Price Monitoring as an Alternative to RAB-based Price Cap Regulation

A report prepared for the CAA

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1. Introduction

This report describes the different ways in which the CAA could build a regulatory regime around a system of price monitoring.

The terms of reference that we were given by the CAA envisages that it might be possible to use the ideas that we put forward in this paper in effecting a move away from RAB-based price regulation at either Gatwick or Stansted airports. We do not advise in this report on the specific circumstances of these airports nor do we recommend whether there should be a change in the airports' price control arrangements. The purpose of our work is simply to give the CAA a set of reasonably well-developed 'candidate regulatory options' which it can, if it wishes, take forward for further consideration as part of the Q6 process.

The paper is structured into five main parts as follows:

- section 2 explains the purpose of price monitoring as a regulatory tool and outlines a set of three candidate price monitoring approaches;
- sections 3 to 5 describe the key features of these candidate regulatory options; and
- section 6 gives our evaluation of the strengths and weaknesses of each approach.

2. Purpose and Approach

2.1 Objectives

A price monitoring regime is a form of regulation that focuses on detecting abuses of market power by a regulated company. It is directed first and foremost at identifying cases of excessive prices, but can also extend into other forms of consumer detriment. In airport context, this might include:

- inadequate service quality;
- under- or over-investment;
- cost inefficiency; and
- insufficient customer information, customer consultation or attention to customers' preferences.

Importantly, the purpose of price monitoring is not limited to the ex post identification, remedy and penalisation of such abuse. To be an effective regulatory tool, and, in the context of this paper, an effective replacement for RAB-based regulation, price monitoring must also act as an ex ante deterrent against abuse. Specifically, the expectation must be that foreknowledge on the part of an airport that the CAA will scrutinise its prices and performance should incentivise the airport to deliver efficient outcomes to users and so avoid situations in which its prices and performance are questioned.

Any criteria that one uses to judge a price monitoring should therefore include at least the following two component parts:

- first, there should be measures in place to protect users from harm in the event that an airport with substantial market power abuses that market power; and
- second, the regulatory regime should encourage an airport to exercise self-discipline and to self-regulate, so bringing acceptable prices and performance to users without the application of those measures or other explicit regulatory intervention.

It is only if these conditions are satisfied that the CAA should move on to consider the benefits that price monitoring brings as regards greater flexibility, reduced regulatory specification and reduction of the regulatory burden.

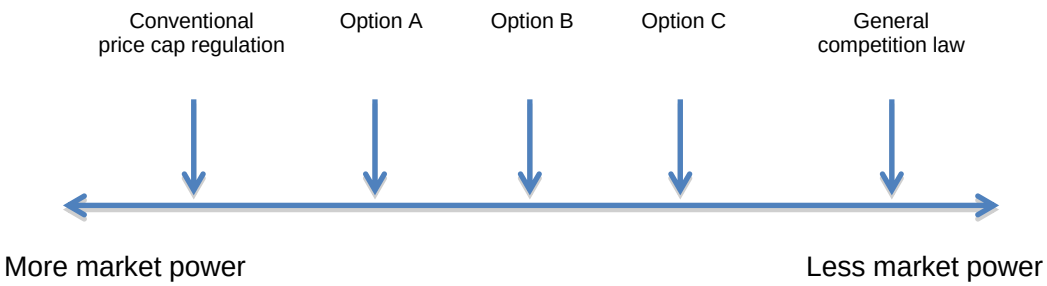
2.2 Candidate regulatory options

The CAA asked us to investigate the range of approaches that could meet these success criteria. A broad definition of three candidate options was agreed at the outset of this study. They comprise:

- a regulatory regime in which the level of an airport's charges is monitored against an external price benchmark and automatically capped in the event that the airport increases prices beyond a pre-defined monitoring threshold (option A);
- a more flexible process involving ex post annual review of prices and outcomes at an airport, without any sort of prescriptive ex ante price cap (option B); and
- a very light-touch approach, in which the review of prices and outcomes is less frequent and more high level than in option B (option C).

The intention was that the candidate options would be applied to airports that have been found to possess substantial market power, but where competitive pressures can be increasingly relied upon to constrain prices. It was also envisaged that the suitability of these candidate options might vary according to the market power that an airport has, as set out in Figure 2.1.

Figure 2.1



For each option we describe in the sections that follow:

- the rationale for the chosen approach;
- the primary obligation that an airport would be imposed on an airport by its licence;
- secondary obligations which would support the primary obligation;
- the CAA's role as economic regulator; and
- the scope for the CAA to re-regulate if it finds that the new regulatory arrangements are not working effectively.

An initial overall summary of the options is given in Figure 2.2 to aid readers ahead of the discussion that follows.

Figure 2.2

	Option A	**Option B**	**Option C**
Principal licence obligation	The annual rate of change in average revenue yield should not exceed the annual rate of change in average revenue yield among a pre-determined selection of comparator airports	No price cap The airport shall provide such information as the CAA requires to produce an annual report on prices, profitability, efficiency, investment and service quality	No price cap The airport shall publish, obtain CAA approval for, and adhere to a code of conduct pertaining to negotiation with airlines
Secondary licence obligations	Accounting requirements Service quality obligations Correction factor	Accounting requirements	
CAA role	Define benchmark Annual audit of compliance End of term review	Annual report on prices, profitability, efficiency, investment, service, etc. Full end of term review	Mid-term review
Review and re-regulation	Possible return to CAA-determined price cap after a five-year period Trigger: breach of cap in three successive years or significant breach of cap in one year	Possible return to price cap regulation Trigger: evidence in CAA report of excessive prices or deterioration in efficiency/ service quality Interim measure: price freeze during transition back to price cap regulation	No explicit threat in short term Arrangements to be reviewed if the CAA finds repeated or widespread airline concern about operation of regime or change in market power

Note: in all three options an airport would also be required to comply with the Competition Act prohibitions on abuse of dominance and anti-competitive and to adhere to Airport Charges Directive obligations relating to airline consultation and notification.

3. Option A

Primary licence obligation	The annual rate of change in average revenue yield should not exceed the annual rate of change in average revenue yield among a pre-determined selection of comparator airports
Secondary licence obligations	Service quality obligations Accounting requirements Correction factor
CAA's role	Define benchmark Annual audit of compliance End of term review
Threat of re-regulation	Possible return to CAA-determined price cap after a five-year period Trigger: breach of cap in three successive years or significant breach of cap in one year

3.1 Rationale

The first of our candidate options provides for price monitoring, and ultimately price capping, with reference to a pre-defined price benchmark. As such, it is a regulatory approach which provides for more flexibility than a conventional 'building block' price cap, with its explicit opex and capex allowances and pre-determined price path, but which also contains in-built protection for users against excessive prices.

As compared to options B and C, the distinguishing feature of this model is that the protection against excessive prices kicks in automatically in the event that monitoring reveals changes to charges which depart from the specified benchmark. We include an option of this type in order to draw out the advantages and a disadvantages of having a clear dividing line upfront between acceptable and unacceptable price outcomes. This contrasts to option B, which provides for a less constrained, more flexible ex post assessment of prices and performance.

3.2 Primary licence obligation

The key challenge in fleshing out this candidate regulatory option is to identify a relevant price benchmark. Possible price benchmarks include:

- consumer price indices (e.g. RPI and CPI);
- published indices which track the costs of the types of labour, materials and equipment that an airport uses in the course of its operations; and
- the prices charged by similar airports.

We give a detailed assessment of the different benchmarks in annex 1 to this paper. Our conclusion is that there is no basis for expecting an airport's prices to track the indices in the first or the second of the above benchmarks. This leaves comparator prices as the best available anchor for option A.

