally based on benchmarking against the average performance of a company in a competitive environment. The key finding from this assessment, which is set out in detail in the Q6 initial and final proposals, is that GAL has improved operating efficiency over the course of Q5, however some issues with GAL's operating efficiency remain, in particular around staff costs which are substantially above benchmarks, both in terms of wages (see the IDS study on employment costs)³⁴ and pension costs (see the Government Actuary Department study on pension costs).³⁵ The assessment also identified savings in maintenance, central support

³³ See appendices C and D of Q6 final view, opcit.

³⁴ IDS, April 2013, Benchmarking Employment costs - Gatwick, available from:
<http://www.caa.co.uk/docs/78/GAL%20report%20version%205%20redaction.pdf>.

³⁵ Government Actuary Department, September 2013, Review of pension costs of Gatwick Airport, available from:
<http://www.caa.co.uk/docs/78/GAD%20-%20Pension%20Report%20-%20Gatwick%20-%20redacted.pdf>.

and other operating costs compared to GAL's opex projections (see the SDG³⁶ and Helios³⁷ studies on opex) and savings in scope, unit costs and on-costs compared to GAL capex projections (see the reports by Davis Langdon³⁸ and SDG³⁹).

- J152 The CAA considers that the strength of the efficiency incentives within the commitments depends on both the level of the price commitment (as a tighter price commitment is likely to lead to greater efficiency incentives), the process at the end of the commitments period and whether GAL is able to pass through increased costs either directly through pass through mechanisms or through increases in other charges.
- J153 The CAA has already reviewed the price in the commitments and considers that it is above what the CAA considers to be a fair price. While the CAA considers that the commitments would provide increased efficiency incentives from GAL's ability to retain the benefits over seven rather than five years compared to a traditional price cap, these benefits would also result from a LBC Licence approach for the period of the licence.
- J154 GAL has included pass through mechanisms for both second runway costs and security costs. Although GAL addressed the CAA's concern on the pass through of security costs by making it bidirectional (both increases and decreases) and subject to a minimum threshold, the CAA maintains its concerns on the second runway costs. As discussed above, although GAL committed to

³⁶ SDG, September 2013, Review of Review of Maintenance, Renewals and Other Operating Expenditure at Gatwick Airport, Phase 3 Final Report, available from:

[http://www.caa.co.uk/docs/78/SDG%20-%20Maintenance%20Renewals%20and%20Other%20Opex%20-%20Gatwick%20-%20Phase%203%20Final%20Report%20\[with%20redactions\].pdf](http://www.caa.co.uk/docs/78/SDG%20-%20Maintenance%20Renewals%20and%20Other%20Opex%20-%20Gatwick%20-%20Phase%203%20Final%20Report%20[with%20redactions].pdf).

³⁷ Helios, Assessment of central support costs at Heathrow and Gatwick airports, Final Report for Gatwick airport, July 2013, available from:

<http://www.caa.co.uk/docs/78/Helios%20-%20Central%20Support%20Cost%20Report%20-%20Gatwick%20-%20Redacted%20for%20public.pdf>.

³⁸ Davis Langdon, August 2013 Gatwick Airport: Q6 capex review for the CAA: Phase Three Report, available from:

<http://www.caa.co.uk/docs/78/DL%20-%20LGW%20Capex%20REDACTED.pdf>.

³⁹ opcit

following the CAA's guidance, the CAA considers that a licence would bring forward incremental benefits by including provisions that ensure the costs being passed through are efficient.

- J155 A LBC Licence would also confer greater efficiency incentives from a tighter control of prices than under the commitments. A licence would provide additional efficiency benefits compared to commitments alone from the increased potential threat of continuing regulation or re-introducing tighter regulation. This would create an incentive for GAL to ensure the efficiency of costs it incurs.
- J156 The CAA considers that capex efficiency could also be improved through a LBC Licence. This is because the CAA could potentially introduce new licence conditions if GAL continuously exceeds the capex budget due to inefficiently incurred expenditure.
- J157 The CAA considers that a LBC Licence should not increase any distortions to incentives on opex and non- aeronautical revenues or remove the benefits from innovation and investment. Under a RAB-based regime there can be incentives for the airport operator for outperformance at the start of the control period but less incentive for outperformance at the end of the period as the gains would be retained for a shorter period of time. In the Consultation the CAA noted that there were ways of reducing these incentives in a RAB-based regime. Under a LBC Licence GAL would have the same incentives for outperformance as under the commitments as at the end of the commitments period there is no assumption that tighter regulation would be re-introduced if the regime is successful.
- J158 The CAA also considers that the LBC Licence should not increase rigidity of the consultation arrangements for capex as the same consultation requirements would apply under the LBC Licence as the commitments.
- J159 Overall, the CAA considers that a licence would provide incremental efficiency benefits compared to commitments alone. While the commitments provide potential benefits from retaining the benefits from efficiency improvements for longer (at least seven years, compared to typically five years from licence regulation), these benefits would also follow from a LBC Licence. A licence would also provide benefits to efficiency from a tighter price control, providing

greater incentives to be efficient, the regulatory protections around the treatment of capex and second runway costs, and efficiency incentives from the increased threat of greater regulation. For the reasons given in the pricing section above, the CAA notes that the LBC Licence approach would eliminate the adverse effects, often seen in full RAB licences, of over-incentivising capex leading to inefficiencies which would be possible under more traditional forms of regulation. The CAA therefore considers that licence regulation will provide net benefits in terms of efficiency incentives to passengers.

Impact 4: Protection against the failure to meet service quality standards that passengers require

CAA's minded to position

- J160 Following a public interest finding by the Competition Commission the CAA introduced a service quality regime at Gatwick. The Q5 regime incorporated a service quality rebate scheme, with targets and rebates paid, set at a maximum of 7 per cent of airport charges, for underperformance across 17 passenger- and airline-facing metrics, and a service quality bonus scheme, with bonuses paid, set at a maximum of 2.24 per cent of airport charges, for outperformance across 6 passenger-facing measures.
- J161 As discussed in the CAA's Consultation, during Q5 GAL has been successful in reducing the level of rebates paid and increasing the bonuses awarded. GAL's Quality of Service Monitor (QSM) survey showed a steady increase in the level of passenger satisfaction since early 2008 and the CAA's ongoing Passenger Survey showed similar levels of satisfaction over recent months.
- J162 The CAA considered there was little doubt that GAL's service quality performance improved during Q5, however, it was difficult to judge whether the improved performance reflected the impact of regulation or competitive pressures. For example, the improved performance against the Q5 SQR scheme could have reflected GAL responding to regulatory incentives rather than competitive pressure. The

improvement in QSM and ASQ⁴⁰ scores could have also reflected the increased focus driven by regulatory incentives (and performance in areas measured by regulatory incentives, or delivered by investment during Q5) rather than competitive pressure.

J163 The CAA stated that it did not consider that the current SQR scheme has stopped GAL from responding to passengers' needs, and in many ways has provided protection to passengers where, absent regulation, there may have been an incentive to allow service quality to decline.

J164 As GAL's proposed commitments included a similar service quality regime to that in Q5, in the Consultation the CAA identified the following incremental benefits of a licence:

- incremental passenger benefits from fine tuning the service quality regime;
- financial benefits from reducing the scope of bonuses and increasing the level where they might be acquired; and
- the ability of the CAA to make changes to the regime in passengers' interests and to take enforcement action where there might be repeated failures.

J165 Because broadly the same service quality regime could apply under both the proposed commitments and licence regulation, the main potential issue associated with the rigidity of licence regulation is likely to be the change mechanism. However, the CAA considered that in the case of a licence it was likely that there was a trade-off between increasing rigidity and greater protection to passengers, with potentially greater protection to passengers provided where there is a degree of rigidity. The CAA considered that a greater degree of rigidity can provide benefits as, in the absence of regulation, service providers with SMP may have a financial incentive to provide lower service quality than would occur in a competitive market.

⁴⁰ The QSM is a customer satisfaction survey data collected by BAA. ASQ is an international customer satisfaction survey overseen by the Airports Council International.

Consultation responses

- J166 GAL noted that under the commitments it would be required to meet minimum Core Service Standards based on the current SQR scheme with the addition of measures associated with outbound baggage and security queues in excess of 30 minutes in any one day. GAL considered that these scope additions were consistent with the extensions proposed by the CAA in its Q6 initial proposals. GAL suggested that the remaining service standards, with the exception of the QSM measures and the aerodrome congestion term, should remain unchanged from the Q5 SQR given the broad passenger satisfaction noted by passengers, airlines and the CAA. GAL stated that it has amended the reporting for the QSM measures to two decimal places, which in effect increased the targets.
- J167 The GACC considered that given GAL's market power GAL would face limited incentives to provide good service levels to either passengers or airlines. The GACC believed service quality was likely to be better under a licence-based approach than under commitments alone.
- J168 BA considered that in principle the approach to service quality in the commitments would be workable but believed considerable work would remain to be done to develop the detail and mechanics of the commitments approach. BA stated it was not willing to pay bonuses as part of the standard tariff and considered that any such payments should be included in bilateral agreements. BA also considered that the SQR scheme on its own would not be sufficient to incentivise GAL to provide outputs and investment needed at the airport. BA expressed concern that the current RAB-based regulation provided strong incentives to invest and a different approach could mean these incentives are lost. BA also expressed concern with the CAA's comment that the commitments should also include protection against repeated failures to meet service quality targets as in BA's view such a case should be subject to enforcement action by the CAA as a licence breach.
- J169 VAA expressed concern whether service quality would be best enforced under GAL's commitments and believed service quality was likely to be better under a licence-based approach. VAA considered

the public interest finding by the Competition Commission and the introduction of a service quality regime in itself illustrated that service improvements were more likely under a licence-based approach.

J170 In relation to STAL, Starkie and Yarrow commented that regulation could distort incentives on innovation, including improvements in service quality.

