



CAP1052

Consultation on Gatwick market power assessment

**Appendix 1: Assessing the Adverse Effects and Benefits of
Regulation**

May 2013

Assessing the Adverse Effects and Benefits of Regulation

At the CAA's request, this paper sets out Gatwick's initial thoughts on whether the current form of regulation at Gatwick would satisfy test C of the Civil Aviation Bill.

Before imposing a licence on Gatwick under the Bill, the CAA will have to ensure that three tests are met. Test C requires the CAA to be satisfied that for users of air transport services, the benefits of regulation are likely to outweigh the costs of regulation. Since the application of Test C would in any case require a consideration of Tests A and B and the analysis of those tests might well affect the manner in which Test C is to be considered, the comments on Test C in this paper can only be in the most general terms.

It is important to recognise that it is the regulatory system which the CAA believes is appropriate, should Gatwick be deemed to meet Test A and B, which needs to be analysed under Test C. Many of the points made in this paper will be relevant to that exercise. Indeed, the OFT and Competition Commission investigations, which resulted in the divestment of Gatwick by BAA and the forthcoming divestment of Stansted, resulted in careful analysis and findings which reinforce the conclusion that current regulatory arrangements would be inappropriate for Gatwick in the future.

With that context in mind, and a view to assisting the CAA, this paper includes:

- Executive summary;
- The first section discusses the framework under which the CAA needs to assess the cost of regulation and the tests it needs to undertake;
- Section 2 provides a summary of the CAA's precedent assessments of the cost of regulation at Stansted and Manchester during the de-designation reviews and key observations made on this topic by the Australian Productivity Commission;
- Section 3 discusses the benefits of regulation against a counterfactual;
- Section 4 discusses the direct costs of regulation; and
- Section 5 discusses the sources of indirect adverse effects of regulation:
 - a) Dilution of incentives;
 - b) Diversion of management time and focus;
 - c) Regulation crowding out a commercial approach; and
 - d) Other potential adverse effects now or in the future.

Before turning to those sections, however, it is appropriate to highlight some procedural matters which have come to the fore during the course of preparation of this paper. If the CAA were to impose regulation on Gatwick under the new legislation, the carrying out of test C would need to take place in the light of (a) findings on test A; (b) findings on test B; and (c) detailed proposals concerning the terms of any regulation. Gatwick is concerned that trying to consider all of these issues simultaneously would be both inefficient and potentially unfair. It is only when the analysis

YOUR LONDON AIRPORT

Gatwick

of test A at least is complete that submissions relating to Test C can be focussed sensibly on regulatory matters.

Furthermore, in the absence of detailed regulatory proposals from the CAA, it is unclear how Test C can properly be assessed. In these circumstances, Gatwick would urge the CAA to consider (and discuss further) a process by which at least provisional findings are made on Test A before any findings relevant to future regulation are made. In some scenarios, substantive submissions on Test C might never be required or, if they were, only some way into the process on the basis of concrete regulatory findings and proposals.

Lastly, even the limited exercise we have undertaken for this paper has brought home to us that undertaking Test C to the evidential standard required will be a very substantial undertaking, especially the assessment of the indirect costs of regulation. It will therefore be important that the CAA allocates sufficient time and resources to enable Test C to be done properly, should that test be found necessary.

YOUR LONDON AIRPORT

Gatwick

Executive summary

This paper provides Gatwick's initial thoughts on how to assess the benefits and incremental adverse effects of regulation for the purpose of 'test C' using current regulation as the relevant framework, and what some of the sources of cost of regulation may be. It also provides an initial, higher level estimate of the direct costs of regulation at Gatwick. However, in doing this, the key legal test of adverse effects on air transport users (i.e. passengers and cargo shifters) must be borne in mind: it is that test and not costs (or benefits) to others which matter.

The CAA has undertaken relevantly similar assessments for Stansted and Manchester airports in 2008, and similar issues were also addressed by the Australian Productivity Commission in 2011. Each of these cases indicated that the cost of regulation was substantial in comparison to the expected benefits above and beyond competition law. We believe that the CAA needs to take note of these precedents when assessing the costs and benefits of regulation at Gatwick.

In order to assess test C correctly, the CAA needs to consider:

- **Benefits:** The incremental benefits of regulation on air transport users taking account of Gatwick's proposed approach and all other constraints including those imposed by law, contract and the existence of competition; and
- **Adverse effects:** The adverse effects of regulation on air transport users. These are likely to be derived from direct and indirect costs imposed on Gatwick, the regulator, industry, and society as a whole through distorted incentives and crowding out of competition, which will result in loss of overall economic welfare.

Overall context

The radical reshaping of the ownership of airports, particularly in the South East of England, which has flowed from the investigation by the OFT and Competition Commission has had a profound effect on how issues of competition and regulation should be considered. Those divestitures mean that London airports are in a new competitive world. As this competition develops it is crucial that the CAA applies all of the relevant tests with a fresh approach. The traditional regulatory structure is not appropriate for this new world. With Heathrow, Gatwick and Stansted (and Luton) all in separate hands, the question must be effectively: what will competition fail to do? It is only where the CAA sees competition as clearly inadequate, and competition law unable to afford sufficient protection against any abuse likely to arise from such inadequacy, that regulation should be considered.

Against that background, assessing the adverse effects of regulation on air transport users under Test C must be forward looking. There are limits to the lessons that can be drawn from past experience, and it is clear that the present regulatory regime, developed to deal with an incumbent monopolist, cannot be justified in relation to an independent, competing Gatwick. Indeed, at this stage in the development of the airports market, the precautionary principle (in the context of the CAA's duty to promote competition) should mean that the CAA does not maintain outmoded regulation but allows competition to develop further, recognising that it has the powers to investigate and act promptly if it sees signs of renewed market failure.

Limited benefits of regulation

The CAA has so far only presented the risks that regulation is trying to address in general terms. However, it will not be sufficient to deal with these issues in such general terms. For test C the

YOUR LONDON AIRPORT

Gatwick

benefits of the regulatory framework proposed by the CAA will need to be assessed against a counterfactual including the Airport Commitments proposed by Gatwick.

Moreover, the CAA will need to assess critically whether regulation will in practice give rise to the theoretical benefits claimed for it. For example, historically a benefit of the traditional RAB model has been that it provided a stable basis for capital investments to progress. However, even if this were true in the past, there are increasing question marks as to whether such benefits can be extrapolated into a very different future market structure.

Counterfactual – competition law, general regulation¹ and Airport Commitments

Both the benefits and costs of regulation need to be judged against a counterfactual of the constraints that would remain if regulation was removed. For Gatwick, this includes the competitive constraints that (linked to the degree of market power determined) Test A identifies, competition law, and other relevant constraints such as the Airport Charges Regulation and the Airport Commitments which Gatwick has volunteered, covering price, service quality, consultation and investment, within which it will negotiate individual, tailored contracts with airline customers (see Gatwick's response to the CAA's May 2012 Document).

Hence, the CAA will need to demonstrate that regulation provides additional net benefit beyond these constraints. The analysis needs to be constructed so as to deal specifically with the circumstances applying at Gatwick.