This benchmark and an associated monitoring threshold would need in this option to be specified in a licence condition. We take from the LeighFisher's parallel report on benchmark design, which we summarise and review in annex 2, that the primary licence obligation is

best expressed with reference to average aeronautical revenue yield rather than published charges. This means that the licence obligation would be a requirement to:

- set prices so that average aeronautical yield is no higher than the average, median or upper quartile average revenue yield exhibited by the comparator group; or
- set prices so that annual increases in average aeronautical revenue yield is no higher than the average rate of change in the comparator population's average revenue yield in the same year.

We think that the second of these options probably makes more sense in a monitoring/benchmarking exercise where the comparator set is relatively small and when LeighFisher's work has Gatwick and Stansted starting with the third highest average revenue yield in the comparator groups. However, the analysis that follows does not preclude the possibility that the CAA might choose during the Q6 process to take a different summary measure from the benchmarking. This would not cause us to make materially different conclusions on this option.

We would, though, expect the CAA to define its rules before the start of Q6. This would mean specifying:

- the airports in the comparator basket;
- the financial and other information that is to be obtained from each airport;
- the method of calculating average aeronautical yield at each airport;
- the single price benchmark – e.g. average annual change in average revenue yield – that is to act as a monitoring threshold for either Gatwick's or Stansted's pricing; and
- the rules for dealing in future with non-availability of data from any one of the comparator airports.

We recommend very strongly that these matters are dealt with upfront so as to avoid a situation in which an airport has a new obligation to price below a monitoring threshold but is in dispute with airlines and the CAA about what that benchmark is. It would especially concern us if there were scope for the airport, airlines or the regulator to behave opportunistically and argue on a year-by-year basis for the inclusion or exclusion of comparator airports on the grounds that they like or dislike the out-turn data.

3.3 Secondary licence obligations

The primary obligation to price below a monitoring benchmark would need to be supported by a number of secondary obligations.

- Accounting requirements – option A relies upon all airports reporting aeronautical revenues and passenger numbers in a comparable and consistent way. Although the CAA cannot control changes in accounting policies at comparator airports, it can impose accounting requirements on the airports that it regulates so as to prevent revisions in the definition and calculation of average aeronautical yield. We would expect these requirements to take the form of accounting guidelines which define aeronautical and non-aeronautical revenues.

- Service quality – as in the Q5 regulatory regime, it would not be in users' interests for an airport to sacrifice service quality. We envisage that there would be some supporting service quality obligations in this option, either in the form of enforceable licence obligations or some sort of continuation of the Q5 financial incentives.

- Correction factor – one of the key challenges that this option presents is that an airport would not know the level of the monitoring threshold in real time (because the data to calculate average revenue yield at some comparator airports does not become

available until after the airports' annual financial statements are made public). This is not a major issue in conceptual terms because the expectation is that an airport should be reacting to cost pressures and changes in market circumstances in a similar way to comparator airports. However, it does raise a practical question about how to ensure that users receive the full protection that this option is intended to deliver. Our suggestion is that this income should be rebated back to airlines once it becomes apparent that the monitoring threshold has been exceeded, which we note may be up to 18 months after the end of the relevant financial year.

There may also be merit in transposing existing public interest conditions – e.g. in relation to consultation – if the associated obligations are not already captured elsewhere in the new regulatory framework for the sector. The presumption in this option is that an airport very clearly possesses substantial market power and the CAA should continue to guard against adverse outcomes for users which go beyond high prices.

3.4 The CAA's role

Option A requires the highest level of upfront set-up cost.

Before the regime came into effect, the CAA would need to define the benchmark, the monitoring threshold and the supporting accounting and other obligations as set out above.

During the control period, the CAA role would be limited to monitoring prices against the benchmark index. We think that this process would work best if the regulated airport(s) were asked to submit an annual report setting out a calculation of the benchmark and the airport's pricing relative to the monitoring threshold. The CAA would review the report and determine whether the airport has complied with its licence obligation. In practical terms, this could require the CAA to opine on the airport's method of dealing with comparator data issues that can be expected to occur from time to time.

Our expectation is that the CAA would let this sort of regulatory regime run for a pre-determined period of time – say, five years. At or towards the end of the control period, the CAA would undertake a review of the operation of the regime and the airport's market power to see whether the option should be continued into subsequent control periods or be replaced by an alternative form of regulation.

3.5 Re-regulation

This option A contains an in-built, in-period protection against excessive prices.

Circumstances that would cause a re-evaluation after five years include a manifest failure by an airport to price at a reasonable level. Because of the delay that there is in this option in knowing the value of the monitoring threshold, failure within the scheduled five years could be defined as a significant (e.g. 5%) breach of the monitoring threshold in one year or a repeated breach of the monitoring threshold over three successive years. Although the proposed correction factor would see money returned to users, such breaches would call into question the value of this option as a real-time protection against excessive prices and so merit at least a reassessment of the purpose and practicalities of the underlying regulatory model.

We must also anticipate in this option a situation in which the benchmark turns out not to be a good proxy for the efficient price path for the particular airport. We would want the CAA to review the effects of the regime on all stakeholders in the first five years of its operation before deciding on its approach for the next five years.

4. Option B

Primary licence obligation	No price cap The airport shall provide such information as the CAA requires to produce an annual report on prices, profitability, efficiency, investment and service quality
Secondary licence obligations	Accounting requirements
CAA's role	Annual report on prices, profitability, efficiency, investment, service, etc. Full end of term review
Threat of re-regulation	Possible return to price cap regulation Trigger: evidence in CAA report of excessive prices or deterioration in efficiency/service quality Interim measure: price freeze during transition back to price cap regulation

4.1 Rationale

The second candidate regulatory option draws heavily on the Australian approach to airport regulation. The guiding philosophy behind this approach is that it is not always necessary to set an ex ante price cap or to regulate airport conduct via licence conditions, even if an airport holds substantial market power. The 'regulatory contract' can instead change fundamentally from one in which an airport has to comply with specific regulatory constraints to a regime in which a combination of competition and the 'threat' of regulatory intervention constrain the airport's market power.

This is not a mindset that has typically been adopted by UK regulators, although it has been part of Ofcom's recent decision to remove most of the regulatory constraints that have until now been placed on Royal Mail (this case study is discussed further in annex 3 to this paper). It relies on a belief that a company is capable of self-regulating if formal economic regulation is withdrawn. In particular, the disciplines on behaviours and outcomes in this form of regulation come from the reputational and financial consequences that a company perceives it will suffer if it is found to have abused its market power and is then re-regulated.

It follows that the key challenges in scoping out this option B are to ensure that the CAA is in possession of all relevant information about prices and performance and can re-regulate swiftly if the information shows that an airport is abusing its market power. It should also be that the management find the prospect of re-regulation unattractive and that shareholders should find re-regulation costly.

4.2 Primary licence obligation

The primary written obligation that an airport would have in option B can be limited – quite deliberately – to a requirement to provide such information as the CAA specifies for the purposes of compiling an annual report on prices. We envisage that the CAA's specifications would be set out upfront, prior to a switch to Option B, but that the CAA would be able to alter the specification on an annual basis as circumstances dictate. In practical terms, this is likely to require the CAA giving a formal notice to the airport under the terms of its licence.

For the avoidance of doubt, we acknowledge that this licence obligation is not a formal discipline on market power in and of itself. The influence on airport behaviour and outcomes comes in this option comes not directly from the enforceable licence condition but from the processes that flow from it, as set out in sections 4.4 and 4.5. In essence, it is more

important in this option B that the CAA is able signal to an airport that abuse of market power will result in unpalatable consequences than it is to define either abuse or consequences in legal terms within the licence.