J171 In response to the consultation of the draft licence with GAL's revised commitment proposals the GACC, BA and VAA raised the following additional concerns:

- generous bonus payments;
- discriminatory modification process for price and service standards based on the 51 per cent of airlines' threshold given the diverse airline base; and
- low service quality rebates in relation to the cost of the remedy.

J172 GAL's December 2013 commitments were still broadly based on the existing regime and included the following key modifications to the Q5 regime, some of which had been made in earlier versions of commitments:

- the exclusion of service bonuses;
- the inclusion of an outbound baggage target (monthly and daily measures);
- the retention of the existing aerodrome congestion term (including a measure of snow event readiness and an amendment to the target);
- an increase in the threshold for modifications to airlines representing 67 per cent of passengers on published charges;
- an incremental penalty factor of 25 per cent applied to the rebate percentage for certain passenger-facing measures if the relevant service standard has not been met for 6 consecutive months; and

- the failure of any airline to meet certain Airline Service Standards would reduce the amount payable by GAL in any month to such airline under the core service rebates.

J173 As part of the Q6 process the airlines have agreed with GAL over the measures and the weights attached to these measures in the service quality scheme but did not agree on the level of the rebate or on Airline Service Standards or pier service standards.

CAA's position

J174 The CAA welcomes that GAL's revised December 2013 commitments addressed some of the airlines concerns regarding service quality. However, not all of those concerns have been addressed. In particular, the status of pier service standards in the commitments is unclear. Pier service standards have not been agreed with the airlines. If GAL introduces pier service standards that the CAA considers are against passengers' interests then with a licence the CAA has the ability to amend the standards.

J175 Notwithstanding the amendments to the commitments, the CAA maintains that the commitments, operating outside the statutory licence framework, do not provide adequate protection against and redress for passengers in respect of repeated service quality failures.

J176 The commitments include a requirement to increase service quality rebates by 25 per cent if failures continue for more than six months and to develop an improvement plan. The CAA continues to have concerns in this area, for example as the increased rebates would only apply if failures are spread across two financial years and that rebates reduce to zero if there are six consecutive months of failure in one financial year. This does not appear to be in passengers' interests unless, as with Q5, there was a backstop of a CAA investigation if failures persist for more than six months.

J177 The CAA also notes that only GAL can initiate changes to core and airline standards.⁴¹ The CAA also notes that pier service standards

⁴¹ The CAA notes that the service quality regime also includes airline service quality penalties on check-in queues and arrivals bag performance. The CAA supports coordination on service standards across the airport where this does not distort the functioning of an effective market, but the CAA does not have the locus in the CA Act to set standards on airlines. The CAA has

have not been agreed by airlines and could be imposed by GAL. Under a licence framework if the commitments were found to be operating against passengers' interests, then the CAA could intervene to enforce the commitments and/or modify the terms of the licence to address any concerns.

- J178 The CAA also considers that given the commitments only require agreement from airlines representing the majority of passengers (67 per cent), this regime would have the advantage of potentially being more flexible. This flexibility will also be available under a LBC Licence, with the backstop of the statutory modification and enforcement framework if the commitments are not operating in passengers' interests. In terms of adverse effects of licence regulation generally, the CAA acknowledges that, while licence regulation can address the above mentioned service quality issues, it could also impose risks. These risks centre around setting the wrong set of service quality requirements for example if the elements of service quality measured and associated financial incentives do not match passengers' priorities (misalignment with passengers' priorities) or there is a focus on attributes that can be easily measured. There is also a risk that licence regulation can fix service quality requirements at a particular level during a control period when circumstances and requirements may change (rigidity of licence regulation).
- J179 Starkie and Yarrow commented that regulation could distort incentives on innovation, including improvements in service quality. The CAA notes that if no licence was imposed on GAL, the airport operator would introduce its commitments which generally include a similar service quality regime as in Q5. The CAA considers that if the regime caused significant distortions, for example to innovation, GAL would not have included a service quality regime comparable to the Q5 scheme in its commitments. The CAA also notes that its proposal for a LBC Licence has not prevented GAL from discussing differential service offerings under bilateral contracts. The CAA therefore does not consider that a LBC licence should distort incentives on innovation, for example in relation to service quality

therefore not included airline standards in licence-backed commitments.

- J180 As mentioned in the Consultation, the CAA does not consider that the current service quality regime has stopped GAL from responding to passengers' needs. The level of service quality at Gatwick also does not appear to be misaligned with passengers' preferences given the increase in passenger satisfaction based on the results of both GAL's QSM surveys and the ASQ survey.
- J181 The CAA considers that the adverse effects and disbenefits associated with licence regulation are significantly reduced under the CAA's proposals for a LBC Licence which are more proportionate than full RAB licensing. In particular as the same service quality regime and modification provisions would operate under both commitments and the LBC Licence, the CAA considers that the problems of rigidity of a licence-based regime would be removed.
- J182 Overall, the CAA considers the existing regulatory regime at Gatwick appears to have provided benefits in terms of service quality which would be maintained under licence regulation. It appears that the costs of licence regulation in terms of rigidity and misalignment with passengers' priorities are likely to be relatively small. If licence regulation was removed then the CAA considers that there is a risk with the enforcement of service quality, both from the potential misalignment of airlines' and passengers' requirements and from repeated service quality failures that could result in significant detriment to passengers.
- J183 If GAL's commitments are backed by a licence, the CAA considers that the service standards in the commitments, should ensure good continued service. The CAA considers the ability of the CAA to monitor service quality performance with the potential to enforce the commitments or introduce additional licence conditions if required would provide significant benefits to users.

Impact 5: Investment incentives

CAA's minded to position

- J184 The CAA noted that licence-based regulation could distort investment incentives, with a potential bias of RAB-based regulation towards capital spend and market-based approaches potentially leading to too little investment. The CAA considered that the Q5 regulatory framework did not appear to have resulted in too much investment in the current control period and there was the potential to strengthen investment incentives under market-based regimes by putting in place additional regulatory requirements.
- J185 The CAA considered that the main thing GAL's commitments offered above the requirements of the ACRs and applicable safety and environmental legislation was the requirement to publish a rolling five year capital investment plan (CIP) and a master plan (although the publication of the CIP could be thought of as means to comply with requirements of the ACRs). The CAA considered that although the publication of a CIP and a master plan would provide users with some clarity as to future investments, the airport operator would be able to change these plans which provided little protection over investment levels and outputs, where an operator had SMP.
- J186 The CAA considered it should be possible to use the flexibility of a licensing system to address other concerns with licence regulation such as fixing investment too far in advance and disincentivising investment for new customers. Nevertheless, licence regulation will necessarily lead to some costs in terms of rigidity particularly in terms of investment consultation, which appear to be required to address potential primary duty concerns.

Consultation responses

- J187 GAL maintained that the individual programmes are:
- closely aligned to the delivering of service levels required under the service quality scheme;
 - undertaken in partnership with airlines to deliver benefits to passengers and airlines;
 - commercial revenue generating; and
 - necessary to ensure that GAL continues to operate facilities that are compliant with all relevant environmental, health and safety standards.
- J188 GAL did not believe it was appropriate to commit, in a more granular fashion, to specific projects or that the core service quality measures should be extended to cover all eventualities. GAL stated that being able to manage its capital investment programme more flexibly was the key differentiation of the commitments from a RAB-based regulation. However, GAL understood concerns about a substantial reduction in the capital programme and therefore proposed to commit to investing a minimum of £100 million per year on average over each of the seven years of the commitments.
- J189 GAL also considered its proposed approach to consultation extended beyond the basic requirements of the ACRs and adopted the key principles of the arrangements set out in Annex G to the CAA's Q5 decision.⁴²
- J190 In response to the CAA's consultation of the STAL market power assessment and in particular with regard to investment incentives, GAL raised concerns about the way the CAA undertook the assessment, in particular by considering how regulation could be adapted to address concerns about distorted incentives rather than by considering whether the removal of regulation would address these concerns.

⁴² The airport operator's consultation requirements were set out in Annex G to the CAA's Q5 decision. These requirements followed an earlier CC finding that existing consultation arrangements were inadequate.

- J191 The GACC stated that it was likely that some beneficial projects would be unlikely to be developed under a non-licence approach but did not elaborate.
- J192 BA expressed concern that under the commitments the ultimate decision on the capex plan would be with GAL, contrary to the approach adopted in developing RAB-based controls. BA considered this was unattractive as GAL could be expected to adopt the approach to capex that was most beneficial to its interests rather than those of passengers and GAL might therefore have incentives to cancel, delay or downgrade worthwhile projects. BA considered that while the commitments incorporated information disclosure and consultation with airlines around capex spend, there remained no commitment to act on the comments from airlines.
- J193 VAA considered that it was likely that the level of investment in the airport would fall under a non-licence based approach as this would increase net revenue for the airport operator and its stakeholders and therefore projects beneficial for the passenger would be overlooked.
- J194 In response to the consultation on the draft licence with GAL's revised commitment proposals the GACC, BA and VAA raised additional concerns on the lack of commitment to deliver the capital plan and considered that the rebates in the service quality regime were too low to incentivise the delivery of capex.

CAA's position

- J195 The CAA notes that GAL's revised December 2013 commitments included the following assurances in relation to investment:
- a commitment to publish a rolling five yearly capital plan, consult with airlines and the Passenger Advisory Group on major projects and report on annual expenditure;
 - a commitment to a minimum capex spend of £100 million per year; and
 - a commitment to explain material differences between the latest forecast, the prior year forecast and the forecast included in the CAA's price review.