The costs of regulation are significant

Regulation tends to produce costs. These will vary with the nature and extent of regulation. However, in the absence, as yet, of an alternative proposal from the CAA we have particularly focussed on RAB-based regulation. We believe that there are both direct and indirect costs of such regulation, with the indirect costs significantly outweighing the direct costs:

- **Direct costs:** We estimate that the direct costs of regulation at Gatwick to airport users to be in the region of **£10m per year**, on average over a five year period. In addition, there are further costs borne by stakeholders, including those incurred by airlines and consumer groups. The CAA will need to assess these.
- **Indirect costs:** RAB based regulation reduces the potential for competition and for a commercial approach to operating an airport. It dilutes regulated firms' incentives to perform well. It slows the speed with which the business can act and react in a dynamic and competitive market. It diverts management time and focus away from running the business and it crowds out commercial and innovative outcomes which could have been developed with that resource. These costs will impact on airport users, whose own incentives and behaviours may also be distorted by regulation. We have not attempted to estimate the indirect costs in financial terms, but the sources of those indirect costs are sufficiently comprehensive to suggest they will be very significant, far outweighing direct costs, not least in the context of a market which, following BAA break-up should (in line with the CC's intentions) be developing in an increasingly competitive and commercial direction.

We note that while various measures could be taken to mitigate the adverse impacts of regulation that we identify, such measures are likely to give rise to difficulties of their own (including added complexity) and are unlikely to fully address the dulled incentives and distortions to competition

¹ This mainly relates to the Airport Charges Directive

YOUR LONDON AIRPORT *Gatwick*

and commercial interactions under a RAB regime. Moreover, while our focus in this paper is on the effects of RAB regulation, many of the impacts will also be relevant to lighter, less intrusive forms of regulation.

YOUR LONDON AIRPORT

Gatwick

Section 1: The assessment framework for test C

In this section we set out the relevant framework under which the CAA needs to assess the cost of regulation at Gatwick.

Before imposing a licence on Gatwick the CAA has to ensure that three tests are met. Test C effectively requires that the benefits which regulation confers on users of air transport services are likely to outweigh the costs of regulation. The three tests are set out in box 1 below.

Box 1: Tests A, B & C

Civil Aviation Bill tests

(3) Test A is that the relevant operator has, or is likely to acquire, substantial market power in a market, either alone or taken with such other persons as the CAA considers appropriate (but see subsections (6) and (7)).

(4) Test B is that competition law does not provide sufficient protection against the risk that the relevant operator may engage in conduct that amounts to an abuse of that substantial market power.

(5) Test C is 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.

(6) Test A is met only if—

- (a) the market is a market for one or more of the types of airport operation service provided in the airport area (or for services that include one or more of those types of service), and
- (b) geographically the market consists of or includes all or part of the airport area.

(7) In relation to an airport area that includes all or part of the core area of an airport (as well as all or part of the rest of the airport), subsection (6) has effect as if the references to the airport area were references to the core area or, as appropriate, the part of the core area.

(8) For the purposes of test B conduct may, in particular, amount to an abuse of substantial market power if it is conduct described in section 18(2)(a) to (d) of the Competition Act 1998.

(9) In test B “competition law” means—

- (a) Articles 101 and 102 of the TFEU,
- (b) Part 1 of the Competition Act 1998, and
- (c) Part 4 of the Enterprise Act 2002 (market investigations).

69 Air transport services

(1) In this Part—

“air transport service” means a service for the carriage by air of passengers or cargo to or from an airport in the United Kingdom;

“provider”, in relation to an air transport service, means a person who has the management of the

YOUR LONDON AIRPORT

Gatwick

aircraft used to provide the service;

“user”, in relation to an air transport service, means a person who—

- (a) is a passenger carried by the service, or
- (b) has a right in property carried by the service.

(2) In this Part references to users of air transport services include future users of such services.

As we noted in our November submission² the assessment against the three tests requires detailed consideration of the characteristics of the market, including comprehensive consideration of the competitive constraints on Gatwick from both within the market, and outside. Even if the CAA was able to establish that Gatwick has substantial market power (despite having market shares below the levels usually associated with dominance), it has to fulfil two further tests before it can impose a licence.

Under Test B the CAA needs to determine both the risk of abuse and why competition law does not provide sufficient protection against any potential abuse of market power. This is a substantial hurdle to pass.

Test C is the third test. It requires an assessment of whether, for users of air transport services, the incremental benefit of regulation is likely to outweigh the adverse effects.

In principle, economic regulation can be used to address a number of potential concerns arising from market power:

- **Price and service quality:** a firm with substantial market power may have an incentive to increase charges, and/or reduce service quality. Economic regulation can potentially reduce the risk of this occurring by setting binding price caps, or other pricing constraints, associated with service quality targets;
- **Efficiency:** the firm may not have a strong incentive to pursue cost efficiencies. Economic regulation can promote efficiency usually by basing price caps/constraints on efficiency targets and allowing the regulated firm to retain for a period any benefits achieved by “beating” these targets; and
- **Investment:** a key consideration of market power is that the firm may have an incentive to invest less, or to delay investment³. Economic regulation can address this by linking price to investment.

In practice, Test C requires the CAA to assess specific regulatory regimes against a counterfactual of competition law and *other constraints*, which may not already be included in test B. This will not only include Regulations such as the Airport Charges Directive (ACD), but also other constraints

² http://www.gatwickairport.com/Documents/business_and_community/Public%20Regulation%20Pages/competition/Q5-050-LGW05%20Redacted%20-%20GAL%20Submission%20to%20CAA%20Review%20of%20Airport%20Competition%20-%2030%20Nov%2011.pdf

³ This is distinct from and additional to the commonly raised concern regarding RAB based regulation which is that it presents a firm with an incentive to invest too much, or to prefer capital based solutions to alternatives.

YOUR LONDON AIRPORT

Gatwick

such as the degree of competition to which the airport (even if judged to have a degree of SMP) can be expected to be subject, and the Airport Commitments regarding price, service quality, consultation and investment that have been put forward by Gatwick.

Test C should assess the benefit of regulation for “users of air transport services”, i.e. passengers and cargo shippers. This means that (notwithstanding Gatwick’s commitments regarding airport charges) the CAA would need to assess the risk of, for example, Gatwick increasing aeronautical charges having an adverse impact on passengers. In all of this analysis it will be critical that the CAA relates its analysis of both costs and benefits to the specific circumstances prevailing, and likely to develop, at Gatwick.

In the following sections we first discuss some previous assessments of the cost of regulation. We then examine the potential adverse effects of regulation in the context of Gatwick. It is worth noting from the outset that, while the direct costs may be easier to quantify than the indirect costs, the latter are likely to be more substantial. Given the development of more a more competitive, commercially oriented airport market, the indirect costs arising from crowding out of competition and commercial interactions are likely to be particularly significant.