4.3 Secondary licence obligations

The secondary obligations in option B would be limited to accounting requirements. Specifically, we think it would be helpful to all parties if the CAA is able to produce accounting guidelines upfront that pre-empt future debates about maters such as asset valuations, aeronautical/non-aeronautical splits and cost allocations. This should hep to ensure that any debate at the time of an annual review is about the interpretation of performance data rather than the veracity or otherwise of the reported statistics.

We have thought very carefully about whether option B should include obligations in relation to service quality, consultation and other airport conduct. We have decided, on balance, that it would be better for the CAA to eliminate all forms of prescriptive conduct regulation in this option. Our fear is that an expansive list of supporting regulatory obligations might cause the airport to see its job in terms of complying line-by-line with CAA requirements when, in fact, it should be self-regulating and adjusting its whole behaviours to more closely resemble the behaviours of an airport that operates in a fully competitive market. There is also a risk that airlines will continue to see the CAA as a hands-on regulator, when it should actually be that the CAA withdraws from day-to-day intervention and allows normal commercial relationships to develop properly.

This does not mean that things like service quality and consultation are unimportant in option B. Rather, it means that such things are best bundled up within an overall expectation that an airport will self-regulate. In section 4.5 we suggest ways in which the CAA can signal that a failure to, say, agree to service obligations or to consult properly will be covered in the annual monitoring report and could trigger re-regulation.

4.4 The CAA's role

Option B has quite small set-up costs but requires a reasonably significant amount of ongoing resource from the CAA.

The main focus of the CAA's efforts would be the compilation and publication of an annual report on prices and outcomes. As noted above, the CAA would specify its information requirements annually. We envisage that the format of the annual report would then be very similar to the ACCC reports in Australia, albeit covering a smaller number of airports. There would be data and commentary on overall market developments, plus factual information about charges, financial performance and profitability, volumes, service quality and customer satisfaction, cost efficiency and investment – i.e. the areas of possible harm that we identified originally in section 2.

A suite of possible monitoring indicators is set out in Box 4.1.

Box 4.1

<u>Prices</u>

Average aeronautical yield
Level of most commonly levied individual aeronautical charges
Comparisons of prices/price changes to comparator airports

Profitability

The percentage rate of return on total airport assets
The percentage rate of return on an airport's aeronautical assets
The percentage rate return on shareholders' equity investments

Volumes, service quality and customer satisfaction

Passenger numbers and cargo tonnage
The range of service metrics that airports currently measure and report on as part of the Q5 service quality rebate scheme
Overall measures of passenger and airline satisfaction

Investment

Total out-turn investment
Total out-turn aeronautical investment
Delivery of investment against business plan
Planned level of investments over, say, the next five years

Operating Costs

Total airport operating costs
Individual aeronautical cost items – e.g. security costs
Productivity metrics, such as operating costs per passenger

Customer consultation

Number of consultations
Customer satisfaction with consultation process

The CAA would use this information as part of an assessment of whether the regime was operating in customers' interests. This would not be as prescriptive or as rules-driven as was the case in option A. For example, if airport charges had increased and seemed high relative to the benchmark and/or if rates of return had moved above the cost of capital and/or if there was an apparent deterioration in cost efficiency, the CAA would wish to understand the reasons for this and would investigate whether the airport's conduct contributed to either unjustifiably high prices or poor service.

As with the other options the CAA will wish to review the operation of the new framework and the market power of the airlines after a reasonable period of time elapses. We suggest that the CAA should programme in a formal review after 4 years to allow time for a possible reversion to prescriptive price cap or other regulatory approach at the start of what would otherwise be Q7.

4.5 Re-regulation

The threat of regulatory re-intervention and the use of this threat as a constraint on the airports' incentives to exploit their market power is a central feature of option B. We think that the CAA should want to retain a degree of discretion as to the outcomes that are likely to trigger re-regulation on the grounds that explicit thresholds could simply cause the airport to target outcomes that come in just below pre-announced limits. This is consistent with the

ACCC's framework in Australia, which consciously contains no fixed dividing lines between acceptable and unacceptable outcomes.[1]

However, we also think that it would help to condition expectations across the market if the CAA is able to set out qualitative criteria to explain the circumstances that might cause the CAA to intervene. Possible tests are set out below. The CAA might state that evidence that a combination of these criteria have been met and, in particular, evidence of sustained or long-term behaviour of the type stated would be likely to increase the case for reintroduction of regulatory controls:

- pricing – price increases in excess of a comparison with a benchmark set of airports or some other measure of efficient prices;
- profitability – a sustained excessive level of profits (taking account of the risks faced);
- cost efficiency – increases in real unit costs either in absolute terms or compared to other benchmark companies;
- discrimination or other anti-competitive activity – evidence of undue price or non-price discrimination between airlines or other unfair or anti-competitive practices;
- service quality – refusal to sign up to service obligations or trend deterioration in service quality metrics;
- the absence of normal commercial negotiations and relationships with customers;
- the absence of good explanations from an airport as to why its costs, prices, profitability, behaviour etc. show the trends that they do; and
- complaints from airlines and final customers about the operation of the regime and the behaviour of the airports.

In practical terms, we would expect the CAA to state clearly in its annual reports whether it has identified evidence that there might have been an abuse of market power. If it wishes to go as far as to propose that an airport should be re-regulated, it might invite the airport and other interested parties to respond formally to such a proposal before it begins developing the necessary licence modifications. (In Australia, the burden falls on the airport to 'show cause' why it should not be re-regulated.)

In order for the prospect of re-intervention to impose the maximum possible discipline on an airport, it would need to be the case that the airport will find itself worse off financially in the event that the CAA finds self-regulation has failed. A concern in this regard is that it may take a number of months for the CAA to give new/replacement obligations legal effect. We note, for example, that the CAA has to follow a defined process before it can modify an airport's licence and that there is a right of appeal to the Competition Commission for both airports and airlines. The airport also has the right to ask the CAA to commence a new market power assessment. All in all, it could conceivably take 18 months from a decision by the CAA to re-regulate until the legal implementation of new obligations is complete.

There may therefore be merit in the CAA programming a short-term default price cap into an airport's licence. This default price cap would automatically switch on in the event that the CAA finds that self-regulation isn't working and there is a need to re-regulate.

[1] The Productivity Commission explained this in its 2002 report as follows: "The potential for inefficiencies may be alleviated to some extent by defining the behavior on the part of the regulated firm that would trigger stricter forms of price regulation (or, indeed, 'good' behavior that would not trigger stricter regulation). Nonetheless, clearly defining such behavior may be difficult — high prices may be a signal that new investment is required rather than an indication that monopoly prices are being charged; high profits may reflect entrepreneurial skills rather than market power, and increases in prices may simply reflect changes in costs or that prices previously were too low. In a capacity-constrained airport, higher prices may be a means to allocate the available capacity efficiently. This suggests that a broad set of principles is likely to be preferable for guiding efficient behaviour to specific criteria that if applied in isolation may not be consistent with efficient outcomes. Specific criteria for triggering regulatory intervention could also encourage strategic behaviour to this end."

One possibility is that an airport should be required to set prices so as to maintain average aeronautical revenue yield at or below average aeronautical revenue in the preceding 12 months. There could conceivably be an opportunity to true-up against this baseline at the point when the CAA switches the airport back to a formal price cap or other regulatory approach.

5. Option C

Primary licence obligation	No price cap The airport shall publish, obtain CAA approval for, and adhere to a code of conduct pertaining to negotiation with airlines
Secondary licence obligations	
CAA's role	Mid-term review
Threat of re-regulation	No explicit threat in short term Arrangements to be reviewed if the CAA finds repeated or widespread airline concern about operation of regime or change in market power

5.1 Rationale

The third and final candidate option is meant to be the lightest touch of the three approaches. The question that we have asked here is: what might permit the CAA to back away from the intense scrutiny of option B and monitor outcomes at an airport at a higher level and/or less frequently? Our advice to the CAA is that two conditions would need to be satisfied:

- first, an airport would need to only just cross the substantial market power test and face meaningful competitive constraints across a significant proportion of its revenue base; and
- second, the CAA would need to be convinced that the airport is committed to working with its customers in a normal commercial manner and to reaching agreements with them without regulatory intervention.

