

YOUR LONDON AIRPORT  
*Gatwick*



Economic regulation of new runway capacity –  
a draft policy  
CAP 1221

Response from Gatwick Airport Ltd

**PUBLIC VERSION**

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### 1) Executive summary

We welcome the opportunity to comment on the CAA's draft policy for the economic regulation of new runway capacity. We support the core three principles of the CAA's draft policy document:

- **Principle 1: Risk should be allocated to those who can manage it best** – we believe that the airport is best placed to manage most of this risk. This result would be achieved through Gatwick's proposed R2 Commitments framework;
- **Principle 2: Commercial negotiations should be encouraged** – the proposed R2 Commitments framework will allow Gatwick to enter into bi-lateral contracts with its airlines, much as it has done under the existing framework; and
- **Principle 3: Capacity can be paid for both before and after it opens** – this approach will be key to delivering the runway, as it will help to underpin financing and so lower the overall project cost. It is also in line with what would normally occur in markets with increasing capacity constraints.

#### **Gatwick's R2 Commitments proposal**

Gatwick is proposing an R2 Commitments framework, which is entirely consistent with these three principles. In summary, our proposal is for:

- Gatwick to commit to deliver a new runway and appropriate infrastructure by 2025, to charge between £12 and £15 per passenger for the period of the regime and to meet appropriate service standards; and
- In return for this, Gatwick needs certainty that this regime will not be altered for a period of X years from opening the second runway, and needs the planning permission for the new runway to be achieved by X.

Also, we would highlight that under this regime Gatwick will be taking on the great majority of the risk associated with the new runway – consistent with the CAA's principles. X

Expansion at Gatwick, underpinned by R2 Commitments, would aid the development of greater airport competition and, separately, greater airline competition. Given the CAA's duties to further passenger interests and the promotion of competition, we believe that the CAA should find the R2 Commitments proposal helpful for the development of the market in a competitive manner.

#### **Applying the policy framework for economic regulation of new runway capacity**

It is critical that the Airports Commission ("AC" takes into account the way risk is to be managed (and therefore Gatwick's R2 Commitments proposal) in its assessment. X

We support the CAA's recognition of the benefits of commercial contracts between airlines and the airport. We believe that significant benefits for both parties are already being derived through such

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contracts and that this can continue in an R2 environment.

While every endeavour will be made to enter into bilateral agreements with airlines at the earliest opportunity, it is genuinely difficult to predict with any certainty the timetable for concluding such contracts. This reflects the level of uncertainty surrounding the second runway development, including which airport will be selected and therefore the level of engagement from airlines.

The R2 Commitments can be more confidently progressed in the short-term to provide sufficient certainty (to the airport, the Government, and the airlines) to advance the planning and development of the second runway. The R2 Commitments will also provide a firm foundation upon which bilateral contracts can be structured.

Given this, we would suggest that the assessment of progress the CAA indicates it will make within six months of any Government decision takes into account both the R2 Commitments and the status of discussions on bilateral arrangements.

The appendix contains detailed comments in response to further items in the CAA's draft policy document.

Finally, we invite the CAA to engage in discussions to allow Gatwick to explain in full its ideas for applying the above policy framework to its expansion option.

## 2) Response to the CAA's principles for the economic regulation of new runway capacity

### Introduction

This section confirms Gatwick's support for the principles expressed by the CAA in Chapter 3, in relation to expansion ("category C") costs. The three principles set out by the CAA are:

- *Principle 1: Risk should be allocated to those who can manage it best;*
- *Principle 2: Commercial negotiations should be encouraged; and*
- *Principle 3: Capacity can be paid for both before and after it opens.*

### Principle 1: Risk should be allocated to those who can manage it best

We support the CAA's principle that risk should be allocated to those who can manage it best since this is likely to be the best way of minimising the costs of the project and therefore protecting the interests of users. If risks are allocated to parties who are less able to manage them, then risk related costs will be higher than necessary. These increased costs would be passed on to passengers in the form of higher fares. Therefore, it is strongly in the passengers' interest to minimise such costs by allocating risks efficiently.

We believe that the airport is best placed to manage the main project risks, within a framework that adequately remunerates it for doing so. We have reviewed the key project risks, which include construction cost, traffic and financing risks and we are in a position to take on the great majority of these risks within our proposed R2 Commitments framework. As we develop our proposal we will provide greater clarity as to which risks we are not able to take on, but would re-iterate that all our analysis indicates that we can take on the great majority of the risks.

Chapter 3 describes our proposed R2 Commitments approach for the expansion of Gatwick, including our general approach to risk allocation. We believe that such a framework offers certainty about risk and its implications (including on pricing) for users, the CAA and the Government.

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### Principle 2: Commercial negotiations should be encouraged

We support the concept of commercial contracts between the airport and airlines. Our current Contracts and Commitments framework is evidence of the opportunity to create and grow flexible win-win bilateral relationships to replace the multilateral, one-size-fits-all approach implicit in a RAB based regime. Since its inception in April 2014, we have entered into contracts with over 80% of our airlines, measured by passenger numbers. This model is working well for both the airlines and the airport.

We believe that contracts between the airport and airlines are no less feasible in an expanding Gatwick. Indeed, runway expansion increases both the need for and the opportunities from commercial contracts; the airlines will gain greater security over the charges they will pay and the airport will have great assurance over the traffic required to justify the investment. Further, the reversal of a contractual approach at the end of the current Commitments period would be a retrograde step given the progress that has been made so far.

We see the new commercial contracts working in a similar way to those under the existing Commitments approach which has enabled Gatwick and the airlines to enter into contracts. The future position with expansion would be similar, with the overarching R2 Commitments framework needing to be developed in conjunction with contract discussions; it is unlikely that contracts will take effect until the R2 Commitments are in place. We have set out in Chapter 3 what we believe the R2 Commitments will need to consist of initially.