The costs and benefits of regulation need to be assessed in light of the adopted regulatory design

Both the benefits and costs of regulation depend heavily on the scope and type of regulation examined, and what problem(s) it is designed to address. In preparing this paper we note that the CAA has not yet demonstrated that Gatwick has market power under test A, has not yet undertaken test B for Gatwick (beyond a general discussion on competition law) and has presented risks of abuse only in a very general form, highlighting that adverse outcomes might manifest themselves in the form of service quality, investment decisions, consultation, innovation and prices charged⁴. It has not related any of this to Gatwick Airport specifically.

In addition, the CAA has yet to make any specific regulatory proposals which can be assessed in detail. At this stage it is therefore not possible to provide a comprehensive assessment of the costs of regulation. We have however provided a number of initial observations on the sources of cost of RAB based regulation. This should be read as an initial guide for the CAA to consider in planning to undertake test C, and not as a “shopping list” of problems calling for a solution through an even more complex regulatory framework nor as an exhaustive list of the issues that arise with regulation.

⁴ Paragraph 45: CAA Heathrow, Gatwick and Stansted – market power assessments, Summary of the CAA’s initial views – January 2012. <http://www.caa.co.uk/docs/5/MarketAssessmentsJan12.pdf>

YOUR LONDON AIRPORT

Gatwick

Section 2: Previous assessments of cost of regulation

This section summarises some of the previous assessments of the cost of regulation that have been undertaken. It focuses on the previous assessments undertaken by the CAA with regard to Stansted and Manchester airports⁵, as well as issues raised in the context of the Australian Productivity Commission's Inquiry Report into the Economic Regulation of Airport Services⁶.

CAA advice on designation of Stansted and Manchester airport (2008)

The principal similar previous assessments undertaken were in the context of the CAA's advice on the designation of Manchester and Stansted airports. While these assessments were undertaken under a different legal framework and against very different circumstances (with, in relation to Stansted, less prospective competition than the CC's break-up of BAA now makes possible) they are nevertheless instructive. The main features of these assessments were that they:

- assessed the costs and benefits of regulation over and above competition law;
- assessed the cost and benefits in aggregate, recognising the limited ability to quantify individual costs and benefits;
- recognised that there was uncertainty over the form of regulation and therefore used different scenarios for regulatory design, including ones with an expanded role for constructive engagement and a market led price cap (LRAIC);
- In particular they considered the impact on:
 - Price – noting that while regulation was potentially effective against excessive pricing, there was a significant risk that price could be set too low, thereby leading to significant distortions;
 - Efficiency – acknowledging that regulation brought both risks and benefits. It can promote efficiency, but can also artificially focus attention on the wrong areas, or lead to the airport focusing too much on efficiency;
 - Service Quality – difficult to measure, and difficulty in choosing the appropriate measure to target; in addition to this they raised the risk of circumstances changing over 5 years, and the risk of unintended consequences;
 - Investments – regulation could promote investment (while monopolies would otherwise have an incentive to underspend), but it risked causing distortions to investment programmes;
 - Innovation – regulation can inhibit innovation as the rewards for innovation under ex ante regulation are usually muted; and
 - Direct costs – the direct costs of regulation are small, but significant, including the costs of the regulated companies associated with the process and compliance, costs of the regulator (as well as the Competition Commission) in undertaking the review and costs incurred by other parties in engaging with the review.

⁵ CAA Manchester and Stansted de-designation advice http://www.caa.co.uk/docs/5/ergdocs/de-designation_advice.pdf

⁶ Productivity Commission, Economic Regulation of Airport Services; Productivity Commission Inquiry Report, 2011 <http://www.pc.gov.au/projects/inquiry/airport-regulation/report>

YOUR LONDON AIRPORT

Gatwick

The CAA's recommendation was that the test was not met for Stansted or Manchester under any of the regulatory regimes considered.

For Manchester:

- **Preventing excessive pricing:** Regulation would not add any incremental benefit at Manchester as the evidence suggested (through pricing below the cap for some periods and slower than average market traffic growth) that there were competitive constraints and that these were unlikely to diminish. In addition to this the risk of setting a cap too low was significant - potentially preventing both Manchester and its competitors from expanding, thereby distorting airline decisions and potentially providing the wrong passenger/quality mix;
- **Efficiency incentives:** The airport displayed reasonable levels of efficiency across several of the areas considered, and ranked well in some areas. It was considered that, in the absence of price control regulation, competitive pressures would provide strong incentives to drive further efficiencies. It was likely that the size of potential benefits to be derived from regulation was limited;
- **Range and level of service:** The regulation of service levels was relatively light touch and it was not clear if the observed improvements in service quality were a result of the regulatory regime, or of competitive pressures; and
- **Incentives to invest:** Given the completion of the second runway at Manchester there was unlikely to be any significant requirement for new capacity, compared to airports operating in more constrained markets. In addition, the CAA highlighted that, "when regulating a business which operates in a more competitive environment, the indirect costs of regulation can extend well beyond a distortion of the behaviour of the regulated company to impact on the behaviour of those companies with which it competes, or might in the future compete, and users across the whole market."⁷

For Stansted:

- **Preventing excessive pricing:** A price cap was unlikely to bring much benefit in managing the risk of excessive pricing as: There was evidence of the airport charging below the cap, competition law would still apply and competition might render the price cap redundant. In addition to this the risk of distortions arising from setting a too low price cap were also present at Stansted;
- **Efficiency incentives:** It was difficult to attribute the capex and/or opex efficiency to the price cap and looking forward it was likely that the airport would face material competitive constraints;
- **Range and level of service:** There was very limited evidence on the effectiveness of regulation at driving levels of service at Stansted. In addition, ex-ante regulation might provide an incentive to focus on efficiency, rather than the range and level of service; and
- **Incentives to invest:** The CAA noted that in the case of Stansted the link between investment, the RAB and the price cap in RAB based regulation could "lead to investment taking place on a greater scale, or too soon..."⁸ It was furthermore noted that these incentives presented a significant barrier to effective dialogue between the airport and its airlines on future

⁷ CAA Manchester and Stansted de-designation advice (paragraph 7.55).

⁸ CAA Manchester and Stansted de-designation advice (paragraph 10.48).

YOUR LONDON AIRPORT

Gatwick

investments. It furthermore noted that when “regulating a business which operates in a more competitive environment, the indirect costs of regulation can extend well beyond a distortion of behaviour of the regulated company to impact the behaviour of those companies with which it competes, or might in the future compete, and users across the whole market.”⁹

A number of points made in these CAA assessments have particular relevance to the circumstances of Gatwick Airport, and to the assessment under Test C that the CAA will need to make. In particular:

- The CAA's emphasis on the potential for regulation to distort competition. This was apparent in the comments it made about both price and investment. Clearly, the potential for such distortion is significantly greater now given the break-up of BAA and the competition that has resulted and will, if permitted, continue to develop. Moreover, experience since break-up (as envisaged by the CC) has demonstrated that competition has potentially more dimensions than envisaged in the previous CAA's analysis. This will need to be reflected in any assessment the CAA undertakes now.
- In the presence of 'reasonable levels' of efficiency in some areas and good performance in others, the CAA questioned how far regulation could be expected to drive further gains. In Gatwick's case there has been significant efficiency improvement in recent years, especially since the change of ownership in December 2009, driven by the need to place the airport in a position to compete effectively.
- The CAA, in assessing the likely benefits from regulation, made due allowance for the constraints on pricing that would apply absent regulation. In the case of Stansted and Manchester this arose from the competitive constraints to which the airports would be subject. Even if the CAA were to find that Gatwick possessed some degree of market power, there is nothing in the evidence that the CAA has so far assembled to suggest that competitive constraints on pricing (and other matters) would be absent. Moreover, they would be buttressed in this case by the Commitments that the airport has said that it will give. In other words, consistent with its 2007 analysis, the CAA will need to consider all the constraints that apply to the airport's behaviour.