On this second point, we think that it is instructive to look at recent developments in Australian airport regulation, where the Productivity Commission has highlighted how regulatory remedies are not necessary if adequate commercial remedies have been put in place to deal with disputes between airports and airlines about prices and associated matters. Our option C is therefore focused as much around the mechanisms which could give the CAA confidence about an airport's behaviours as about price monitoring per se.

Our advice to the CAA is that the best way of structuring this regulatory model is to provide for the airport to enter into a voluntary 'code of conduct' before the start of Q6. If the CAA is convinced by the undertakings within this code of conduct, it can then back away from day-to-day oversight of the airport. If it is not content with the undertakings, there would be no move to option C.

In this context, we think that the proposed code of conduct would ideally cover:

- an airport's overall intentions – e.g. to negotiate in good faith, to avoid undue discrimination between like users;

- specific and meaningful commitments to cost transparency, information provision and timetables for airport-airline negotiations;
- provision for arbitration or other dispute resolution processes; and
- willingness to submit to enforcement by airlines of its undertakings, possibly via an independent adjudicator or similar function.

We would emphasise that this option envisages more than just discharging the obligations that airports have already under the Airport Charges Directive (ACD), noting, in particular, that it is possible for an airport to satisfy the letter of the ACD obligations without the behaviours that one would expect to observe in a fully competitive, commercial marketplace. The code of conduct that we are proposing in this option goes well beyond the ACD obligations and requires an airport to commit to processes which results in mutual agreement about charges and associated matters and which does not see charges imposed on airlines unwillingly.

5.2 Primary licence obligation

The formal licence obligation in option C would require:

- an airport to develop and enter into a voluntary 'code of conduct' before the start of Q6;
- the CAA to approve this code.

The expectation would be that the airport would develop its code of conduct in discussion with airlines and reach agreements with them about the airport's obligations and associated enforcement mechanisms. The CAA would then perform a final check of the code in order to satisfy itself that the airport's undertakings are sufficient to ensure that matters that have previously been resolved through regulatory processes will in future be resolved through commercial mechanisms.

5.3 Secondary licence obligations

There are deliberately no further obligations on an airport in Option C, for the reasons set out in section 5.4 and 5.5.

5.4 The CAA's role

Option C requires the lowest level of involvement from the CAA. We provide for the CAA to oversee the set up of an airport's code conduct but then deliberately remove the CAA from the enforcement of the airport's undertakings and any day-to-day disputes that might emerge between the airport and its customers.

The CAA's would continue to keep an eye on outcomes at the airports but at a much higher level than for the other options. This might mean, for example, that the CAA focuses on measures of airline and passenger satisfaction rather than detailed analysis of prices, profitability, etc.. It would also only intervene in the operation of the regime if there were likely to be a major customer detriment – for example, if there was a complaint about repeated breaches of the code of conduct or an abuse of market power by an airport that was sufficient for it to consider action under the Competition Act.

Because this is the most novel of the approaches and represents the biggest departure from the existing price cap regime, we suggest that the CAA should carry out a review of the new regulatory arrangements after a comparatively short period of time has elapsed – say 3 years.

At or towards the end of what would otherwise have been Q6, the CAA would undertake a full review of the operation of the regime and the airports' market power to see whether it should be continued into subsequent control periods or replaced by an alternative form of regulation or, conceivably, full regulatory withdrawal.

5.5 Re-regulation

We do not provide for a specific prospect of re-regulation in option C. However, the CAA would need to ensure that it is ready to deal with complaints by airlines (or other stakeholders) about a potential abuse of market power by an airport.

We would consider option C to be a failure if the CAA were overwhelmed by the number of complaints or if it were to launch lengthy investigations into matters that are better dealt with by other routes. It would therefore be important to set criteria for airlines or others to bring complaints, with the CAA retaining discretion over whether to take them forward. A potential model for the CAA is Ofcom's enforcement guidelines for deciding whether to open an investigation.[2] Ofcom considers a range of criteria in an initial inquiry phase before deciding whether or not to open a full investigation. Ofcom's guidelines consider:

- the resources required to conduct an investigation, given the need to do justice to the interests of all parties likely to be affected by an investigation;
- the risk to the interests of citizens or consumers as a result of the alleged contravention or infringement (and whether that risk is immediate or not and whether it is direct or indirect);
- whether the issue that has been identified directly relates to Ofcom's broader strategic goals or priorities (including those within Ofcom's Annual Plan);
- whether the conduct is ongoing;
- whether the allegation concerns conduct that is, or that appears to be, a repeated, intentional or particularly flagrant contravention or infringement;
- whether there is a point of public policy of wider application with respect to which an investigation would help to clarify Ofcom's approach for stakeholders;
- whether the company under investigation has a history of similar contraventions or infringements, or a demonstrated record of poor compliance; and
- whether there are other alternative proceedings (for example, planned market reviews) that are likely to achieve the same ends, or deal with the same issues, as the planned investigation. This could include, for example, whether other agencies may be better placed to investigate the complaint.

The use of a filter with a high hurdle modelled on Ofcom's guidelines which also require the complainant to gather as much evidence and information as possible before bringing their complaint would seek to maintain a balance between promoting complaints that raise real concerns about the operation of the regime or the behaviour of the airports and keeping a manageable cap on the overall resources and role of the regulator.

[2] Ofcom Enforcement Guidelines http://stakeholders.ofcom.org.uk/binaries/consultations/draft-enforcement-guidelines/annexes/Enforcement_guidelines.pdf

6. Evaluation

Having set up our candidate regulatory options, we now review their strengths and weaknesses. We start by establishing the evaluation criteria.

6.1 Criteria

The four tests that we think a new regulatory regime needs to satisfy are as follows.

Credibility

There is no point in the CAA going to the trouble of setting new regulatory rules if the affected airports and/or the airlines do not believe that the new rules are credible. The CAA must be able to state convincingly that any new regime it puts in place will stay in place. It must also have confidence that airports and airlines will act within the spirit as well as the letter of the framework.

Promotion of competition and normal commercial behaviours

Part of the rationale for a move away from RAB-based regulation would be a fear that conventional price caps will distort competition between airports, distort investment decisions and get in the way of normal commercial relationships between airports and airlines. It follows that the candidate regulatory options should not produce similar undesirable outcomes.

Protection of users

We began this paper by explaining that price monitoring should protect users from abusive behaviour by an airport that has substantial market power, by remedying abuses when they occur but also, and more importantly, by incentivising airports to self-discipline and self-regulate.

Financeability

The CAA will soon have a duty to secure that airports are able to finance their activities. We interpret this to mean that our candidate options should give the airports a reasonable prospect of earning a fair rate of return on investment, having regard to other competitive constraints on prices and the risks that they face.

6.2 Assessment

The performance of each candidate option against these criteria is assessed below.

Credibility

The first of our criteria has been at the front of our minds since the start of the study and, as a consequence, has influenced the shape of our candidate options in a number of ways. We have been concerned to ensure that all stakeholders see the ‘rules of the game’ as fixed and so focus on working within the new rules rather than put their efforts into continued lobbying of the CAA for a switch to whatever happens to be their preferred form of regulation. Such behaviour could, if not given short shrift by the CAA, cause the regulatory regime at an airport to collapse into total uncertainty and as such is to be avoided at all costs.