- J196 The CAA also acknowledges that one of the reasons bilateral contracts could be more likely in a commitments approach could be the more flexible approach to capex which provide greater support for differentiated services.
- J197 According to GAL's commitments, investment would be driven by the service quality scheme and GAL's vision for the airport.⁴³ Commitments would avoid some of the perverse incentives from RAB-based regulation particularly around investment incentives. Consultation arrangements are similar to those in Q5. However, there is no guarantee that investments that do not directly impact on outputs covered in the SQR scheme would be taken forwards.
- J198 GAL raised concerns about the way the CAA undertook the assessment, in particular by considering how regulation could be adapted to address concerns about distorted incentives rather than by considering whether the removal of regulation would address these concerns. The CAA considers that it would be irrational when considering the potential implementation of licence regulation, not to consider amendments to the regime to address concerns that had been highlighted. The CAA considers that it has assessed the impact of removing regulation in its assessment, in particular in the absence of regulation, an airport operator with SMP is likely to take forward too little rather than too much investment and consequently is likely to suffer from some of the same problems of market-based forms of licence regulation (as the direct link between investment and future returns would be removed), but without the regulatory tools to address the shortcomings.
- J199 As discussed in the Consultation, the CAA understands the potential negative impact of the RAB-based regulation on investment incentives, the focus on inputs and outputs, the incentives to deliver outputs efficiently, setting capex in advance, the incentives on capex as well as on airline incentives (for example against investment for potential new airline customers). The CAA notes that as set out in the Consultation some of these distortions do not appear to have affected the current RAB-based regime and measures can be introduced to mitigate or reduce potential distortions. The CAA also

⁴³ This was discussed in chapter 10 of CAA's Q6 final proposals, opcit.

notes that it is not proposing to introduce RAB-based regulation for GAL. These distortions should not occur under the LBC Licence as the capex framework are the same as the commitments simply backed by a monitoring regime.

- J200 The CAA maintains its concern that the commitments do not include a commitment to any outputs from the capital plan apart from maintaining the service quality regime and a commitment to a minimum spend of £100 million per year over the term of the commitments. GAL's proposed spend under a RAB-based framework is around £200 million⁴⁴ per year (£1.1 billion under a RAB-based 5-year period) and many of the schemes produce outputs that are not reflected in the service quality regime, for example the early bag store will provide the ability for early check-in; the international departure lounge (IDL) schemes will provide increased circulation space and new children's and outside areas; the check-in schemes will provide new bag drop facilities; the north terminal arrival scheme provides a much enhanced arrival area etc. While GAL has committed to provide an explanation of any material differences between the latest CIP forecast and both the prior year forecast and the forecast incorporated in the CAA's Q6 price control review, it has not committed to any programme of specific capex. The CAA is therefore concerned that GAL could significantly reduce capex and not deliver the outputs that the CAA considers are in passengers' interests. With a LBC Licence capex spend can be monitored and if issues arise then enforcement action can be taken or new licence conditions can be introduced. Consequently the CAA considers that a LBC Licence would provide additional protection to passengers.
- J201 The CAA considers that a LBC Licence, encompassing GAL's commitments to consult and explain material differences with the CAA's forecasts, should provide adequate protection to users despite the difference between the capex in the fair price and the minimum spend in the commitments.

⁴⁴ Following the CAA's Q6 review of GAL's schemes and identified efficiencies the average core capex under a RAB-based framework falls from £200 million per year to around £158 million per year over five years (£184 million total core and development capex) or £168 million per year over seven years (£187 million total core and development capex).

J202 In summary, the LBC Licence will facilitate efficient investment as GAL would have flexibility to tailor investment to the needs of airlines, while the licence will provide users with additional benefits from allowing the CAA to intervene if capital investment that was in the passengers' interest was not being taken forwards. As the typical adverse effects of a RAB-based approach would be avoided under a LBC Licence approach, the CAA considers the benefits of its proposed licence regulation in terms of investment outweigh the adverse effects and is a proportionate measure that does not impose an onerous regulatory burden on GAL.

Impact 6: Operational resilience

CAA minded to position

- J203 The CAA considered a licence can be used to compel or incentivise the airport operator to adopt certain behaviours regarding the needs of the passengers that, as a monopoly provider without a direct contractual relationship with the passenger, it otherwise might not consider necessary. One example of this was requiring the airport operator to ensure operational resilience, especially in times of disruption. The CAA considered that a licence condition could require the airport operator to have adequate plans in place to deal with disruption and to keep passengers informed at such times.
- J204 Recent events have suggested that such a licence condition could be beneficial to passengers. The consequences of severe disruption due to snow in January and December 2010, as well as severe disruption due to the Icelandic ash cloud, highlighted the lack of adequate emergency planning at many airports.
- J205 The CAA considered that GAL's commitments created some accountability to airlines but not to passengers themselves, either directly or through the CAA. As noted in regards to enforceability of the commitments, the CAA would have no ability to step in to protect passengers if things went wrong. Consequently, the CAA considered that a licence condition could give greater protection to passengers for two key reasons:

- a licence can be used to compel or incentivise GAL to adopt certain behaviours regarding the needs of passengers that, as a provider with SMP that does not have a direct contractual relationship with the passenger, it otherwise might not consider necessary by making GAL fully accountable to passengers through the CAA; and
- a licence condition could be useful in situations where there is no agreement between the stakeholders to facilitate greater progress to incentivise a greater willingness, or even requiring them, to take their stakeholders' needs into account.

Consultation responses

- J206 GAL pointed out that the commitments require it to develop and maintain an operational resilience plan which will set how GAL intends to operate an efficient and reliable airport to the levels required by the commitments or otherwise agreed with users and in particular how the airport operator will secure the availability and continuity of airport operation services especially in times of disruption. GAL also pointed out that it plans to consult annually on the resilience plan with all interested parties including the CAA.
- J207 BA in principle agreed with the CAA's proposed requirements in terms of operational resilience while disagreeing that airlines should be required in all circumstances of operational disruption to comply with airport rules of conduct. BA considered it inadequate that GAL's operational resilience plan be developed after the CAA's decision on licensing and at GAL's discretion.

CAA's position

J208 The CAA welcomes GAL's commitments proposal to develop and maintain an operational resilience plan which would be annually consulted on and have regard to any relevant guidance issued by the CAA. The CAA, however, has two main concerns about the operational resilience conditions under the commitments.

- The commitments include a requirement to have regard to, rather than comply with, any guidance issued by the CAA when developing operational resilience plans. The CAA considers that this could allow GAL to develop operational resilience plans that are not in passengers' interests.
- The commitments are not clear that any actions within the resilience plans must be proportionate and relate specifically to securing the availability and continuity of airport operation services. The CAA has concerns that the lack of such a condition could allow GAL to exert its SMP over airlines and groundhandlers, particularly in a way that is not in the interests of passengers.

J209 In such circumstances, the CAA considers that a LBC Licence could address the above concerns by, for example, allowing the CAA to enforce the commitments in passengers' interests and allowing the CAA to introduce additional licence conditions if GAL's operational resilience plans are not in passengers' interests. The CAA therefore considers that there would be additional benefits from a LBC Licence.

Impact 7: Financial resilience

CAA's minded to position

- J210 GAL's commitments included a commitment not to take any action which would result in the loss on an investment level credit rating of GAL and to provide an annual confirmation of adequate financial resources to operate the airport, including the provision of those services in respect of which the core service charges are raised. The CAA considered that this would not be sufficient, as GAL's services go beyond the core services and this commitment did not provide reassurance that GAL would have adequate recourses to provide such services and there were no obvious consequences of not having a clean 'adequate resources' certificate. The CAA also stated that GAL's commitments did not require GAL to produce regulatory accounts and therefore the CAA would have no ability to collect financial information about assets employed or income and costs other than that required by statutory accounts reporting requirements, making it difficult to monitor the performance of the commitments regime.
- J211 As licence conditions could address some of the above concerns, the CAA considered that a licence condition in relation to financial resilience could have a benefit to users over GAL's commitments.
- J212 The CAA also identified the following additional requirements that it considered were necessary to facilitate financial resilience, including:
- restriction on business activities;
 - parent company undertakings;⁴⁵
 - continuity of service plan;⁴⁶ and

⁴⁵ For a licence-based approach this is a parent company undertaking not to do anything that would be likely to make the licence holder do anything to breach its licence. For a commitments-based approach the parent undertaking would be not to do anything that would be likely to make the airport operator breach the commitments.

⁴⁶ The continuity of service plan in the commitments focused on operational resilience. The CAA's initial proposals proposed a continuity of service plan that would minimise the risk of the airport's closure in times of the operator's financial distress.

- reporting of any changes in the banking ring fence.

Consultation responses

- J213 GAL stated that its updated commitments require it to provide an annual confirmation of the adequacy of its financial resources to operate the airport, notify the CAA of changes to current financing arrangements and maintain a continuity of service plan. In response to the CAA's consultation of Q6 initial proposals GAL also questioned the benefit of a holding company undertaking given the ownership structure of GAL.
- J214 BA in principle agreed with the CAA's proposed requirements in terms of financial resilience.

CAA's position

- J215 The Government has been keen for the CAA to consider whether the licence could be used to strengthen the financial resilience of airport operators in line with the approaches commonly seen in other regulated sectors. Financial resilience is important as financial distress could cause detriment to passengers' interests in both the short and longer term. The economics of an airport whose operator has SMP suggest that, even in a time of financial distress, the airport is likely to remain open because it would generate a positive cash flow, however, there could be a temporary closure, for example, while an administrator resolves legal and operational issues. Financial distress may also lead to reduced expenditure on the airport with implications for future service quality.
- J216 The CAA notes that GAL's revised commitments include a requirement for the directors to provide an annual confirmation of adequate financial resources. There is, however, no indication in the CoU of the time period to be covered by this confirmation. The CAA considers that unless the confirmation covers a period of at least two years then there is a risk that there would be insufficient time for remedial action to be taken if issues arose.
- J217 The CAA maintains its earlier concerns that the commitments do not include a restriction on business activities as GAL stated that the finance documents include a similar restriction. The CAA is

concerned that the finance documents could change, and in the absence of licence protection, remove the protections to users.