As far as we are aware, there has not been any competition issues investigated in relation to Manchester airport since de-designation. We also note that the airport has continued to invest in facilities, and to attract traffic, including Emirates bringing an A380 to the airport.

⁹ CAA Manchester and Stansted de-designation advice (paragraph 10.52).

YOUR LONDON AIRPORT

Gatwick

The Australian Productivity Commission's inquiry into airport regulation (2011)

Australia introduced new regulatory arrangements for its main airports in 2002. The new regulatory arrangements replaced a price cap regime with a price monitoring regime. Following its introduction, the regime was first reviewed by the Australian Productivity Commission in 2006, which found it to deliver important benefits relative to the previous regime. It furthermore recommended that the monitoring arrangements continue. The Australian Productivity Commission undertook a further review into the regulatory arrangement in 2011 and the final report found that:

“Under the light-handed monitoring regime that replaced price cap regulation:

- There has been a marked increase in aeronautical investment and airports have not experienced the bottlenecks that have beset other infrastructure areas
- Aeronautical charges do not point to the inappropriate exercise of market power
- Service quality outcomes overall are ‘satisfactory’ to ‘good’, although airlines have, on occasions rated two airports as ‘poor’.
- Australian airports’ aeronautical charges, revenues, costs, profits and investment look reasonable compared with (the mostly non-commercial) overseas airports.”¹⁰

and

“Commercial agreements with airlines are becoming more sophisticated. Agreements often include service level obligations, consultation on capital investment, price paths and dispute resolution when ‘in-contract’, but not during contract formation.”¹¹

For its 2011 review the Productivity Commission found that, while a number of airports still had significant market power, this was decreasing and there was not a case for increasing the scope of regulation. It furthermore found that the coverage of the monitoring regime was appropriate, and the benefits of attempting to fine tune the monitored aeronautical facilities and services were unlikely to outweigh the costs¹².

In its final report the Productivity Commission made a number of observations relating to the cost of regulation which are of particular relevance to the Test that the CAA is required to undertake under new duties which (unlike the Airports Act) focus on end users and the promotion of competition and in new circumstances where competition and commercial contracting can now develop following BAA break-up. These included:

On price incentives:

“Airports do not provide air services to passengers directly. Rather, they provide services that airlines rely on to provide their own services to passengers. The extent to which increases in aeronautical prices impact on the welfare of society as a whole depends (at least in part) on the airlines response to such increases.” (p.71 – also box 5.2 p71)

“The extent to which airlines can price discriminate against passengers (including the degree to which it can discriminate which passengers pay airport charges) reduces the welfare effects of an increase in airport charges. In practice, airport charges make up such a small proportion of total

¹⁰ Productivity Commission, Economic Regulation of Airport Services; Productivity Commission Inquiry Report, 2011, p. xx

¹¹ Productivity Commission, Economic Regulation of Airport Services; Productivity Commission Inquiry Report, 2011, p. xx

¹² Productivity Commission, Economic Regulation of Airport Services; Productivity Commission Inquiry Report, 2011, p. XLVII

YOUR LONDON AIRPORT

Gatwick

airfares that even large increases in these charges are unlikely to have significant welfare effects, and will largely represent a 'distribution' between airlines and airports." (p.72-73)

"... it remains the Commission's view that regulatory measures that artificially reduce airport charges below efficient levels are likely to have a net social cost to the community greater than those associated with more broadly-based redistribution measures." (p.86)

"...the commission remains of the view that airport charges are a small component of airfares overall (and to the total cost of travel), and that any 'inefficient' component of an airports charge is an even smaller proportion again." (p.95)

On commercial contracting:

"The period of light-handed monitoring has seen increased contracting between airports and their users, and as noted in chapter 8, the vast majority of passengers travelling through the major capital city airports do so on airlines that have a contract with the airport, covering prices, and in many cases, service levels. Moreover, it is not evident that the transaction costs of forming such contracts presents a significant barrier to their use." (p.88)

On market failure and market power:

"... a risk that the costs of regulating to address the abuse of airport market power may in some cases exceed the costs of inaction." (p.95)

"...the identification of market imperfections alone is not a sufficient justification for intervention" (p.95)

On investment incentives:

"... the possibility of regulatory changes in the future (including price or revenue constraining regulation during the life of an asset) increases the risk to earnings from the asset, and thus could increase the minimum return required to undertake new investments." (p.105)

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Gatwick

Section 3: Benefits of regulation

Test C requires assessment of the benefits of regulation relative to its adverse effects. To reach a soundly based answer, grounded in better regulation principles, the CAA needs to assess the benefits of regulation against a counterfactual of what would be in place in its absence – that is, the costs of regulation need to be assessed against the incremental benefits flowing from it.

The CAA has so far not set out any risk(s) of abuse specific to Gatwick. It has simply set out in very general terms in its summary of market power at Heathrow, Gatwick and Stansted that airports with high levels of market power could “allow airports to raise prices, deliver inadequate levels of service quality and scale back on investment.”¹³ It also noted that Gatwick may be able to raise prices, or reduce service quality to some segments if regulation was to be removed¹⁴.

While regulation can in principle address concerns over prices, service quality and investment, that is not the essence of Test C. It is not there to enable the CAA to determine the policy question of whether regulation is better than no regulation, or better than competition law in addressing any concerns it may have. Rather, Test C needs to consider the specific circumstances of Gatwick airport and whether regulation will produce benefits over and above those conferred by competition law, other generally applicable regulation, the forces of competition and the Commitments (and bilateral contracts) framework proposed by Gatwick. This is the appropriate counterfactual against which the CAA must assess any regulatory proposals. The scope of the proposed Commitments was set out in more detail in our July Submission, but is reproduced in box 2 for convenience¹⁵.

Box 2: Gatwick’s proposed airport commitments

Airport Commitments

Price Commitment

We would propose a price path which would limit the average aeronautical yield, calculated on the basis of airport charges revenue per passenger, over the duration of the Commitment Period. This would consist of an initial proposed price and then an RPI+X Commitment for the remainder of the Commitment Period.

Service Quality Commitment

Core Service Standards would include the existing SQR metrics. We would propose the immediate introduction of a service metric associated with outbound baggage, since this is currently excluded from the scheme. We would propose that the standards at the end of Q5 would be those applying in the Commitment Period. A reasonable system of penalties and bonuses should also apply. The Core Service Standards could be varied from time to time as agreed.