Specific measures that have come out of these concerns include:

- the announcement of pre-determined control periods and review points;

- the minimisation of secondary regulatory obligations and, by implication, the potential for in-period substitution of airport-airline dialogue with regulation;
- the design of option C as a set of obligations towards users rather than to the CAA; and
- the idea that the CAA should signal to users the circumstances in which it would usually expect to proceed and not proceed with competition law investigations and other regulatory measures.

We have also deliberately sought to be imprecise about what the alternative would be if there were a switch away from any option so as to rule out any possibility than an airport or their airline customers might start arbitrage across the actual regulatory rules and a 'shadow' regulatory regime. This is a particularly pertinent issue at Stansted, where there could be no guarantee that the CAA would fall back to a price cap built around the current RAB and where the CAA might need to consider price control options afresh.

We recognise that a regulator cannot fetter its discretion as to how it will respond to specific requests that stakeholders will make of it in the future. However, we consider that a combination of the above measures along with clear public statements of belief from the CAA in its preferred regulatory regime will go along way to erasing any doubts that airports and airlines will have about the CAA's commitment to its new rules.

Accordingly, we do not think that there is any reason on paper to choose between the three options when it comes to the first of the criteria. The CAA may, however, wish to return to the issue of credibility when it sees how individual stakeholders respond to any proposals that it puts to them.

Promotion of competition and normal commercial behaviours

All three candidate regulatory options have been designed with the intention that the regulatory constraints will supplement the competitive and market constraints on an airport and that an airport with substantial market power, on seeing these constraints, will choose not to abuse that market power. There can obviously be no cast iron guarantee that this will be the case. However, we are optimistic that there is a high likelihood of success. This is because:

- the reputational consequences to an airport of being found to have abused substantial market power are unattractive, especially if the airport has previously argued that it does not have substantial market power and/or has lobbied for a lighter touch form of regulation; and
- the financial consequences of re-regulation should also be unfavourable, especially under our proposal that there should a default cap (which could conceivably be different from our proposed nominal price freeze) during the transition back to heavier touch regulation.

The main concerns that we have under this criterion relate to option A. Because this option, in effect, contains a prescriptive price cap, there is a danger that an airport will become preoccupied with the level of its cap and pay less attention than it should to the importance of normal commercial decision-making. For the avoidance of doubt, it was not our intention that an airport would set out to price to a cap, but rather that a monitoring threshold would offer an ex post check on the airport's pricing behaviour and some degree of backstop protection for users.

The concerns that we have about option A are compounded by one specific feature of the LeighFisher benchmarking: the inclusion within the comparator set of airports that are subject to regulator-set price caps or which price on a cost plus basis. If the CAA's perception is that RAB-based price regulation in the UK has led to counter-intuitive

outcomes, it is perhaps a little odd to replace RAB-based price caps with benchmarking to outcomes in similar regimes overseas.

(As an example, one of the concerns that the CAA has previously expressed in relation to RAB-based regulation is the way in which new investment, once included in the RAB, tends to increase prices, whereas in competitive markets prices tend to fall when new capacity comes on stream. Benchmarking to prices charged by comparator airports that operate in a RAB-based price cap regime or under cost recovery rules might unwittingly preserve existing links between prices and the investment cycle rather than reverse them. Similarly, airlines have highlighted that prices usually go down when a market experiences an unfavourable external demand shock, whereas prices at regulated airports in the UK go up if there has been volume under-performance in the preceding control period. The concern here would be benchmarking to certain comparator airports could preserve pro-cyclicality rather than break it.)

For the above reasons, we think that option A scores less well against our second criterion than either option B or option C.

Protection of users

We also have concerns about the fullness of protection that option A offers users. A limitation of any benchmarking work is that there can be situations in which a comparator's data moves in an extreme, atypical or irrelevant way from the perspective of the entity that is subject to the benchmarking. In this instance, there is the potential for individual comparator airports' prices to change unexpectedly as a consequence of:

- country- or airport-specific changes in investment levels and capacity constraints;
- country-specific changes in passenger demand;
- the sorts of distorting price cap outcomes that we highlighted in the preceding discussion;
- significant catch-up of historical inefficiencies;
- conscious step-changes in pricing policies imposed by a regulator or a government owner; or
- one-off episodes of atypical inflation or deflation.

There is also scope for changes in the reporting of data to move an airport's average revenue up or down even without any incidence of the above sorts of events.

The problems that these things would ideally be minimised by using a basket of comparator airports. However, due to the relatively small size of the LeighFisher comparator baskets for each airport, even if only one or two airports experienced an atypical change in costs, the average annual change in average revenue yield could still be significant.

This means that there are doubts about option A's ability to remedy abuses of market power. Specifically, users are exposed to the risk that the monitoring threshold/price cap might increase to an unexpectedly and unjustifiably high level. Insofar as option A was designed primarily for airports that more clearly meet the CAA's substantial market power test, this should be a worry for all parties.

The backstop protection afforded to users in options B and C, by contrast, is not so formulaic and so is not so exposed to 'data shocks'. Users must instead trust that the CAA will use properly the discretion that is afforded to it under these options. Importantly, this means more than the CAA intervening promptly and effectively ex post when an airport is potentially abusing its market power; it also means holding back and giving space ex ante so that an airport is able to show that it can appropriately discipline its own behaviours.

There is, however, a risk with using the threat of re-regulation as the ex ante constraint on market power, because it is effectively a 'one-shot gun'. The CAA is likely (correctly) to be unwilling to reintroduce regulation after setting up a deregulatory framework (not least because it would be an admission that their proposals had not worked). Therefore there is a risk under options B and C that airports will exercise some market power but aim to operate at below the threshold of abuse of market power that might lead the CAA to re-regulate. This is an inherent issue with all ex post regimes that allow the regulated company the freedom to operate commercially subject to the threat of regulatory intervention.

Although there is an ever-present risk of regulatory failure in both options B and C, we do not think that the scale of this risk should be over-stated and so we find options B and C to be stronger than option A on the third of our criteria.

Financeability

The assessment against the fourth and final criterion is to a large extent a mirror image of the assessment against the third criterion.

The risk in option A is once again that the monitoring threshold/price cap will come out at an unexpected level as a result of unforeseen changes in one or more comparators' specific circumstances. Indeed, the consequences of a price cap that is unjustifiably low are arguably more serious than the consequences of a price cap that is unjustifiably high for the simple reason that an airport is automatically constrained by a low price cap but does not have to price up to a high price cap.

Options B and C present much less concern. There is nothing in these options to prevent an airport from seeking out a fair return for shareholders and, accordingly, it is difficult to see how either option could cause an airport that has been found to have substantial market power to fear for its financeability.

6.3 Conclusions

It can be seen from the preceding discussion that we are much more comfortable with options B and C than we are with option A.

Our overall sense is that price benchmarking is a useful piece of evidence for the CAA to have on its books and could quite easily become a component part of the ongoing monitoring work that the CAA does within options B and C. But we worry that the benchmarking analysis might not be able to bear the weight that the CAA would be placing on it if it tried to extract a specific metric from the analysis and were to build a binding monitoring threshold around that metric. Importantly, the specific concerns that we have are not ones that the CAA can eliminate by revisiting LeighFisher's report and altering specific aspects of the consultants' work. They relate to the intrinsic limitations of benchmarking exercises.

Options B and C, by contrast, are more flexible and give the CAA more opportunity to adjust the oversight it gives in light of the specific circumstances that it finds in front of it. This may be especially helpful when an airport just crosses the substantial market power threshold and at airports where there is countervailing buyer power. The main concern we have about these options is that the CAA should commit credibly to backing away. The worst outcome that these options could produce is one in which the CAA uses, or comes under pressure to use, the threat of re-regulation to exert soft influence over day-to-day airport-airline negotiations. We do not expect that the CAA would fall willingly into this trap, but it is very important that the regulator signals very clearly the amount of time that it is willing to give the new arrangements to bed down and the thresholds that would have to be passed before there could be any thoughts of intervention.