- J218 The CAA also maintains its earlier concerns that the commitments do not include a requirement to obtain a holding company undertaking. The CAA considers that a holding company undertaking is required to prevent the airport operator from being open to pressure to do something which is not consistent with passengers' interests. The CAA does not consider that GAL's current ownership, which could change during Q6, negates the need for this requirement.
- J219 The commitments include a requirement to notify the CAA of any variations in the banking ring fence that relate to the credit rating requirement. However, if the protection in the banking ring fence changes, in the absence of a licence, there would be nothing the CAA could do to replace that protection. The CAA therefore considers that this commitment would only be effective if the commitments were underpinned by a licence.
- J220 In light of the above concerns the CAA considers that, in terms of financial resilience, a LBC Licence would have a number of benefits over GAL's commitments. Given the scale of passenger disbenefit that could occur if there were financial concerns around GAL, the CAA considers the benefits of a LBC Licence would outweigh the costs in this regard.

Impact 8: Direct costs

- J221 Licence regulation will undoubtedly have costs. These costs can include indirect costs, such as the impacts on incentives set out above, and direct costs, such as the CAA's costs and the time and expenditure of management and regulation staff at regulated airports and their airlines.

CAA minded to position

- J222 The CAA considered that overall the direct costs of the current RAB-based regulatory regime could be as much as £10 million per year. This was based on GAL's estimate of its own costs of £8 million per year. The CAA considered that GAL's costs were overstated and the costs could be half of the amount estimated by the airport operator. There would also be additional costs, which the CAA estimated as CAA costs of £1 million per year and airline costs of £1 million per year. The CAA noted that airlines, in general, have supported a continuation of a RAB-based framework and must therefore consider that there would be a net benefit from doing so.
- J223 The CAA considered that the above costs could be substantially reduced through refinements to the existing regime or under different forms of regulation, in particular a licence-based approach. The CAA also noted that the commitments themselves were unlikely to be costless and estimated that the cost could be up to £3 million per year while noting that these costs would increase if there was not effective partnership between GAL and the airlines and if there were numerous complaints to the CAA under competition law or the ACRs.

Consultation responses

- J224 GAL did not provide a revised estimate of the cost of regulation, hence maintaining its view of direct costs of regulation at £10 million per year (£8 million once the estimated CAA's costs of £2 million are accounted for).
- J225 The GACC did not accept GAL's estimate of the cost of regulation, however, due to lack of sufficient data, it has not been able to scrutinise the financial assessment of £10 million per year in direct costs from regulation. The GACC considered that GAL does not need to spend £8 million per year on regulation, even if that was what it spent until now, and considered this cost out of proportion to the £1 million per year associated with the CAA. The GACC also questioned whether GAL's estimated costs properly reflected the additional costs of a licence as much of the expenditure would be necessary or desirable even without a licence, for example business cases would still be required for capex developed irrespective of a

licence requirement. The GACC considered that responding to challenges made by the CAA and the airlines reflected the time and effort most companies would spend in responding to challenges provided by the actions of competitors. The GACC also considered that some of the estimated costs were driven by Annex G of the 2008 regulatory decision, which put in place procedural consultation obligations on GAL, and a better alternative could be for the CAA to impose lighter process requirements that would accept any projects signed off by airlines.

- J226 VAA questioned GAL's estimate of costs of regulation of £8 million per year (with a further £1 million year associated with the CAA). VAA considered that the majority of this expenditure is unnecessary and is an overestimate of the actual spend on the regulatory process. It did not elaborate on this but welcomed a clearer break down of these costs and their justification in order to identify efficiencies. In general, VAA acknowledged that there will be some costs associated with a licence but considered that costs borne under a non-licence-based approach would ultimately be more costly due to the uncertainties associated with a new process.

CAA position

- J227 The CAA considers that the most appropriate way to consider the costs of the LBC Licence is first to consider the costs of the existing regime and then to consider whether the LBC Licence would alter these costs.

CAA direct costs

- J228 In 2007 the CAA estimated the CAA's and Competition Commission (CC) costs for the Q4 review (covering all three designated airports) was around £3 million and acknowledged that there would be additional costs of the airport operators and airlines.
- J229 The CAA acknowledges that the CAA charges are levied on airport operators who then take into account these costs when levying airport charges to airlines, who will in turn pass on the costs to their passengers.
- J230 The CAA's annual charges for economic regulation at Gatwick are around £0.8 million per year, with additional costs of around £0.5m

per year during the periodic review.⁴⁷ In addition there are likely to be the costs of any appeals to the Competition Appeal Tribunal (CAT) and the CMA, which may be borne to some extent by the industry. The extent and cost of these appeals are not known.⁴⁸ The direct costs at Gatwick compare to an annual charge for Luton, which is unregulated, of less than £0.1 million per year.⁴⁹ Based on the same charge per passenger would give a charge of £0.25 million per year for an unregulated Gatwick.⁵⁰ Based on this, the CAA maintains its previous estimate of CAA direct costs of the current regime of around £1 million per year on average during a 5-year control period.⁵¹ The incremental costs of licence regulation would be around £0.8 million per year. The CAA notes that costs would vary between different frameworks under licence regulation. In the short term the CAA does not consider that a LBC Licence would reduce its annual costs although these costs should reduce over time if the regime is successful and monitoring can be reduced. In addition, the costs of any periodic review would be spread over seven rather than five years (reducing the CAA annual costs by around £0.3 million per year).

J231 The CAA considers that even under a commitments approach in the absence of a licence, as GAL would still have SMP, the CAA's costs

⁴⁷ This is based on around 17 million arriving passengers at Gatwick (CAA Airport Statistics) and a charge of 4.75 pence for designated airports and 3.12 pence per arriving passenger for the Q6 review for Gatwick. Source: CAA charges 2013/14 consultation document. This document can be accessed at:<http://www.caa.co.uk/docs/1352/CAACHarges1314ConsultationDocWebFinal.pdf>.

⁴⁸ The DfT estimated that the cost of a CC appeal was £2 million, see the impact assessment for the Civil Aviation Bill, paragraph 321 http://www.legislation.gov.uk/ukia/2012/329/pdfs/ukia_20120329_en.pdf

⁴⁹ For non-designated airports the charge is 1.49 pence per arriving passenger. There are around 5 million passengers arriving per year at Luton. Source: CAA Airport Statistics and CAA charges 2013/14 consultation document. This document can be accessed at:<http://www.caa.co.uk/docs/1352/CAACHarges1314ConsultationDocWebFinal.pdf>.

⁵⁰ For non-designated airports the charge is 1.49 pence per arriving passengers, with 17 million arriving passengers at Gatwick, gives an annual charge of £0.25 million.

⁵¹ Assuming a two year review period would mean that the periodic review would lead to additional CAA charges of £1 million over a 5-year control period, or £0.2 million per year if spread over the five years. This would be in addition to the charge of £0.8 million per year, to give a total annual charge of around £1 million per year.

were likely to be higher than for a competitive airport operator, in particular due to the need for continued monitoring in case re-regulation is required, and to deal with any ACR/AGR or CA98 complaints that might arise (which might be more likely under a commitments only framework in the absence of any licence because a licence offers a wider range of regulatory tools. The CAA notes that although these costs are hard to estimate they could be considerable if the regime broke down into repeated ACR or competition law complaints (which are noted previously would not provide effective protection to passengers).

Airport operator and airline direct costs

- J232 In addition to the costs of the CAA there will be the cost of management and regulation of staff at the airport and airlines as well as the costs of compliance with regulatory measures. As with CAA's direct costs the CAA has considered the costs of the existing regime and whether the LBC Licence affects those costs.
- J233 GAL has not revised its previous estimates and therefore maintained that the total costs of the existing regulatory regime would be around £10 million per year. GAL has included CAA costs of around £2 million per year in this estimate which would give net costs to GAL of around £8 million per year.⁵² GAL acknowledged that this is a high-level estimate. This estimate is made up of two parts:
- a cost of £3 million associated with direct costs of regulation, which includes the cost of the regulation team and a proportion of the costs of the legal and development team; and
 - a further cost of £5 million associated with the significant capex overheads compared to non-regulated airport operators, primarily related to the consultation requirements under the existing regulatory regime.
- J234 After reviewing GAL's estimate of its own direct costs the CAA considers the actual direct costs of the existing regime are substantially less than those estimated by GAL.

⁵² Correspondence from GAL.

- GAL stated that the cost estimate includes the cost of the strategy and regulation team (which makes up around half of the cost) and a proportion of the costs of the legal and development team. The CAA notes that GAL's strategy and regulation team work on more than regulation, including the development of the second runway, which are not direct costs of regulation. GAL's estimate of legal costs was based on the costs for 2012/13. The CAA notes that GAL's legal costs increased by 70 per cent in this year to £1 million per year, mainly due to the requirements of challenges related to the AGRs and section 41 of the Airports Act 1986. These costs are not directly related to licence regulation. While GAL has only included a proportion of legal costs it is unclear whether an allowance has been made for these unrelated legal costs. For these reasons the CAA considers that GAL's direct costs are likely to be overstated.
- GAL's estimate that incremental costs of current capex consultation regime are around £5 million per year. This compares to annual capital expenditure over Q5 of around £200 million per year. GAL is therefore stating that the existing consultation arrangements make up 2.5 per cent of the total budget for capex. The regulatory consultation arrangement is focused on enhancements (new schemes) rather than renewals (replacements). Consequently just focusing on enhancement expenditure, GAL is effectively stating that the existing consultation arrangements are increasing costs by 3 to 4 per cent of total capex costs. This seems improbably high and GAL has not provided a more detailed breakdown to substantiate this estimate.