In addition, we would be proposing airport wide standards, covering the performance of all stakeholders at the airport, with performance published. This would continue the improvement generated by the publication of UKBF and arrivals baggage performance. Any performance

¹³ Paragraph 1: CAA Heathrow, Gatwick and Stansted – market power assessments, Summary of the CAA’s initial views – January 2012. <http://www.caa.co.uk/docs/5/MarketAssessmentsJan12.pdf>

¹⁴ Paragraph 45: CAA Heathrow, Gatwick and Stansted – market power assessments, Summary of the CAA’s initial views – January 2012. <http://www.caa.co.uk/docs/5/MarketAssessmentsJan12.pdf>

¹⁵ Section 5.3: GAL’s response to the CAA’s May 2012 Policy Update available at www.gatwickairport.com/regulation/competition1/

YOUR LONDON AIRPORT

Gatwick

incentives for individual airlines would be contained within any bilateral contracts entered into. Areas beyond the airport's direct influence to be covered would include

- Immigration
- Arrivals baggage
- Check-in
- On-time performance
- PRM performance.

In addition, Gatwick would publish its quarterly ASQ performance, with the stated aim of achieving upper quartile performance in the relevant ASQ comparator set.

Consultation Commitment

Gatwick would consult with its airlines on all major capital expenditure programmes. We would publish and consult on a Masterplan. We would publish and consult annually on a rolling five year capital expenditure programme. As part of the annual consultation on airport charges, we would of course satisfy the requirements of the Airport Charges Regulations, as apply to all airports over 5mppa in Europe. Gatwick's financial accounts are published (in accordance with the UK listing requirement) and would be provided to the CAA giving transparency over the financial performance, investment and asset base of the airport. There would be no requirement on the CAA to approve a Regulatory Asset Base.

Investment Commitment

Gatwick would commit to the capital expenditure necessary to maintain the Service Quality Commitment. However, we would not be proposing an explicit level of capital expenditure to achieve this Service Quality Commitment. Any incentives as to delivery associated with a particular capital project would be agreed, as appropriate, when that particular project came through the normal consultation process. To be clear however, our current business plan for the period to 2020 remains as published in April 2012.

Duration of Commitment Period

Gatwick would propose that the Commitments are for a period of three years – ie to April 2017, though this period could be extended with the agreement of our airlines. That should give sufficient time both for the conclusion of longer term contracts with airlines and for the CAA to assess further how competition is evolving, given that in 2017, it would then be over 7 years since Gatwick had been in separate ownership. We would also expect Stansted to have been in separate ownership for some years by then, giving further evidence for the CAA, as to the level of competition.

Expiry of Commitment Period

Prior to the expiry of the Commitment Period, several options might apply. One of these, in line with other industries in transition to competition, is that the CAA may choose to carry out a market review. The outcome of such a review could be to conclude that Commitments were no longer necessary; to request or require an acceptable extension of the Commitments, or a reversion to a more formal regulatory framework. Gatwick's view is that no further Commitments would be necessary. Clearly, Gatwick would be keen to ensure that any market review found that

YOUR LONDON AIRPORT

Gatwick

competition, not regulation, remained the best way to promote the interests of passengers. It is important to recognise also that it would be open to the CAA to conduct such a review at an earlier stage should there be sufficient evidence that the market and / or the Commitments were not working as anticipated.

Dispute resolution

In line with normal contractual arrangements, it would seem sensible that a form of dispute resolution was agreed. We would not suggest that this was the CAA since this would seem to cut across the CAA's intervention powers.

The CAA's intervention powers

In relation to our proposed Commitments, the CAA would take the role of standard competition regulator, a position that would be consistent with the concurrent Competition Act powers it will be given under the Civil Aviation Bill. As with other sectors, this provides a powerful level of intervention should Gatwick not abide by its Commitments or if the airport was acting anti-competitively in an area not covered by the Commitments.

The CAA has been concerned that standard competition law does not provide a swift enough response to any complaints with respect to abuse of a dominant position. Gatwick is not sure how much weight can be accorded to this to argument since it would apply in principle to all sectors. However, as the body with concurrent Competition Act powers, it is the CAA that would have control over the timetable of any Competition Act investigations.

YOUR LONDON AIRPORT

Gatwick

Section 4: Direct costs of regulation

The most easily discerned and measurable costs of regulation are those directly incurred by industry. While these costs may be less than the indirect costs discussed later, they are nevertheless significant.

These direct costs arise in the following forms:

- Cost of undertaking the regulatory process including:
 1. Cost incurred by regulated company in undertaking regulatory reviews, including staff costs, legal costs, consultancy and management time;
 2. Cost incurred by industry and stakeholders (such as passenger groups), again including staff costs, consultancy and management time;
 3. The CAA's direct costs; and
 4. Cost of appeal(s).
- On-going compliance costs:
 1. Cost of the airport's and airlines' regulatory and compliance teams;
 2. Cost of operational teams (such as Product Development) undertaking consultation processes mandated by the regulator which exceed those required by generally applicable regulation or normal commercial practice;
 3. Costs for stakeholders above and beyond normal commercial relationships; and
 4. The CAA's direct oversight costs.

In aggregate, we estimate that the direct cost of regulation purely for Gatwick airport is at least **£5.5m** per year, including the cost of on-going compliance, consultancy spend and CAA direct costs.

In addition to this, we estimate that we incur substantial direct capex overheads compared to non-regulated airports related primarily to the forms of consultation mandated by the CAA. This would translate to **a further £5m per year**.

Accordingly we estimate the direct costs of regulation at Gatwick airport alone to be in the region of **£10m per year** on average over a five year period.

We recognise that even if we were deregulated Gatwick would still consult its airline users and stakeholders, over and above any commercial discussions in which it may be involved. Aside from the clear advantage to the airport from such consultation, it has legal obligations under the ACD. However, such consultation is likely to be of an entirely different order to that now sponsored and required by the CAA. For example, the airport has held, over a period of some 5 months, 23 meetings of the CE working group and another 5 meetings of the oversight JSG¹⁶. This is at the same time as it is attempting commercial negotiations with a number of key airlines. It is clear that such consultation requirements are both extremely onerous and unlikely to be replicated in a commercial environment. Nor are they required by the ACD.

¹⁶ As of 21 September 2012

Section 5: Indirect adverse effects of regulation

While the direct costs of regulation are significant, they are not as substantial or as pervasive as the indirect adverse effects of regulation. We set out in this section what we see as the main sources of adverse effects of current regulation at Gatwick going forward. We have grouped them under the following headings:

Principal sources of indirect adverse effects of regulation:

- a) Dilution of incentives;
- b) Diversion of management time and focus;
- c) Regulation crowding out a commercial approach; and
- d) Other problems with regulation.

We have not attempted to quantify these adverse effects, as doing so to a reasonable degree of accuracy is well beyond the resources we have available and of the scope of this paper. It will, however, be necessary for the CAA to undertake a full assessment as part of Test C.

As explained above, we have in the absence of alternative proposals focussed on current RAB-based regulation. Different forms of regulation may lead to different sources and extents of cost, but many of the sources of costs identified in this section are likely to result from all but the lightest forms of regulation. Even the Australian system has involved a periodic review of how the system has been working, with associated direct and indirect costs.