Our overall summary of the options is given overleaf using the same headings that the CAA uses in its Q6 approach paper. We deliberately cast options B and C as candidate regulatory approaches for an airport that faces some competitive constraints and which, in the CAA's judgment, accepts and understands the need for self-regulation. For the avoidance of doubt, our assessment would be quite different if an airport did not face meaningful competitive constraints or if options B and C were to be forced on an unwilling airport.

Option A

Price protection	?	We have identified a list of factors that could cause the benchmark to diverge from the efficient price at the benchmarked airport. This could cause prices to be higher than is necessary or desirable.
Service quality protection	✓	Service quality requirements/incentives can be specified separately in the licence
Promote competition	?	Setting prices in relation to comparators could remove distortions from the current RAB-based approach. However, it could also cause distortions of its own if the benchmark moves in an unexpected way.
Allows efficient business to finance its activities	?	The factors that cause us to question the price protection offered to users also cause us to have concerns about the possibility that prices will be capped at a level that is lower than is necessary or desirable. This may cause financing difficulties.
Efficient and effective investment	?	Price benchmarking could deter investment if the benchmarked airport's capex sits legitimately at a higher level than comparator airports' capex
Operational efficiency	✓	Because prices are delinked from costs, this should create incentives for efficiency
Transparent, accountable, proportionate, consistent and targeted	✓	The rules can be set out clearly and mechanistically and can easily be understood by all parties. It should therefore satisfy the better regulation principles.
Practical implementation and stakeholder confidence	x	There is a risk that users or airports could lose confidence in a regime that is vulnerable to unexpected outcomes

Option B (as applied to an airport that faces some competitive constraints and willingly accepts the need for self-regulation)

Price protection	✓	Price monitoring leads to self-regulation of prices. There will be a switch to a default price caps and re-regulation if this self-discipline is not evident.
Service quality protection	✓	Service quality would be one of the indicators that could trigger a switch to default price caps and, ultimately, re-regulation,
Promote competition	✓	The intention of this option is that the airport will behave in the same way as airports that do not have substantial market power
Allows efficient business to finance its activities	✓	There is no reason why an airport would set prices at a level that does not permit it to finance its activities
Efficient and effective investment	✓	An airport would not be constrained from bringing forward efficient new investment plans
Operational efficiency	✓	Cost efficiency would be one of the indicators that could trigger a switch to default price caps and, ultimately, re-regulation
Transparent, accountable, proportionate, consistent and targeted	✓	There should be no reason why the rules in this option would not be understood clearly by all parties, It therefore is capable of satisfying the better regulation principles.
Practical implementation and stakeholder confidence	?	This option requires all stakeholders to believe that an airport will behave responsibly. We cannot guarantee that all stakeholders will have this belief.

Option C (as applied to an airport that faces significant competitive constraints and willingly accepts the need for proper commercial behaviours)

Price protection	✓	This option requires airports with substantial market power to exercise self-discipline. Competitive constraints, the scope for third-party arbitration and, ultimately, re-regulation by the CAA ought to be sufficient to protect users if the airport only just crosses the substantial market power threshold.
Service quality protection	✓	Service quality would be one of the matters that could be referred to dispute resolution and, ultimately, trigger re-regulation
Promote competition	✓	The intention of this option is that the airport will behave in the same way as airports that do not have substantial market power,
Allows efficient business to finance its activities	✓	There is no reason why an airport would set prices at a level that does not permit it to finance its activities
Efficient and effective investment	✓	An airport would not be constrained from bringing forward efficient new investment plans
Operational efficiency	✓	Costs would be one of the matters that that could be referred to dispute resolution and, ultimately, trigger re-regulation by the CAA
Transparent, accountable, proportionate, consistent and targeted	✓	There should be no reason why the rules in this option would not be understood clearly by all parties. It therefore is capable of satisfying the better regulation principles.
Practical implementation and stakeholder confidence	?	This option requires all stakeholders to believe that an airport will behave responsibly. We cannot guarantee that all stakeholders will have this belief.

Annex 1
Possible Price Benchmarks

This annex examines whether it is possible to define in advance an index or indices whose value(s) can give the CAA guidance as to the reasonableness of an airport's prices. The thinking is that the CAA might be able in Q6 to focus regulation around comparisons of an airport's out-turn prices to the out-turn values of the chosen benchmark rather than the out-turn values of a RAB-based price cap formula.

There are several types of data that might interest the CAA:

- consumer price indices;
- published indices which track the costs of the types of labour, materials and equipment that an airport uses in the course of its operations;
- the prices charged by similar airports; and
- sector-specific measures of efficient airport costs – e.g. LRIC.

The fourth of these areas is being considered in a separate consultancy study. We explore the first three possibilities in more detail below.

A1.1 Consumer price indices

Airport price caps have historically been anchored to a measure of consumer prices. Specifically, under the RPI – X form of regulation, there is a straight feed-through from the annual rate of RPI-measured inflation to the annual rate of change in the cap on average aeronautical revenue yield. There are also similar RPI links in electricity, gas, rail, telecoms and water price caps.

RPI or the retail prices index is a benchmark that tracks the prices of around 650 goods and services that are bought by UK households. An overview of the current composition of the index is given in table A1.

Table A1

	Weight, parts per 1000
Food	114
Catering	47
Alcoholic drink	56
Tobacco	29
Housing	237
Fuel and light	46
Household goods	62
Household services	67
Clothing and footwear	45
Personal goods and services	39
Motoring expenditures	131
Fares and other travel costs	23
Leisure goods	33
Leisure services	71

Source: ONS.

It can be seen straight away that most of the items in the RPI basket bear little resemblance to expenditures that an airport makes. It is also fairly easy to see that RPI-measured inflation

and airport-specific cost changes can be driven in different directions by very different factors.

This does not call into question the relevance of RPI within the current regulatory regime. When airports prepare business plans and the CAA sets price caps, there is a recognition that airport costs and consumer prices can be expected to increase at different rates and to follow different paths over time. Allowance for some level of 'real price effects' – i.e. increases in costs that exceed or fall short of RPI-measured inflation – is therefore built into the price cap calculation upfront. This, along with other inputs to the price cap calculation, eventually translates into an X-factor which moderates RPI and creates an overall limit on prices that more accurately tracks expected airport costs.

In this study we are required to think about the relevance of alternative price benchmarks in a world in which the CAA no longer uses cost-based X-factors. Stand-alone RPI is one of the first indices that most naturally springs to mind when one thinks of published cost and price metrics that might be useful to the CAA in Q6. However, a cursory inspection of table A1 will show that it is unlikely that the CAA will obtain much useful information from an index that measures the costs of a basket of items that airports rarely encounter.

Accordingly, we think that the CAA would need to exercise a great deal care if it were to use RPI or RPI-measured inflation – in isolation – as a benchmark for out-turn airport prices in Q6. While there are some types of costs – e.g. wages – which might themselves be linked to RPI, a majority of the inputs to the current 'building block' price control calculation can be shown to move in a way that is not especially well correlated to out-turn consumer price inflation measures. It is therefore very difficult to argue that there should be an a priori expectation that the rate of change in an airport's price should follow RPI.

The same conclusion applies in the case of CPI, RPIX and other CPI/RPI variants, all of which derive from similar basket of goods and services.

A1.2 Published labour, materials and equipment indices

RPI is just one of a large range of price and cost indices that are published by the Office of National Statistics. There are also private-sector firms that compile and publish tailored indices for sector-specific use.