- GAL's costs of consultation make up part of the on-costs of capital schemes. On-costs are generally defined as the internal GAL management costs and external design and commercial management consultancy costs required for the definition and delivery of a project. As part of its review of GAL's capital schemes, the CAA's consultants identified that GAL's on-costs were between 18 per cent to 21 per cent for enhancement schemes, which was well above external market benchmarks of 9.5 to 15 per cent, and should be reduced to an average of 17 per cent.⁵³ Based on these estimates the consultation arrangements alone account for 10 to 20 per cent of the total on-costs. This seems improbably high, given that the majority of on-costs are typically made up by design and specialist consultancy support.
- The vast majority of GAL's estimate of the costs of the existing regime are related to staff costs. The CAA's consultants have identified that, on average GAL's pay rates are between 9 and 13 per cent above industry benchmarks. Again this indicates that GAL's estimate is likely to overstate the efficient costs of the current regulatory arrangements.
- The costs of the existing consultation arrangements should not all be regarded as incremental as for example airport operators that operate competitively are likely to undertake extensive consultation on capital schemes, for example to make sure that customers will pay for enhancement through additional charges and will be content with the operational impacts during and after enhancement works are carried out.

J235 The CAA considers that the incremental direct costs to the airport operator and airlines from a LBC Licence will be small, as compared to the Commitments Counterfactual. Many of the regulatory protections will be included in the commitments themselves rather than directly in the licence. As with the commitments themselves, the main focus of enforcement under the LBC Licence will be by the airlines, which will better align with normal commercial approaches. A LBC Licence simply allows the CAA to enforce, including in

⁵³ Davis Langdon, March 2013, Gatwick Airport, Q6 capex review: Phase Two report, <http://www.caa.co.uk/docs/78/Q6DLangdonCapex.pdf>.

passengers' interests, which may impose some additional costs. The monitoring regime will focus on information already provided under the commitments, with the addition of a requirement for a shadow RAB calculation, which should be relatively simple for GAL to calculate as it has already committed to publishing changes to its asset base.

Conclusion on direct costs

- J236 For the reasons set out above the CAA considers that GAL's estimates of its own incremental costs of the existing regulatory regime appear to be overstated. The CAA notes that the direct costs of the current RAB-based licence would be substantially reduced through a LBC Licence regime because in particular the majority of costs will be borne as part of the commitments and so will not be incremental due to the LBC Licence.
- J237 In the Gatwick Q6: notice of the proposed licence, the CAA discussed the respective merits of a LBC Licence compared to RAB.⁵⁴ The CAA considers that a LBC Licence approach would also be cheaper. The CAA considers that the LBC Licence regime would impose minimal additional costs to GAL over and above the costs associated with the Commitments Counterfactual given the main focus of the licence and monitoring is to ensure the enforceability of the commitments, with the main costs likely to be associated with the provision of information for the monitoring regime. The LBC Licence could actually reduce the costs of the commitments framework as it would reduce the risk of legal disputes.
- J238 The commitments themselves would not be costless. However the increased focus of the regime on the airport operator-airline relationship is likely to reduce airport operator and airline direct costs compared to the existing regulatory regime as discussions will be more closely aligned through normal commercial arrangements. The commitments would also reduce costs compared to the current regulatory regime from the simpler consultation arrangements on capex.

⁵⁴ Gatwick Q6: notice of the proposed licence, Appendix I "Form of regulation", opcit.

- J239 The main incremental costs of the LBC Licence would be CAA costs of the monitoring regime and, where necessary, any appropriate enforcement. The CAA considers that a LBC Licence approach, as it minimises the airport operator's and airlines' direct costs of regulation, is most proportionate and appropriate approach for GAL.

Impact 9: Indirect adverse effects

CAA's minded to position

- J240 The CAA considered that above the earlier mentioned distortive effect from regulation there could be a potential adverse effect of crowding out a more commercial approach and management distraction by focusing the airport operator more on maximising the value from a regulatory settlement.

Consultation responses

- J241 During consultation of both the CAA's minded to position and Q6 final proposals GAL maintained that commercial agreements were unlikely under a RAB-based approach.
- J242 In response to STAL's consultation document GAL suggested the CAA should carry out a full analysis of what GAL believed are very substantial indirect costs of regulation.
- J243 Starkie and Yarrow noted that in a highly regulated sector the need to influence regulatory decisions leads to the diversion on management effort and attention from dealing with customers to dealing with regulators.
- J244 The GACC considered that perverse incentives and the opportunity for gaming by airport operators could arise from both a licence and non-licence approaches and did not accept that licence regulation would be more likely to distort investment, pricing or reduce scope for commercial agreements.
- J245 VAA stated it did not accept the view that a licence-based approach at the airport would crowd out a more commercial approach as the airport operator already had the ability to enter into commercial agreements and alter the structure of prices. VAA also did not agree that a licence-based approach would distort investment and pricing

as the regulatory controls should be able to replicate commercial market pressures and would have a benefit over a non-licence-based approach.

CAA's position

J246 The discussion above considered a number of potential distortive effects from licence regulation:

- The price cap could be set too low, distorting competition and investment decisions at other airports (see paragraph J143);
- The increased rigidity of a regulatory system in particular in relation to the consultation arrangements and changes in charges and service quality (see paragraphs J158 and J181);
- The distortions to incentives on opex, non-aeronautical revenue and investment (see paragraphs J157 and J199);
- The potential for reduced incentives for innovation (see paragraph J179); and
- The requirement for capex plans to be set too far in advance and not to invest for new customers (see paragraph J199).

J247 Three other potential distortive effects from licence regulation are: incentives for regulatory gaming, the crowding out of a more commercial approach and management distraction. GAL states that the indirect costs of regulation from these distortions are in excess of the direct costs.⁵⁵ The CAA notes that GAL has not provided estimates of these indirect effects. The CAA itself has not been able to quantify them. The CAA has, however, undertaken a qualitative assessment of these costs which is set out below.⁵⁶

⁵⁵ This point was also recognised by the CAA in its recommendations to the Secretary of State in the de-designation of Manchester and Stansted airports.

⁵⁶ As mentioned earlier in this document the CA Act does not dictate a particular method of impact assessment and as a result such assessment may be qualitative or quantitative or a combination of both depending upon the availability of the relevant data.

Regulatory gaming

J248 The CAA does not consider that a LBC Licence should have a material impact on regulatory gaming, compared to the commitments without a licence as:

- the same capex regime applies in both the commitments and a LBC Licence, this should not distort airline incentives on capex;
- the LBC Licence simply allows the CAA to enforce the commitments but the main focus of both the commitments and a LBC Licence regime will be the airport operator-airline relationship, minimising the potential for gaming; and
- the bid and counter bid approach that can affect regulation is also present in normal commercial negotiations, for example the discussions around bilateral contracts in a competitive environment, and GAL has improved the commitments itself as a result of CAA and airline responses.

J249 The CAA acknowledges that the monitoring regime could potentially create scope for regulatory gaming through responses to the 2016 monitoring review. However the CAA considers that this should be minimised as the focus of the 2016 review is whether the commitments are operating in passengers' interests and the CAA is undertaking the review in 2016 to allow relationships to bed down. Consequently the CAA does not consider that the monitoring regime and therefore the LBC Licence should have a material impact on regulatory gaming compared to the commitments themselves.

Crowding out of a more commercial approach

- J250 One of the key areas where RAB licence regulation could create distortions is through crowding out of a more commercial approach through negotiations between the airport operator and airlines. In the absence of SMP and regulation, airport operators and airlines would be incentivised to enter into mutually beneficial bilateral contracts or deals. These deals could vary in terms of the duration, scope and service requirements depending on the needs of individual users and characteristics. Bilateral contracts can also provide benefits to airport operators from traffic and growth commitments and the utilisation of new facilities. Such bilateral contracts characterise much of the competitive airport sector in the UK. The CAA has also recognised the potential benefits of bilateral contracts and the airport operator's commitments at Gatwick.⁵⁷
- J251 A regulatory settlement can crowd out such contracts as both the airport operator and airlines will want to know what the potential settlement is before agreeing to any deal. This is why the CAA has been keen to encourage commercial agreements where possible, for example on the extension of the Heathrow and Gatwick price controls⁵⁸ and by encouraging a similar arrangement at Stansted. The CAA notes that the current regulatory framework has not been a block on STAL reaching a commercial bilateral contract with some airlines, most recently with Ryanair.
- J252 The CAA considers that the prospect of and potential structure of licence regulation has been the main reason why GAL has entered into discussions on bilateral contracts. Airlines have suggested that the CAA's Q6 final proposals provided GAL with an impetus to try and reach agreements. Despite these bilateral discussions a number of airlines have also indicated continued support for regulation and

⁵⁷ CAA stated that: "In the right circumstances, bilateral contracts and airport commitments could be capable of providing protection that is at least as good as what regulation can provide, while also allowing more diversity and flexibility of provision than regulation easily allows. At its best, such a system could be better than regulation, and therefore be in the interests of passengers" CAA, October 2012, Gatwick Airport Mid Constructive Engagement (CE) Review, <http://www.caa.co.uk/docs/5/121005LGWKCJSG.pdf>.

⁵⁸ The extension of the Gatwick Q5 price control was itself partially to allow the airport operator to reach commercial agreements with its airlines.

the continued need for regulatory protection. The CAA therefore does not consider that its proposed approach for a LBC Licence has crowded out a commercial approach. To some extent a LBC Licence could be seen as encouraging bilateral contracts and a greater focus on the airport operator-airline relationship, where - if otherwise - airlines looked for other mechanisms to try and protect their rights (such as competition law or appeals to the CAT or appeal courts).

J253 The CAA recognises that bilateral contracts could be more likely under a commitments only regime, not least as the airport operator would not be looking for the regulator to stand over any arrangements. However the CAA recognises that in some circumstances bilateral contracts may not be good for passengers; for example where the contract would not have been signed but for the airport operator exercising its SMP. That is why when discussing bilateral contracts and airport commitments at Gatwick the CAA stated that:

“if a commitment/contract regime were to be a main reason why a price control would not be put in place (when it otherwise would be), that regime would also need to be fair to airlines. This means the overall deal would have to be reasonable compared to a potential regulatory settlement, and that non-discrimination was observed”.