Principal sources of indirect adverse effects we can identify in the operation of the current regime

In this section we discuss the indirect adverse effects of regulation. These adverse effects are likely to be derived from the effect of regulation on Gatwick, the regulator, industry, and society as a whole through distorted incentives and crowding out of competition, which will result in loss of overall economic welfare. The adverse effects itemised below represent our current assessment of the principal problem areas. We do not suggest that this list is exhaustive.

a) RAB based regulation dilutes incentives

We believe that RAB based regulation fundamentally dilutes regulated firms' incentives to perform well. In its most basic form, the RAB based framework tends over time towards rate of return regulation and firms earn similar returns whether or not they achieve excellence in output delivery, service quality, cost efficiency, innovation or capacity. While various measures can be taken to mitigate this problem, those measures raise difficulties of their own, and do not tend to address the dulled incentives under a RAB regime entirely.

The generic dangers of a RAB based framework are well documented and include:

1. An excessive focus on inputs rather than outputs (since inputs are easier to measure; e.g. capital expenditure triggers may be defined in terms of £ millions) or, more usually, on project delivery rather than on the service intended to be delivered;

YOUR LONDON AIRPORT

Gatwick

2. Dulled incentives to deliver outputs and service quality which do not cover all areas of the passenger experience (in particular those under airline control), and do not encourage or reward innovation;
3. Dulled incentives to deliver outputs cost efficiently, with skewed incentives to substitute operating expenditure with capital expenditure;
4. Mixed incentives on capex with, on the one hand, RAB-based returns potentially encouraging airports to build bigger and earlier than required but, on the other, the lack of a long term framework (given periodic reviews of returns) meaning that there may in practice be more focus on lower risk, incremental investments;
5. Equalisation over time of the financial advantages/disadvantages obtained by users of the airport, dulling any incentive to compete or innovate;
6. Undue management focus on making gains in those areas or periods where savings can be retained, at least for a period;
7. A reduced incentive to innovate. The change of ownership of Gatwick has demonstrated that, once released, the forces of competition can deliver innovation for beyond that previously achieved through regulation;
8. Incentives for regulatory gaming which, as well as failing to ensure the best delivery of outputs, may end up generating perverse incentives to under-perform in some circumstances. The incentives to game are a generic effect of regulation and apply to airlines as well as airports. They also undermine airport-airline relationships by encouraging the adoption of “extreme” positions to put before the regulator and focussing energies on the regulatory “contest”, rather than allowing the inter-dependent interests of airports and airlines to be properly realised (e.g. the on-going negotiation about, and revision of, capex triggers and whether they have been met or not);
9. Extension of the above problems to non-regulated activities through the single till; and
10. Temptation for the regulator to micro-manage the airport in an effort to address the problems noted above.

We believe that it is testament to GAL's determination to compete that we have been resisting many of such problems to the best of our capability. However, we fear that continued regulation beyond Q5 could threaten this status quo.

In the subsequent sections we discuss some of these aspects further. However, our views on the costs of regulation are informed by behaviours (our own and others') we see in the developing competitive market. Given that competition is a dynamic process and not a steady state outcome it is not possible ex-ante fully to anticipate all the benefits competition will reveal and the distortions that regulation has created. These are increasingly being revealed. However, based on experience to date it is possible to identify significant areas of concern.

YOUR LONDON AIRPORT

Gatwick

b) Diversion of management time and focus

It is clear that regulation causes a diversion of management time and focus towards the regulatory settlement at the expense of running the business. This is a natural response given the extent to which value is dependent on the regulator's decisions. It is also a result of the inevitably complex and time-consuming nature of regulatory processes.

The diversion is not limited to the most senior management and dedicated regulatory staff. Regulation is now pervasive, involving many operational managers in the intensive airport consultative processes and in preparations for them. This crowds out time which could be spent more productively on developing the business and responding to the competitive environment. This is not an issue for the airport alone (although it bears most of the burden). Airlines too need to spend substantial time and effort on regulatory processes.

c) Regulation crowding out a commercial approach

The CC, in its airports market report, anticipated that one important benefit of competition would be that airports would have incentives and competitive pressures to deliver services and outputs that their users demanded¹⁷. One mechanism for achieving this could be the emergence of individual contracts and deals, which might vary between airlines, with the potential for a wide variety of deals emerging. Some contracts might be linked to an individual route or service while others might be a cover an airline's entire operations. Contracts could also vary in length, and the possibility of adopting long run deals linked to volumes or the number of aircraft based at the airport would clearly be one avenue to consider.

Individual deals are potentially highly valuable to users and passengers, particularly at Gatwick where users vary considerably in terms of the services that they provide, their requirements for facilities, their time horizon, and their potential contribution to future growth at the airport. It should be readily understandable that the most appropriate agreement for access concluded with a major long haul carrier such as BA might vary from that concluded with a major low frills carrier such as easyjet, which in turn is unlikely to be the best arrangement for a charter carrier operating primarily in the summer peak. Accordingly, there are potentially large gains to be had from moving access arrangements onto a more customer orientated and commercial basis away from arrangements that are determined through a regulatory process.

The desirability of deals of this type has been recognised by the CAA and the CC. The CC, in its market investigation, says that:

"from our case studies of airport competition, it appears that airports and airlines setting prices through a process of individual negotiations can have positive effects on competition, resulting from the ability to engage in differential pricing in favour of airlines guaranteeing incremental passenger volumes or entering into long-term contracts."

The CC reports on its January 2009 hearing with the CAA, that the CAA was of the opinion that:

*"To facilitate competition, it was therefore necessary to step back or regulate in a way that encouraged parties to enter into a range of short-term and long-term contracts depending on their circumstances."*¹⁸

¹⁷ BAA market airports investigation, CC (March 2009), paragraph 5.16(f): "The process of rivalry to win and retain airlines will induce the airports to improve their offerings to the benefit of airlines and customers."

¹⁸ Summary of hearing with the Civil Aviation Authority held on 23 January 2009, CC (2009), paragraph 13.

YOUR LONDON AIRPORT

Gatwick

However, continued tightly binding regulation will tend to undermine the evolution of this sort of approach. This is because in such an environment, airports will have limited incentives to offer discounts against a binding, cost based price cap, especially where the benefits of doing so (such as increased volumes) may materialise primarily in the medium term and may merely fall into the regulatory till, and as such not flow to the airport. More generally, tightly binding regulation tends to promote a “one size fits all” mentality both within airports and amongst airlines.

We understand that up to 2007 Stansted enjoyed normal commercial arrangements with users, which included the use of long term contracting and offering substantial discounts to airline customers¹⁹. These discounts were said by the CC to have been of significant benefit to airlines, while at the same time allowing Stansted to increase its profitability²⁰. However, that was in a context where the regulatory arrangements were not binding. This example illustrates the real potential for how a move away from tight price regulation could provide space for normal commercial agreements to be concluded between airports and users.

Gatwick is actively engaging with our customers. An important downside to continued tightly binding regulation is its potential to significantly reduce or crowd-out entirely the scope for such interaction, partly as a result of the management focus on time consuming regulatory processes but also because a tight cost based approach does not permit the room that normal businesses have to tailor price and service to the requirements of individual customers.