If RPI is too consumer-focused, an alternative approach is for the CAA to dig into the catalogue of labour, materials and equipment indices and select data that is more directly relevant to an airport operator. It is possible to envisage the CAA constructing an airport cost index from a basket of published indices comprising:

- wage inflation measures;
- energy price indices;
- relevant materials and equipment price indices; and
- output price indices for the construction sector.

It is not within the terms of reference for this study to select the specific series that would go into such an index. However, we know from work we have carried out in other regulated sectors – e.g. the water industry[3] – that it is feasible to complete the task that we have outlined and that there is regulatory precedent for the approach.

It should, however, be noted that we are talking here about producing a measure of input cost inflation. This is not the same as a measure of output price inflation, which is properly the subject of this report. The CAA ideally needs to know not just what level of cost push an

[3] UKWIR (2011), Alternative Measures of Inflation in the Regulatory Framework.

airport is facing but also how an efficient effort would manage input cost inflation pressures and how it would offset cost inflation via productivity growth. The CAA should also be interested in capturing more generally the natural relationship between costs and airport prices over investment cycles and over the macroeconomic cycle – a key part of the rationale for considering a move away from cost-based regulation.

This means that any bespoke airport cost index will be an incomplete answer to the task in hand. Such indices are used elsewhere in regulation, and may be useful to the CAA in Q6, either in projecting future levels of operating expenditure and capital unit costs as an input into a building block price cap calculation or for the purposes of conducting ex post evaluation of out-turn efficiency and actual out-turn cost data. But they do not have such obvious relevance as a reference point for aggregate prices, whose value ought to be affected by factors that extend beyond input cost levels.

A1.3 Comparator airport prices

A separate study by the consultants LeighFisher has identified comparator airports for Heathrow, Gatwick and Stansted and made recommendations on the construction of price benchmarks. We give a brief review of LeighFisher's work in annex 2 to this report.

Unlike the published price indices that we consider above, the LeighFisher price benchmarks are intended to capture the full range of influences on an airport's costs and prices. That is to say that they take in the effects of input cost inflation, ongoing productivity growth, improvements to service quality/standards/outputs, growth in capacity and the market constraints in each comparator airport's pricing over investment and macroeconomic cycles.

This does not mean that they automatically reflect the ways in which such factors impact on the specific airports that the CAA regulates or specific circumstances affecting those airports. The nature of benchmarking is such that there will always be differences and reasons why prices at either the home airport or the comparator airports will move in an atypical or idiosyncratic manner. This does not invalidate the benchmarks; rather, it is a limitation that we keep in mind when we set up the candidate regulatory options.

A1.4 Summary

Our conclusion from the above discussion is that price data from comparator airports is likely to give the CAA a more relevant reference point than published consumer or input price indices. Both types of data need to be used with a degree of caution, but the comparator information permits like-for-like checks to be applied to an airport's out-turn prices whereas other published indices require considerable further manipulation to make them a suitable price benchmark.

Annex 2
Review of LeighFisher Report

The terms of reference for this study asked us to review the report by LeighFisher 'Comparing and Capping Airport Charges at Regulated Airports'.

LeighFisher's work puts forward benchmarks for prices at Heathrow, Gatwick and Stansted airports. It identifies suitable comparators for each airport, investigates the merits of alternative price measures, deals with issues of data comparability and data cleansing, and ultimately produces benchmarking comparisons for the period 2002 to 2010.

The key points that we take from LeighFisher's analysis are that:

- it is possible to identify reasonably broad-based comparator baskets for all three airports (Heathrow – 5 comparators, Gatwick – 10 comparators, Stansted – 9 comparators);
- some of the comparator airports are unregulated UK airports, but LeighFisher also considers that certain overseas airports also provide useful price benchmarks;
- the composition of the comparator baskets is unlikely to change significantly within short periods of time;
- the best definition of 'price' is average aeronautical revenue yield. This measure captures the charges that airlines actually pay, which is not the case for measures constructed from published charge lists;
- the source data for aeronautical revenue is typically from published accounts. Most, but not all, airports give a sufficient breakdown of their revenue to be able to separate aeronautical from non-aeronautical income;
- it is necessary to make certain adjustments to reported revenues in order to facilitate like-for-like comparisons across airports. The adjustment amounts vary from year to year and need to be recalculated on an annual basis;
- international comparisons should be made on the basis actual exchange rates in a base year (LeighFisher use 2010) and adjusted for own-country inflation; and
- the consultants make no specific recommendations about the most relevant benchmark to take from the comparator population.

We do not have any specific comments on the above. Our assessment is that LeighFisher has exploited the available data to its maximum potential and has put forward an intuitively sensible methodology for extracting relevant benchmarks from that data. We cannot find any specific fault in LeighFisher's proposals and we do not wish to recommend any modifications to the report's conclusions.

We should nevertheless highlight that LeighFisher's suggested benchmarks present the CAA with a number of challenges. For the avoidance of doubt, these are not the consequence of deficiencies in the consultant's work, but rather a function of the natural limitations in the data set. We note that:

- LeighFisher cautions that there is a +/-10-15% margin of error in their calculated benchmarks;
- given the number of comparators, any summary statistics that the CAA takes from the data – e.g. average, upper quartile – will be quite sensitive to changes at individual airports;
- some of the comparator airports are subject to the cost- or RAB-based regulation that the CAA would be trying to move away from if it opts for alternative forms of regulation at UK airports;
- it is only possible at present to calculate benchmark values up until 2010. Because financial information is sourced from companies' accounts, it will in future be up to 18

months after the end of a calendar or financial year until it is possible for airports, airlines and regulator to know the value of that year's price benchmarks; and

- there can be no guarantee that all comparator airports will continue to report aeronautical yield on a consistent basis or, indeed, that the comparator airports will continue to report aeronautical yield data at all.

These limitations influence the proposals that we develop in the main body of the report.

Annex 3
Regulatory Precedent

A3.1 Airport Regulation in Australia

Australia dispensed with formal price caps for airports and put in place a system of annual monitoring in 2002 after a review by the Productivity Commission found that price cap regulation was not working effectively. The Commission's key finding was that:[4]

> Where airport market power is not substantial, or where there are commercial constraints on the misuse of market power, price monitoring has significant advantages over stricter forms of price regulation. Provided there is no easy recourse to regulatory intervention, a price-monitoring regime can promote efficient outcomes while reducing the risk of regulatory failure. Price monitoring also has the potential to reduce compliance costs and promote commercial negotiations.

The body that is responsible for the monitoring of airports is the Australia Competition and Consumer Commission (ACCC). Currently five airports are formally within the monitoring regime: Adelaide, Brisbane, Melbourne, Perth and Sydney.

The ACCC reports annually on its findings. The reports are typically 300-plus pages long and contain airport-by-airport reviews and reporting of the following metrics:

- volumes – number of passengers, tonnes landed, number of aircraft movements;
- prices – level of specific aeronautical charges (landing fees, parking fees, facility fees, surcharges, etc.);
- revenue – total revenues, total revenue per passenger, aeronautical revenues, aeronautical revenue per passenger;
- costs – total operating expenditure, total operating expenditure per passenger, aeronautical operating expenditure, aeronautical operating expenditure per passenger;
- profits – total profit, total profit per passenger, aeronautical profit, aeronautical profit per passenger;
- asset values – total asset value, value of aeronautical assets;
- rates of return – total return on assets, return on assets for aeronautical services, return on equity;
- quality of service – overall and service-specific satisfaction ratings; and
- car parking – car park specific charges, revenues, costs, profits, satisfaction ratings.

This factual information is prefaced by an overall summary of outcomes. This comprises:

- reporting of the comparative trends in volumes, prices, costs, profits, rates of return, etc. across all five airports; and
- the ACCC's qualitative assessment of each airport's performance.