J254 Consequently, while a regulatory settlement can create distortions by discouraging bilateral contracts from being agreed, it does not stop such agreements and, in cases where the airport operator has SMP, like GAL, it can prevent the airport operator from abusing its market power in such agreements (see for example the reduction in the commitments price made by GAL in response to the threat of licence regulation). Consequently, the CAA does not consider that simply backing commitments with a licence would prevent bilateral contracts being agreed with airlines. Given that such contracts do not contain rights for passengers as third parties, incorporating the commitments within the licensing framework rather than just in the CoU will ensure that passengers have more immediate and direct forms of protection.

Management distraction

- J255 GAL considered that RAB-based regulation could distort incentives by distracting management by focusing the regulated company more on maximising the value from a regulatory settlement rather than focusing on improved efficiency or service quality. GAL has previously stated that the diversion is not limited to senior management and regulatory staff but is now pervasive and involves many operational managers in the extensive consultation processes and in preparations for them, and involves the airlines as well as the airport operator. Starkie and Yarrow also mentioned the indirect cost of management distraction in a regulated market.
- J256 The CAA agrees that management distraction is a potential impact of regulation. The CAA recognises that the existing regulatory regime has involved the distraction of regulatory and management staff. However, the CAA does not consider the distraction to operational staff at GAL has been significant given that both opex and commercial revenue discussions during Constructive Engagement (CE) have been high level and most of the involvement has been associated with one-off consultancy studies.
- J257 The CAA considers that while some management distraction from the regulatory process is likely from licence regulation the scale of regulatory distractions would be minimised through a LBC Licence (compared to the situation under a RAB licence) in which any management distraction would be focused on any subsequent periodic review, with the main focus of the relationship between the airport operator and airlines.

Conclusion

J258 The CAA considers that the above adverse effects could be minimised under less rigid forms of regulation than the current RAB-based price cap. Particularly, a licence regulation in the form of a LBC Licence would minimise these effects as the main focus of the licence is to ensure the enforceability of the commitments.

Overall conclusion: LBC Licence

J259 Overall, the CAA welcomes GAL's commitments proposal. However, the CAA is not sufficiently convinced that the enforceability of and the substantive terms of the commitments proposal assures benefits to passengers and cargo owners to a sufficient degree. Further, the CAA does not consider that the revised commitments offer sufficient protection against the potential abuse of SMP, for example in terms of excessive pricing, inefficiency, inferior service quality and investment.

J260 Against this the CAA has considered the potential adverse effects of a LBC Licence in terms of the direct costs, distortions to incentives, regulatory gaming, management distraction and crowding out of a more commercial approach etc. The CAA notes that these adverse effects are minimised through a LBC Licence, given the focus of the regime on the airport operator-airline relationship and the focus of the licence is to ensure the regulatory oversight and enforceability of the commitments. Overall, the CAA's judgement is that the benefits of a LBC Licence are likely to outweigh the adverse effects.

Assessment of alternative factual scenario: Licensing Generally

- J261 As already noted, for completeness, the CAA has also considered the costs and benefits of regulation by means of a licence that is not in the form of an LBC Licence. In this section, the CAA considers that factual scenario against the Commitments Counterfactual.
- J262 The assessment has been undertaken considering the same impacts as considered above.⁵⁹

Impact 1: Enforceability

- J263 The CAA considers that the same concerns around the enforceability of the commitments are likely to arise whether considering licence regulation or LBC Licence. The mechanism for addressing these concerns is likely to vary across different forms of regulation. For example under a RAB-based approach and other ex ante forms of regulation, the CAA is likely to address these concerns by directly putting in licence controls to address the main risks of the abuse of SMP, for example around price, efficiency, service quality and investment, and would also introduce additional provisions to address issues such as operational and financial resilience. To some extent these would be similar to terms in the commitments. Under price monitoring the CAA could set out a framework to monitor these issues.
- J264 Both ex ante and ex post regulation would have similar enforceability benefits to a LBC Licence: in terms of the ability to enforce in passengers' interests, allow important protections in the CA Act such as the right of appeal to the CMA, facilitate timely regulatory intervention and allow a range of regulatory and enforcement measures. Although the enforceability benefits of ex post monitoring are likely to be lower than other forms of regulation given the potentially slower speed of response (as controls are ex post rather than ex ante).

⁵⁹ The assessment of Existing Regulation conducted above is also relevant to the assessment of this factual scenario and has been taken into account.

Impact 2: Protection against excessive prices

- J265 Given the concerns highlighted with the enforceability of the commitments the CAA is likely to introduce some form of price controls in other forms of regulation whether they be ex ante price caps or ex post price monitoring. Under RAB regulation the CAA is likely to set a price cap based on the fair price as this has been calculated using RAB building blocks. Price caps could also be introduced using long-run incremental costs (LRIC) or pegging tariffs to comparator airports. While these approaches would have benefits in terms of certainty the CAA notes the problems with setting price caps using these approaches as set out in the Q6 final proposals. The CAA could also monitor prices under the commitments. This would have benefits over commitments in terms of speed of response and the ability to introduce a range of enforcement and regulatory measures compared to commitments alone, much of the protections would rest on the commitments themselves (and the issues that raises) and the CAA would therefore need to set clear expectations for the future path that it would consider appropriate (in particular given that the CAA considers that the fair price is below the commitments price). The CAA acknowledges that price monitoring on its own may not provide sufficient protection given the market power held by GAL.
- J266 Licence regulation would also have benefits beyond price controls in terms of the ability to regulate the pass through of costs, in particular those associated with a second runway. While as set out in the Consultation the CAA acknowledges that there were risks from a licensing regime, for example from the potential impact on agreeing bilateral contracts (although bilateral contracts are not prevented under alternative forms of regulation), the CAA considers these risks are outweighed by the potential benefits over GAL's proposed commitments in terms of ensuring that prices charged are in passengers' interests.

Impact 3: Efficiency

- J267 Licence regulation can be an effective way of promoting opex and capex efficiency. The strength of efficiency incentives will depend on the type of regulation. Licence regulation can also create adverse effects in particular through the distortion of incentives between opex and capex efficiency. In general it appears that a variety of forms of regulation would provide greater efficiency incentives than relying on the commitments alone.
- A RAB approach as with the commitments, would provide incentives to outperform the price cap, but would have stronger efficiency incentives due to the tighter price cap.
 - A market-based price cap (such as one based on LRIC or airport comparators or other forms of licence-based price caps) will provide efficiency incentives as the price cap would be delinked from expenditure, although the strength of these incentives would depend on the accuracy of the calculations and the level of the price cap.
 - Price monitoring, in the right circumstances could provide incentives for efficiency as prices would be delinked from expenditure with the strength of incentives dependent on the strength of competitive pressure and the perceived impact of any threat of more prescriptive regulation.
- J268 Any form of licence regulation can include requirements for increased transparency, for example through the publication of detailed financial data in regulatory accounts (which could go further than the information GAL has committed to provide in its statutory accounts). This can provide a strong incentive on airport management to be more efficient.
- J269 Any form of licence can also include limits or checks and balances on elements of cost pass through, for example on second runway costs, which can improve efficiency. There will also be efficiency benefits from the threat of enforcement action or tighter regulation if efficiency does not improve.

- J270 The CAA acknowledges that licence regulation can distort incentives, for example by concentrating efficiency gains at the beginning of the control period, where the benefits to the airport operator are greatest, although this does not seem to have prevented GAL from improving efficiency during the Q5 control period.
- J271 The CAA also acknowledges that there are likely to be some benefits of the commitments in terms of the greater efficiency incentives from the longer period of operation (seven years compared to five years for a traditional RAB approach), although these benefits are likely to be eroded by the potentially looser price cap and the elements of full cost pass through.
- J272 Based on this analysis, licence regulation in general could provide stronger efficiency incentives than the commitments alone from the potentially tighter price cap, increased transparency and the full cost pass through.

Impact 4: Protection against the failure to meet service quality standards that passengers require

- J273 GAL's proposed commitments include a similar service quality regime to that in Q5. A similar regime could be introduced under any of the alternative forms of regulation. The incremental benefits of a licence would therefore be:
- incremental passenger benefits from fine tuning the service quality regime (although the CAA notes that large parts of the commitments have been agreed with airlines although not in the important area of pier service);
 - increased financial incentives from fine tuning the rebate levels (although the CAA is proposing the same money at risk in the Heathrow Airport Limited (HAL) service quality regime); and
 - the ability of the CAA to make changes to the regime in passengers' interests and to take enforcement action where there might be repeated failures (in particular as under the commitments rebates can reduce to zero if failures continue for more than six months).

- J274 Because broadly the same service quality regime could apply under both the proposed commitments and licence regulation, the main potential issue associated with the rigidity of licence regulation is likely to be the change mechanism. However, the CAA considered that in the case of a licence it was likely that there was a trade-off between increasing rigidity and greater protection to passengers, with potentially greater protection to passengers provided where there is a degree of rigidity backed up by licence regulation. The CAA considers that a greater degree of rigidity can provide benefits as, in the absence of regulation, service providers with SMP may have a financial incentive to provide lower service quality than would occur in a competitive market.

Impact 5: Investment incentives

- J275 The CAA acknowledges that licence-based regulation can distort investment incentives, with a potential bias of RAB-based regulation towards capital spend and market-based approaches potentially leading to too little investment. However the CAA considers that the Q5 RAB-based framework has not appeared to have resulted in too much investment in the current control period and there was the potential to strengthen investment incentives under market-based regimes by putting in place additional regulatory requirements.
- J276 Given the flexibilities in the commitments over the capital plan any form of licence regulation can provide incremental benefits by ensuring that investment is undertaken in passengers' interests. Licence regulation could also provide benefits from strengthening the consultation requirements for capex, although this could increase costs and rigidity.
- J277 The flexibility of a licensing system could be used to address other concerns with licence regulation such as fixing investment too far in advance and disincentivising investment for new customers. The CAA also acknowledges the potential negative impact of the RAB-based regulation on investment incentives, although as set out in the Consultation measures can be introduced to mitigate or reduce these impacts.