Impact on other airports

Regulation that forces down regulated airports' prices below those which would be expected in a competitive market, and/ or gives rise to the expectation that future price levels will be held at low levels, may have adverse effects on the ability of other airports to compete and expand their outputs and capacity. This problem has been recognised by regulators in the past. The CAA adopted a somewhat lighter price cap for Manchester Airport in 2003 in part because of concerns that an aggressive approach on the price cap would undermine the emergence of competition from Liverpool airport. Concerns about allowing competition to flourish in the North West were also part of the rationale for de-designating Manchester²¹.

In the context of Gatwick there are a number of fringe competitor airports as well as larger, more established airports that could be adversely affected in such a way. Not only does the current regulatory regime inhibit their ability to attract passengers and airlines today, it also restricts their ability to grow and develop into stronger competitive constraints in the future. And the overall impact is likely to be decidedly perverse at a time when there is increasing policy focus on the needs of users for increased airport capacity in the South East.

¹⁹ Competition Commission report on BAA London airports, CC (November 2002), paragraph 2.493. *Stansted Airport Q5 price control review*, CC (October 2008), paragraph 5.32. *De-designation of Manchester and Stansted airports for price control regulation, The CAA's advice to the Secretary of State*, CAA (July 2007), paragraph 8.40.

²⁰ Competition Commission report on BAA London airports, CC (November 2002), paragraph 2.303.

²¹ *Economic Regulation of Manchester Airport*, CAA (March 2003), paragraphs 3.4 and 5.6: "...the CAA therefore considers that when setting the price cap at one airport it has to take into account its impact on the interests of users of other airports in the UK as well as the interests of those other airports in terms of operation and investment. The CAA has done so in reaching its decision in this document."

"Given a choice between competing with Manchester subject to a tight price cap or with Manchester subject to a loose price cap Liverpool's strong preference was for the former."

De-designation of Manchester and Stansted airports for price control regulation, CAA (July 2007), paragraph 7.40: "Manchester Airport has significant competitive interactions with neighbouring airports and can be said to operate in a relatively broad market that includes, amongst others, Liverpool, Leeds Bradford and Doncaster Sheffield airports. The indirect costs of setting a price cap for Manchester, therefore, need to take into account the possibility of such costs extending well beyond the regulated company and detrimentally affecting those companies with which it competes."

YOUR LONDON AIRPORT

Gatwick

Innovation for passengers

The existing SQR regimes have inherent weaknesses:

- Fixed for 5 years and not able to respond to changing passenger needs;
- Focus on certain specified targets, potentially to the detriment of other worthy important service objectives;
- Incentives can distort behaviours if set incorrectly; and
- Can have multiple unintended consequences.

Without regulation, Gatwick would be incentivised, like any other company, to understand our passengers' needs and provide the relevant service, responding flexibly to changing passenger needs. In the shorter term we would also provide certainty through our airport Commitments.

Without regulation, service would not need to be a 'one-size-fits-all'. If the regime of commoditised service was removed, we would be free to meet the expectations of service-sensitive passengers, and improve efficiency by ensuring that the service regime is continually responding to passenger needs.

Rigidities of regulation make it difficult to accommodate the variety of airline and passenger needs

The rigidities of regulation present a particular difficulty at Gatwick given the increasing proliferation of airline business models operating at the airport after separation. Not only do airlines increasingly require different service levels but also their passengers, even passengers on the same flights.

Product development and consultation

Product development and investment is an important aspect of managing an airport. The airline is the direct customer of the airport and product development will need to be closely informed by what our customers want and are willing to pay for. Getting this right is very important to ensuring Gatwick can compete.

Within the current regulatory setup, the consultation process happens in two stages:

- At an operational stage; and
- A "permission" stage.

The permission level gives rise to significant inefficiency. It is effectively part of a multilateral pseudo-commercial negotiation between the airport on one side and a group of product differentiated airlines (competing with each other) on the other side, all under the moderation of the regulator. This outcome does not remotely replicate a competitive outcome as it:

- Presents an opportunity for airlines to influence the services their competitors receive, and potentially to prevent, or delay desirable investments by their competitors at the expense of passengers. Thus it has the effect of restricting airline competition;
- Prevents the airport innovating on a bilateral basis with individual airlines;

YOUR LONDON AIRPORT

Gatwick

- Moves the focus from the commercial relationship to the professional regulatory lobbyists of the airport and airlines.

Without a RAB, shareholders would have to consider investment without guarantees of the recovery of sunk costs. The removal of regulation would not take away the investment risk to shareholders who, if anything, would be even more interested in capital planning and effective programme management.

We would expect our airline customers to retain an important interest in our planning; as with other normal commercial transactions, we would expect this engagement to occur through the negotiation and due diligence one associates with bilateral contracting. By removing RAB based regulation, operational level consultation at the design and product development stages would be enhanced. The airport's ability to increase prices would ultimately be limited by the market through airline contracts and the price path and service level specified in Airport Commitments.

This reduces the regulatory link between capital investment and price, but re-establishes the link between return and spend. The detailed scrutiny of projects will shift largely to the airport management and its shareholders, as in other competitive sectors²².

Service levels and future service provision would be at the airport's risk without the protection of regulation. We could develop clearer links with the airlines' operational teams to help facilitate their growth at Gatwick.

Planning horizon

RAB based regulation requires a substantial degree of inflexible planning which is very rarely (if ever) seen in competitive sectors. In the absence of regulation, capex and future service would not be fixed for what is effectively 7 years. We would expect Gatwick to adopt a process more akin to that of competitive companies. This could involve:

- Setting out and maintaining a Masterplan vision for the long term;
- Maintaining a more detailed plan for the shorter term; and
- Acting flexibly in the medium and short term to provide the capacity that is needed given changes in the market and traffic forecast. This would increase the focus on operating efficiency and reduce the risk of inefficient capital spend.

This approach would enable Gatwick to respond in a commercially agile way to changing market conditions. Our market position has been impacted by a number of events over the recent past which the regulatory regime was (understandably) unable to foresee:

- The change in traffic mix, including the operational decisions by BA, and the sudden move of trans-Atlantic services to Heathrow in response to the replacement of the Bermuda II regime with the Open Skies regime;
- The rapid expansion of easyJet; and
- The 2006 liquid bomb threat (reducing security productivity by around 30% overnight).

²² In competitive sectors, contracts are commonly entered into following a period of mutual due diligence. This is different in many ways from the existing Constructive Engagement process in that there are few (or no examples) of competing entities conducting due diligence jointly on projects.

YOUR LONDON AIRPORT

Gatwick

The regulatory system requires the airport to predict things for up to 7 years ahead in a world that can change quickly. To be able to compete and grow, we need to be able to respond in a flexible and timely fashion, to be able to innovate quickly and where appropriate take risks – all things which a regulatory system cannot adapt to.

Undermining of potential gains from competition in investment

The CC's airports market investigation concluded that competition could be expected to emerge in relation to the pursuit and delivery of new airport capacity and other major capital expenditure projects²³. However, if binding regulation continues this is unlikely to transpire.