The regime is generally considered to provide an effective discipline on airport behaviours. Neither the ACCC nor the government have found it necessary to enact any form of re-regulation, although on some occasions, including in the latest 2010/11 report, the ACCC did find some specific causes for concern at certain airports. The Productivity Commission has reviewed the monitoring regime on two occasions in 2007 and 2012 and in both cases recommended that it should continue broadly unmodified. The most recent report in 2012 focused on three main enhancements to the process:

[4] http://www.pc.gov.au/__data/assets/pdf_file/0004/19714/airports.pdf

- a process of formal notification by the ACCC to an airport that should 'show cause' why its conduct should not be subject to a more detailed regulatory inquiry, with the possibility of re-regulation thereafter;
- the option for an airport to go to binding dispute resolution as part of its contract formation process instead of the show cause process; and
- some specific improvements to service quality monitoring.

A3.2 Energy Supply Regulation in the UK

Ofgem has recently reintervened in the liberalised electricity and gas supply markets following complaints about the behaviours of the big six energy suppliers. Much of this reintervention has been targeted at obtaining greater transparency for customers. Measures include requirements to:

- limit the number of tariff offerings;
- be explicit about the nature and amounts of any discounts offered to customers;
- calculate and promote a single 'tariff comparison rate' which tells domestic customers how much a typical household will pay in a year under each tariff;
- inform customers if a cheaper deal becomes available; and
- possibly, inform customers if another supplier is offering a cheaper deal (NB: this is still a proposal).

Ofgem has also increased reporting requirements and market monitoring activity significantly.

Since 2009 Ofgem has required vertically integrated energy companies to published 'consolidated segmental statements', which set out the profitability of generation and supply activities separately. These statements are published annually by the companies in accordance with accounting rules laid out in a licence condition.

Ofgem as regulator has been putting out two types of reports. The first type of report has been an ex post review of liquidity in the wholesale energy market. This review takes the form of reporting and analysis of factual information about trade volumes and spreads, qualitative feedback from a questionnaire that Ofgem sent to market participants and Ofgem's overall conclusions about market liquidity in the preceding year.

The second type of report is a weekly review of the net margins that suppliers are pricing into tariffs. This very simple report is contained within a single webpage which shows the current average margins on electricity, gas and dual fuel tariffs against margins earned in the preceding seven years.

It is too early to say what effects these interventions are having on customers. A first round of re-regulation in 2008/09 is now perceived not to have gone far enough and Ofgem (and the government) is hoping that some of the newer measures set out above will improve the effectiveness of competition.

A3.3 Postal Regulation in the UK

Ofcom's decision on the regulatory framework for postal services for 7 years from April 2012 to March 2019 removed the price cap and notification requirements that had previously covered over 70% (by revenue) of Royal Mail's services and replaced it with three regulatory safeguards:

- a detailed monitoring regime;

- a 55p cap (indexed to the CPI) on second class basic-weight stamp prices to protect vulnerable consumers and ensure affordable basic mail services[5]; and
- an obligation to provide access to competitors at inward mail centres with ex ante headroom protection between the retail and equivalent access price.

The monitoring regime focuses on four areas:

- financial performance – cash flow and operating margins and returns on capital both at an absolute level and between products and markets;
- operational performance – performance against efficiency targets and quality of service targets including reasons for variances;
- universal service prices – including assessing whether they remain affordable; and
- competition – access prices, transfer charging, headroom and cost allocation.

The financial reporting requirements require Royal Mail to:

- publish full audited annual financial statements, with appropriate supporting information, for the Relevant Group (RMG Limited excluding POL and its subsidiary undertakings) and the Reported Business;
- deliver to Ofcom, on a confidential basis, quarterly updates to the cash flow projections of the Relevant Group following their approval by its Board; and
- deliver to Ofcom, on a confidential basis, annual updates to its budget and ad hoc updates to its Strategic Business Plan following their approval by its Board, together with annual confirmation of the existing Strategic Business plan;
- to prepare FAC national product cost estimates on a quarterly basis from its costing system, notifying Ofcom of changes to the costing methodology;
- to produce consistent zonal cost estimates reviewed at least once a year, using specific zonal costing rules; and
- publish an up-to-date Costing Manual documenting its FAC product costing methodology and provide Ofcom with quarterly Technical Appendices.

In addition, for each of the four financial reporting divisions (upstream USO, upstream non-USO, downstream services and end-to-end only products), Royal Mail is required to:

- prepare, maintain audited annual income statements, capital employed statements and annual cash flow statements using the proforma in the Regulatory Accounting Guidelines (RAG);
- prepare (confidential information) and publish (non-confidential information) annual reconciliations of the quarterly information with the annual information in the income statements using the proforma in the RAG;
- comply with the detailed rules in the RAG;
- provide and publish an audited split of the annual income statement for the Reported Business between universal service and other products; and
- provide 32 audited annual product profitability statements, disaggregating the profitability to FAC level.

In addition to the annual information above, Royal Mail must provide the following unaudited information:

- quarterly profitability statements to FAC level for each financial reporting division, the split between universal service, other mails and non-mails products and the 32 product groups;
- monthly information on revenues, volumes and costs

[5] Note that while this safeguard is in the form of a price cap, it is not designed to promote efficiency, but rather to protect vulnerable customers from large price increases.

To ensure the quality and reliability of this information, Ofcom require Royal Mail to have tri-partite audit arrangements (Royal Mail, Ofcom and the auditors) for its annual regulatory statements. The audit opinion is on the basis that the statements have been 'properly prepared' in accordance with the requirements in the RAG.

Royal Mail will be required to publish audited financial statements for the Reported Group and Reported Business, the Costing Manual excluding technical appendices, and a split of the annual income statement between universal service and other products. All other reports remain confidential to Ofcom.

Ofcom believed that increased commercial flexibility with a detailed monitoring regime would provide appropriate efficiency incentives and protect against abuse of Royal Mail's market power because:

- ongoing volume decline will put pressure on Royal Mail to reduce costs to contain the need for price rises;
- the government's intention to privatise Royal Mail is likely to provide incentives to management to demonstrate a track record of efficiency improvements;
- there is a threat of more intrusive regulation – if the detailed monitoring regime highlights a record of increasing prices rather than improving efficiency;
- price rises are likely to occur under any scenario (given Royal Mail's poor financial situation and declining postal volumes) and giving more commercial freedom will allow Royal Mail to limit the impact on traffic volumes.

The framework also relies on both Ofcom's Competition Act powers and a formal dispute resolution process[6] with a 4 month timetable in order to constrain Royal Mail's incentive to abuse its market power.

The regime has been designed to protect and facilitate access competition (collection, sorting and trunking of mail by other operators which is then delivered by Royal Mail) and to protect against abuse of market power in both wholesale and retail markets (where RM is the largest player). However it also reflects a desire to allow prices to rise quite significantly in order to restore RM profitability and support privatisation. Ofcom believed that the previous price cap regime had not worked and therefore a new approach was called for. A key part of the new regime is the threat of re-imposition of more direct regulation if monitoring suggests that Royal Mail is not 'playing ball' (i.e. it is addressing financial difficulties by raising prices rather than improving cost efficiency). However, the regulator is not explicit about a threshold that would make them move to re-regulation or what such regulation might look like.

While removing the price control from the vast bulk of Royal Mail's services gives them far greater commercial flexibility and removes the regulatory requirement to forecast efficient capex, opex, return on assets, traffic volume etc. in order to set a price control, the detailed monitoring of Royal Mail's performance it is likely to require more, rather than less regulatory resources both from Ofcom and Royal Mail. It is therefore deregulatory in its effect on RM's commercial and operational decisions but not 'light touch' in terms of the management of the regulatory regime.

[6] See Ofcom's Dispute Resolution Guidelines
http://stakeholders.ofcom.org.uk/binaries/consultations/dispute-resolution-guidelines/statement/guidelines.pdf