- J278 Overall the CAA considers that licence regulation would provide benefits over the commitments in particular by ensuring that capex is undertaken in passengers' interests.

Impact 6: Operational and financial resilience

- J279 The CAA considers that requirements for operational and financial resilience could be introduced under any form of licence regulation. These measures, together with the back-up of the potential for enforcement action, would provide incremental benefits above commitments alone.

Impact 7: Direct costs

- J280 Licence regulation will undoubtedly have costs. As set out above in the assessment of a LBC Licence the CAA's incremental direct costs of the current RAB-based regulatory regime are around £0.8 million per year. As RAB-based regulation is resource intensive some of the alternative forms of regulation may be cheaper, for example there will not be a requirement to estimate individual building blocks and the expensive consultancy that this entails. However a LRIC approach is likely to be resource intensive as it requires the calculation of forward looking or modern replacement costs. Even a price monitoring regime would require some regulatory involvement from an annual review of costs and performance, with these costs likely to be in excess of £0.2 million per year and could be as much as the current regulatory arrangements (as under the monitoring regime proposed under the LBC Licence). As noted above, a commitments regime is unlikely to be costless, as GAL will still have SMP, in particular from a requirement for continued monitoring in case re-regulation is required. The costs from a commitments regime could be considerable if the regime breaks down.
- J281 As set out in the assessment of a LBC Licence, the CAA considers that GAL's direct costs of the existing RAB-based regime were overstated and could be substantially lower than the £8 million per year estimated by the airport operator. GAL's costs from alternative forms of regulation are likely to be markedly lower, in particular due to the reduced requirements for capex consultation. Licence regulation will also place costs on airlines, particularly around the

costs of any periodic review and capex consultation requirements. In the Consultation the CAA estimated that these costs could be £1 million per year for the current RAB-based approach. These costs would be reduced under alternative forms of regulation. Licence regulation could reduce costs compared to the commitments if it avoids recourse to the courts for breaches of the commitments.

Impact 8: Indirect adverse effects

Regulatory gaming

J282 The CAA also acknowledges that any form of licence regulation can lead to a bid and counter bid approach. Such an approach is also a feature of commercial relationships, for example the negotiations around bilateral contracts in a normal commercial environment. Consequently the CAA does not consider that licence regulation should necessarily result in any greater gaming than normal commercial negotiations.

Crowding out a more commercial approach

J283 The CAA acknowledges that bilateral contracts are less likely under price cap regulation, not least from the risk that a typical 10-year bilateral contract is likely to span more than one regulatory period. Nevertheless licence regulation does not prevent bilateral contracts (and GAL has provided incentives to some new long-haul services under the existing RAB-based regime) and licence regulation can provide benefits over the commitments on their own by ensuring that the terms of the counterfactual to the contract are reasonable, reducing the risk that GAL could abuse its SMP.

Management distraction

J284 The CAA acknowledges that any form of licence regulation is likely to cause some element of management distraction. However as set out above, the CAA does not consider that the current RAB-based regime has caused significant distraction to operational staff.

Conclusion on General Licensing

- J285 As the foregoing analysis demonstrates, the precise nature of the benefits and the adverse effects of a licence regime will depend on the specifics of the licence adopted. There are significant differences in this regard along the spectrum between (for example) a RAB-based licence at one end and a bare monitoring regime at the other.
- J286 Overall the CAA considers that a licensing regime offers the potential for substantial benefits for passengers over the commitments, in terms of enforceability, price, efficiency, investment incentives and other impacts. There will also be adverse effects to some degree. The extent depends on the model of licensing adopted. Any particular model of licence regulation would have to satisfy the CAA's general duties, including that of targeted, necessary and proportionate intervention. The CAA has identified one particular means of licence regulation amongst the range of possibilities, in respect of which it has concluded that the benefits are likely to outweigh the adverse effects, namely the LBC Licence. The CAA has therefore concluded that the benefits of licence regulation in general are likely to outweigh the adverse effects in the circumstances of the present case.

The alternative counterfactual: No Commitments

- J287 The foregoing analysis proceeds on the counterfactual that GAL will maintain in place its commitments ("the Commitments Counterfactual"). This reflects GAL's stated position that it is committed to its proposed commitments framework whatever the outcome of the CAA's market power assessment.
- J288 For completeness, the CAA has briefly considered the alternative counterfactual under which GAL does not maintain those commitments, the "No Commitments Counterfactual".
- J289 As the above analysis makes clear, the commitments clearly offer substantial benefits for users, even if not backed by a licence. On the face of it, users are significantly worse off on the No Commitments Counterfactual than under the Commitments Counterfactual. The

CAA has noted above the limited protection afforded to users by Existing Regulation and competition law.

- J290 Thus, overall, the benefits of regulation (under either the LBC Licence or Licensing Generally scenarios) are likely to be much greater when compared to the No Commitments Counterfactual than under the Commitments Counterfactual.
- J291 The CAA accepts, however, that the direct costs of regulation are likely to be higher on the No Commitments Counterfactual than under the Commitments Counterfactual. This is because the commitments themselves cover a range of matters (including price and service standards) that would, or might otherwise form part of licence regulation.
- J292 As an illustration of the net benefits of a LBC Licence versus the situation in the No Commitments Counterfactual the CAA has considered the impact of the price monitoring regime in the LBC Licence. The CAA has stated that it would consider the introduction of controls if GAL's actual prices are above its fair price benchmark of RPI-1.6 per cent per year. While the CAA cannot be certain of the prices that GAL would charge in a No Commitments situation, it could be thought that these would at least be as high as the prices in the commitments that GAL originally proposed, which were RPI+4 per cent per year. The difference between these two prices is 5.6 per cent per year. At currently forecast passenger numbers, this is equivalent to an average difference in charges of £78 million per year, or 26 per cent of total charge income over five years.⁶⁰ There would also be users' benefits from the service quality regime, efficiency and investment incentives and enhanced operational and financial resilience contained in a LBC Licence over and above the situation under Existing Regulation alone. The CAA does not have precise figures for the incremental cost of a LBC Licence compared to the No Commitments case as much of the cost relates to the commitments themselves. The CAA has therefore considered the costs of a RAB-based approach to provide an indication of scale. Even based on GAL's direct costs of RAB-based regulation of £8 million per year (which the CAA considers is overstated and would

⁶⁰ This does not include any impact of changes in charges on passenger throughput

be lower under a LBC Licence regime due not least to lower requirements on capex consultation) together with the CAA's estimates of CAA and airline costs of a RAB approach of £2 million per year, the benefits of a LBC Licence in the absence of commitments are likely to outweigh the costs.

- J293 The CAA's judgement is that the benefits of licence regulation would be likely to outweigh its adverse effects under either the LBC Licence or Licensing Generally scenario. As already noted, any particular model of licensing would have to satisfy the CAA's general duties, including that of targeted, necessary and proportionate intervention.

Conclusion

- J294 As the foregoing analysis makes clear, the CAA's judgement is that the benefits of licence regulation are likely to outweigh the adverse effects, whether by reference to an LBC Licence or Licensing Generally.
- J295 In summary form, the CAA's reasons are as follows.
- J296 As the market power assessment has been undertaken in parallel to CAA's Q6 review of the form of regulation for GAL after April 2014, the CAA considers that these unique circumstances allow it to assess Test C on the basis of both licence regulation in general as well as on the specific form of licence regulation which it considers to be most appropriate for GAL, in this case GAL's proposed commitments backed by a licence and monitoring framework.
- J297 The CAA has assessed the merits of the LBC Licence and licence regulation against the No Commitments Counterfactual (no licence at all) as well as an alternative counterfactual, based on GAL's commitments ("the Commitments Counterfactual").

Commitments Counterfactual

Benefits of a LBC Licence compared to commitments

- J298 The CAA has taken account of the benefits of existing legislation, in terms of the ACRs, GHRs and competition law. The CAA considers that the legislation provides limited protection against the risk of abuse of SMP in terms of price, efficiency, service quality and investment.
- J299 On the Commitments Counterfactual, the CAA concludes that a LBC Licence will contain the same advantages as the commitments in terms of flexibility, commerciality and increased certainty from the 7-year period. However it will also provide additional benefits over and above the commitments as incorporating the commitments within a statutory framework will address a number of concerns with the commitments.
- J300 The CAA has identified the following benefits of a licence which are presented under subheadings.
- **Price:** GAL's commitments price of RPI+0.0 per cent per year based on the blended average rate resulting from its published rate and rates under concluded bilateral contracts is above the CAA's assessment of a fair price forecast as part of the Q6 review. The CAA considers that in the absence of a licence GAL will be able to increase prices leading to a detriment to users. By backing the commitments with a licence the CAA will be able to monitor and intervene, if GAL does not reduce prices in line with the fair price. In that way, it can ensure that charges that are actually applied are consistent with the fair price and modify them accordingly. In addition, the commitments include a pass through of costs of a second runway which could result in significant costs to users without due regulatory safeguards that the costs are efficient and incurred in users' interests. Under the monitoring regime the CAA will continue to ask GAL to undertake a shadow RAB calculation in case there is a need to re-introduce tighter regulation. Consequently, licence regulation is likely to provide additional benefits in this area by not allowing price increases that would not be in the general interest of passengers or which would be detrimental to competition.