Currently the provision of airport capacity and other major capital investment projects is largely dependent on regulatory decisions and commitments. If the regulator gives clear and credible commitments to allowing the capital expenditure to be remunerated (whether in the context of the RAB model or otherwise), capital investment incentives will be heavily influenced by these commitments (and less by competition or other market imperatives). If the regulator fails to give credible commitments, the outcome will be suboptimal since airports will continue to regard future regulatory actions as critical to whether these investments are expected to be profitable, but these actions will be highly uncertain. It will not result in competition and market demands determining capital expenditure; more likely it will simply result in the project risks rising appreciably.

More generally, this is an area that is likely to raise particularly difficult questions for the regulator. Capacity expansions at one airport will not be independent of capacity expansions at other, potentially regulated, airports and it is unclear how the regulator will take this into account given the importance of such investments to the commercial futures of individual airports. Given that Q5 ends in 2014 before decisions on capacity in the South East that are expected in the following year, the CAA will need to be clear how any scheme of regulation bears on the treatment of new runway projects that might become available following Q5. The CAA will need to consider the costs and benefits of any such arrangements, but also the costs that are likely to flow from any lack of clarity as to how the CAA will treat investments pursued by individual airports in an increasingly competitive market. These issues are dealt with further below.

d) Other potential adverse effects now or in the future

As well as the above specific issues related to RAB-based price controls, other important problems with regulation in general that the CAA will need to bear in mind include:

1. Distortion of market signals where airport charges are held below capacity clearing levels, as is the case with the operation of a single till RAB-based price control, or below long run average incremental costs (LRAIC). Such issues are of greater importance where substantial capacity enhancement is envisaged, since the absence of market signals risks the mis-specification or mistiming of major investments;
2. A tendency to a one-size-fits-all approach and to negotiations "by committee", thus failing to accommodate the wide variations in different airlines' and passengers' demands (e.g. as evident in the constructive engagement process, and the concept of "competitive equivalence" which leads to similar pricing and service approaches for all users); and

²³ *BAA market airports investigation*, CC (March 2009), paragraph 5.22: "We consider that there is considerable scope in the South-East for the process of competition to improve capacity delivery and in so doing overcome existing capacity constraints and the consequent need for price cap regulation (at least at Gatwick and Stansted) and deliver customer benefits."

YOUR LONDON AIRPORT

Gatwick

3. A risk of focussing selectively and excessively on the narrow and short-term interests of airlines – since they are the most vocal potential participants – with less weight placed on passengers interests (e.g. the failure of the regulatory regime to tackle check-in queues which cause significant detriment to passengers²⁴). Such a situation would be at variance with the CAA's revised statutory duties.

The performance of the traditional model may be worse in future

As we have pointed out above, the problems with regulation that have contributed to – or at least permitted – poor airport performance may be difficult and complex to remedy. Moreover, there is significant risk that the performance of the traditional regulatory model will be worse in the future, rather than better. The principal benefit of the traditional RAB model has been that it provided a stable basis for capital investments to progress with relatively low regulatory risk associated with them. However, even if there was reasonable regulatory credibility in this area in the past, there are increasing question marks regarding whether that credibility would survive into the future if the traditional model were to be adopted. As we have outlined earlier, RAB based regulation provides mixed incentives on capex with, on the one hand, RAB-based returns potentially encouraging airports to build bigger and earlier than required but, on the other, the lack of a long term framework (given periodic reviews of returns) meaning that there may in practice be more focus on lower risk, incremental investments.

In considering the likely future performance of a RAB based regulatory model the following observations should be taken into consideration:

- The CAA was unable to provide a clear sense of direction in respect of the regulatory arrangements for a second Stansted runway (prior to the 2010 change in Government policy)²⁵. This removes the principal benefit of the RAB framework, namely its ability to reduce regulatory risk in respect of significant projects and raises significant questions as to how forthcoming or durable any future commitments might be in respect of other projects.
- The difficulty of accommodating the greater competition arising from the new ownership structure. Post-sale Gatwick now faces much greater competitive pressures than prevailed in the past. Even if the regulatory regime attempts to commit to remunerating investments in the long run, Gatwick faces genuine risks of downside scenarios emerging in which it could fail to recover its investments. The danger is that continued regulation would cap the upside, while leaving Gatwick to deal with the downside. This asymmetric risk would lead inevitably to reduced incentives to invest in projects which are otherwise desirable and in the interest of passengers.
- More generally, it is not at all clear how the CAA would set binding price caps (and the associated investment programmes) for different airports in circumstances where the regulatory decisions for one airport may have consequences for other competitive airports. While Gatwick

²⁴ This risk has been well aired in recent regulatory debates, and is reflected in the DfT's proposed changes to the CAA's statutory duties. *Reforming the Framework for the Economic Regulation of Airports*, DfT (December 2009) paragraphs 3.24 and 3.26: "Given the broadly competitive nature of the airline market, the incentives of passengers and airlines will frequently be aligned, but this is not universally the case. Where their incentives are not aligned, the interests of end users of airport services should quite properly take precedence over airlines'."

"We believe that a primary duty focusing on passengers is crucial to putting the passenger at the heart of the new regulatory regime."

²⁵ *Economic Regulation of Stansted Airport 2009-2014 CAA Decision*, CAA (March 2009), paragraph 5.45: "The CAA has, in line with the recommendations of the Competition Commission, drawn up its proposals for the Stansted Q5 price cap without evaluating the strength of the case for a second runway."

YOUR LONDON AIRPORT

Gatwick

has not yet fully explored these sorts of interdependencies, clearly they will need to be fully worked through by the CAA in coming to a view on the balance between the costs and benefits of regulation.

Some of these problems may well arise even if a more light handed regulatory approach is adopted. To the extent that this is the case, the CAA will need to factor this into the design of any regulation and its assessment of the costs and benefits.

YOUR LONDON AIRPORT

Gatwick

There is no regulatory panacea

In order to regulate Gatwick with a licence the CAA needs to pass the substantial hurdles represented by the three tests. These include demonstrating that Gatwick possesses SMP, that this results in risk of abuse that competition law is insufficient to address, and that the benefits of any proposed regulation outweigh the costs. To establish this for the purpose of Test C the CAA needs to consider:

- The incremental benefits of regulation relative to all other constraints. These include, in addition to competition law other constraints such as from competition, the Airport Charges Directive, and the Commitments in terms of Price, Service Quality, Consultation and Investment volunteered by Gatwick.
- The cumulative adverse effects of regulation, resulting from direct and indirect costs imposed on Gatwick, the regulator, industry, and society as a whole through distorted incentives and crowding out of competition, which will result in loss of overall economic welfare.

While in this paper these have been largely presented in terms of RAB regulation it is clear that many of the adverse effects identified apply more generally to economic regulation and that attempts to 'perfect' regulation are likely to also lead to distortion and resulting costs, as well as to greater complexity. Given the continuing development of competition, and the Commitments and contracting framework proposed by Gatwick, there are unlikely to be regulatory solutions available where the incremental benefit outweighs the costs – even assuming that Tests A and B identify a problem sufficiently significant to suggest that regulation needs consideration. The evidence so far available does not lead in that direction.