- **Efficiency:** The impact of the commitments on efficiency is likely to be mixed, with benefits from retaining the gains from efficiency improvements for longer (at least seven years, compared to typically five years from licence regulation), but adverse effects from a looser control on prices. However, the CAA considers that a LBC Licence would have incremental benefits as it would encourage lower prices to be charged under the commitments and therefore provide greater incentives for GAL to be efficient. The CAA considers licence regulation would create greater efficiency incentives for the airport operator than competitive pressure, as GAL has SMP (and hence the competitive pressure to improve efficiency would be weak). The additional benefits of a LBC Licence approach include additional incentives from the threat of regulation, possibility to ensure the efficiency of pass through costs and possibility to introduce licence controls if inefficiency is identified.
- **Service quality:** The commitments include much the same service quality regime as used for Q5 although they do not include bonuses paid by airlines. However, the limits placed on the total rebates, the absence of rebates if failures continue for more than six months in a financial year and the offsetting impact of airline service quality failures might reduce GAL's liability for repeated service quality failures, which may act against passengers' interests. Again, the LBC Licence would enable the CAA to oversee GAL's service quality performance and intervene to modify or enforce the licence where appropriate.

- **Investment:** The commitments do not include a commitment to any outputs from the capital plan apart from maintaining the service quality regime and a commitment to a minimum spend of £100 million per year over the term of the commitments. While some investment will be required to meet service quality requirements, other investments would bring wider benefits. Given the position of the SMP of the airport operator there is a risk that some beneficial enhancements for passengers would not be taken forward. The consultation arrangements are also less onerous than those under the Q5 settlement. Licence-backed commitments would provide benefits from allowing the CAA to intervene if capital investment that was in passengers' interests was not being taken forwards.
- More specifically, licence-backed commitments would provide additional benefits in terms of operational and financial resilience.

Enforcement of a licence compared to commitments

- J301 For commitments to be an effective substitute for licence regulation they must be clear and enforceable so that airlines and other stakeholders have confidence that the benefits GAL say would accrue from the commitments would be delivered in practice. Those benefits must also further the interests of passengers and cargo owners as the 'users' protected by the CAA's statutory duties.
- J302 The CAA considers that GAL's current proposal to include commitments in the CoU raises a number of concerns about the substance and enforceability of the provisions. In particular, the CAA is concerned that the CoU (including the commitments) would be enforceable by airlines only. As such, they will not deliver as much benefit to passengers and cargo owners, as their interests might not always align with those of the airlines.
- J303 This would compare to a licence enforceable by the CAA which has a statutory duty to further the interests of passengers and cargo owners. Licence-backed commitments will enable the CAA to have regulatory oversight so that it can enforce the commitments directly in passengers' interests and ensure that the commitments promote competition as appropriate.

- J304 In addition, the CAA is concerned about the potentially slow speed of any response to failures to comply with the commitments and any issues that might arise could allow user detriment to persist for some time unchecked. The process of re-introducing licence regulation may take two to three years. These issues could be avoided under licence regulation, where new licence conditions could be introduced relatively quickly.
- J305 By incorporating the terms of the commitments within the statutory licensing framework, the CAA would have a range of regulatory and enforcement measures, for example by either enforcing the commitments as a condition of the licence itself or modifying and/or introducing new licence conditions as required (subject to the safeguard of appeals). In appropriate cases, the CAA would be entitled to proceed with interim remedies or to impose penalties for a breach. A licence is therefore likely to lead to a quicker, more efficient resolution of issues. Importantly, a breach of the licence-backed commitments could lead to a directly actionable right of damages for any person affected by the breach (including passengers and cargo owners as well as airlines). Accordingly, there are real benefits from the licence framework in terms of enforcement and deterrence that are not provided by the voluntary contractual commitments on their own.

Adverse effects of a licence to users compared to the Commitments Counterfactual

- J306 A licensing approach will entail direct costs of staff and consultancy associated with a regulatory review. GAL estimated its costs of the existing RAB-based regulatory regime are around £8 million per year, mainly incurred in consultation. The CAA considers that these costs are overstated and could be half that estimated by GAL. In addition there would be CAA costs, estimated to be around £1 million per year, and airline costs of up to £1 million per year. These costs of regulation would be significantly reduced under the LBC Licence, where the main incremental costs would be to the CAA from monitoring, and where appropriate enforcing the regime.
- J307 Commitments without a licence are unlikely to be cost-free and the potential cost savings would be significantly reduced and perhaps

eliminated if there is not effective partnership working between GAL and the airlines, and if there were numerous complaints to the CAA under competition law or the ACRs/AGRs. Airline feedback on the commitments has, at best, been mixed.

- J308 Licence regulation also carries potential adverse effects in the form of management distraction, and the creation of perverse incentives, for example potential distortions to capex incentives under a RAB-based framework, or the potential for regulatory gaming. Commitments on their own could avoid management distraction as their enforcement would be linked to commercial negotiations. They could also avoid potential distortions to competition and have the advantage that bilateral contracts are more likely under commitments. However, all of these advantages would still be available under the LBC Licence as GAL would have the same, if not greater incentives to agree bilateral contracts.
- J309 The adverse effects of licence regulation would be minimised under the LBC Licence, as the focus would remain on the airport operator and airline relationship and the main focus of the licence and CAA involvement would be to enforce the commitments or address problems that arose, minimising perverse incentives and regulatory gaming. For these reasons, the CAA considers that licence-backed commitments are more proportionate than the alternative of a full RAB licence and will minimise any costs and potential distortions to competition.

Balancing and proportionality assessment

- J310 Overall, the CAA welcomes GAL's commitments proposal. However, the CAA is not sufficiently convinced that the enforceability of and the substantive terms of the commitments proposal assures benefits to passengers and cargo owners to a sufficient degree. Further, the CAA does not consider that the revised commitments offer sufficient protection against the potential abuse of SMP, in particular through excessive pricing, inefficiency, inferior service quality or investment by reference to the topics most commonly addressed by economic regulation.
- J311 Against this the CAA has considered the potential adverse effects of the LBC Licence in terms of the direct costs, distortions to incentives,

management distraction and crowding out of a more commercial approach etc. The CAA notes that these adverse effects are minimised through licence-backed commitments given the focus of the regime on the airport operator-airline relationship and the focus of the licence is to ensure the regulatory oversight and enforceability of the commitments. Overall, the CAA's judgement is that the benefits of licence-backed commitments are likely to outweigh the adverse effects.

Benefits and adverse effects of licence regulation in general compared to commitments

J312 The benefits of licence regulation compared to commitments are similar to the benefits of the specific form of licence-backed commitments. In particular licence regulation will provide benefits in terms of:

- enforceability from the ability to enforce in passengers' interests, allow important protections in the CA Act such as the right of appeal to the CMA, facilitate timely regulatory intervention and allow a range of regulatory and enforcement measures;
- the ability to set tighter controls on prices than available under the commitments, increase efficiency from the threat of regulatory action and regulatory scrutiny of cost pass throughs in particular second runway costs;
- service quality in particular from the ability to undertake enforcement action for repeated service quality failures;
- investment incentives from ensuring that investment is undertaken in passengers' interests; and
- improved operational and financial resilience.

J313 Against these benefits have to be weighed the adverse effects. These would include the direct costs of licence regulation, which based on GAL's estimates of its own costs could be £10 million, although the CAA considers that GAL's estimates are substantially overstated. In addition the CAA notes that commitments themselves are not costless and cost savings would be reduced if not removed if the regime breaks down. Licence regulation can also encourage

regulatory gaming, although it would not necessarily lead to any more gaming than normal commercial negotiations, and could crowd out a commercial approach, although the CAA notes that is unlikely to happen entirely and the bilateral contracts that are currently under discussion are somewhat linked to the CAA's regulatory proposals. Licence regulation can also cause management distraction, although even under RAB-based regulation this is unlikely to significantly impact on operational staff. Licence regulation can also distort incentives, for example the potential distortions to incentives on capex from RAB-based regulation.

- J314 The CAA considers that the appropriate form of regulation will depend on the circumstances of an individual airport operator and in particular the risks of abuse.
- J315 Overall, at a high level of generality, the CAA considers that a licensing regime offers the potential for substantial benefits for passengers over the commitments, in terms of enforceability, price, efficiency, investment incentives and other impacts. There will also be adverse effects to some degree. The extent depends on the model of licensing adopted. Any particular model of licence regulation would have to satisfy the CAA's general duties, including that of targeted, necessary and proportionate intervention. The CAA has identified one particular means of license regulation amongst the range of possibilities, in respect of which it has concluded that the benefits are likely to outweigh the adverse effects, namely the LBC Licence. The CAA has therefore concluded that the benefits of licence regulation in general are likely to outweigh the adverse effects in the circumstances of the present case.

The alternative counterfactual: No Commitments

- J316 For completeness, the CAA has briefly considered the alternative counterfactual under which GAL does not maintain those commitments, the "No Commitments Counterfactual".
- J317 The commitments clearly offer substantial benefits for users, even if not backed by a licence. On the face of it, users are significantly worse off on the No Commitments Counterfactual than under the Commitments Counterfactual. The CAA has noted above the limited

protection afforded to users by Existing Regulation and competition law.

- J318 Thus, overall, the benefits of regulation (under either the LBC Licence or Licensing Generally scenarios) are likely to be much greater when compared to the No Commitments Counterfactual than under the Commitments Counterfactual.
- J319 The CAA accepts, however, that the direct costs of regulation are likely to be higher on the No Commitments Counterfactual than under the Commitments Counterfactual. This is because the commitments themselves cover a range of matters (including price and service standards) that would, or might otherwise form part of licence regulation, although these costs should be lower than the costs of the existing regulatory regime, not least due to the lower capex consultation requirements.
- J320 The CAA's judgement is that, compared to the situation under Existing Regulation with no commitments in place, the benefits of licence regulation would be likely to outweigh its adverse effects under either the LBC Licence or Licensing Generally scenario.

Conclusion

- J321 Overall, having regard to all the costs and benefits above, whether on a quantitative or qualitative basis, the CAA considers that Test C is met in relation to GAL as the airport operator and that, from the perspective of passengers, the benefits of regulating GAL by means of a licence are likely to outweigh the adverse effects.