However, there needs to be realism about the timing of airport-airline contractual agreements, given the current extent of uncertainties. We discuss these limitations and their implications further in Chapter 4.

### Principle 3: Capacity can be paid for both before and after it opens

We support the CAA's position that charging for new capacity can occur both before and after it opens, primarily for the same reasons as the CAA mentions:

- 1) **Reducing funding risk:** The overall cost of the project is reduced, because the cost recovery risk is mitigated. This would reduce the cost to passengers, which would be in the passenger interest;
- 2) **Usual competitive response:** It is consistent with the working of competition in a market with capacity constraints where charges would be related more to the balance between supply and demand over time than the opening of new capacity. Further, a proportion of the scarcity rents that benefit the industry (including airlines) ahead of the opening of new capacity<sup>1</sup> should be used to invest in capacity growth, as would be the case in any other competitive market with capacity constraints; and

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<sup>1</sup> This point was supported by the OECD's International Transport Forum, in its recent report for the Airports Commission: "If demand for airport capacity is larger than supply and prices for using that capacity for airlines are lower than the market clearing price, excess capacity produces an economic rent. This is the 'potential for earning a return in excess of the average cost of supplying runway service' (Starkie 1998, p.112). These excess returns cannot be captured entirely by airports such as Heathrow and Gatwick under the current regulatory framework as their prices are capped. The airlines, however, will charge the passengers what the market can bear in matching demand with available seats and hence, the airlines capture the economic rent." ITF. "Expanding Airport Capacity: Competition and Connectivity; The case of Gatwick and Heathrow". December 2014. Page 78.

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- 3) **Smooth pricing:** Steady increases in charges are preferable to sudden larger steps, and can help to reduce a single large increase in charges when the capacity opens.

We would add the following factors, in support:

- 4) **Benefits of correct pricing signals:** Increases in charges ahead of the opening of capacity help to test the market and so to fine tune the precise amount of capacity to be made available under Gatwick's phased approach. This helps to reduce traffic risk and thereby lowers cost; and
- 5) **Early recovery of costs is important for the business case:** Without the ability to recover some of the costs earlier than the opening date for new capacity, funding for the expansion will be more challenging. This point has been recognised by the AC.



We would refer the CAA to our comments on the topic from the previous round of consultation<sup>2</sup>.

We note that the CAA refers to the “front-loading” of costs as implying that users would carry the demand (traffic) risk, and that if the benefits of such a proposal do not compensate users for carrying this risk, then the CAA will not implement the policy<sup>3</sup>. Our R2 Commitments proposal, as described in Chapter 3, entails Gatwick bearing usual traffic risk as part of the overall package. Therefore, in the Gatwick proposal, users would not carry usual traffic risk and so this factor should not be a barrier to the CAA's policy.

We note also the CAA's concern that a market clearing price, absent of regulation, “*might be very high and that taking full account of this price level could create substantial volatility that is not in the long-term interests of users*”. Our R2 Commitments proposals feature a mechanism for smoothing prices over the long term, to prevent price volatility. Further, our R2 Commitments proposal sets a realistic and affordable price cap level designed to encourage traffic growth in conjunction with opening the new capacity, rather than to constrain demand. In this regard, the interests of the airport and passengers are aligned.

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<sup>2</sup> Gatwick. “Discussion paper on the regulatory treatment of issues associated with airport capacity expansion CAP 1195: Response from Gatwick Airport Ltd”. July 2014. Page 31.

<sup>3</sup> CAA. “Economic regulation of new runway capacity – a draft policy”. Paragraph 3.27.

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### 3) Gatwick's proposal for R2 Commitments

#### Introduction

Gatwick proposes to extend to R2 the successful concept of Commitments already entered into by Gatwick as an alternative approach to managing economic risks at the airport. This chapter sets out a summary of the key principles that have shaped the proposal, together with an outline of the R2 Commitments ✂.

#### Building on the existing Commitments

During the most recent review of economic regulation at Gatwick Airport, the concept of Commitments was supported by the CAA as a better approach than a RAB based price control, aligning the interests of airlines and airport and allowing the development of commercial bilateral arrangements. The CAA backed-up the Commitments approach with a licence and monitoring programme.

These “existing Commitments” set out, amongst other matters, the service standards that Gatwick will deliver to passengers and airlines, the minimum investment in infrastructure it will undertake, and the limits on airport charges that Gatwick may levy. The existing Commitments have a 7 year duration. The Commitments provide an overarching framework within which Gatwick and its airlines can operate, but also allow for the development of bilateral contractual arrangements between Gatwick and individual airlines.

The R2 Commitments are a logical extension of this successful concept, providing a long-term framework for investment in the airport, the specification of service standards, and the setting of airport prices. ✂

We are encouraged to note that the CAA's draft policy paper recognises that “*the commitments approach adopted at GAL ... could provide a useful framework for us to build on*”.

#### Risk allocation

In drafting the R2 Commitments, we have taken into account the CAA's first principle that: *risk should be allocated to those who can manage it best*. The R2 Commitments provide that the airport bears long-term traffic, market price, and construction risks, while having the latitude to set prices within certain defined boundaries. This approach to risk management similarly creates the right incentives to efficiently manage the development and operation of the airport.

#### Commercial negotiations

In drafting the R2 Commitments, we have taken into account the CAA's second principle that: *commercial negotiations should be encouraged*. The implementation of an overarching Commitments framework has enabled already Gatwick to enter into a series of long-term bilateral contracts with airlines. We are confident that, in due course, such contracts can form the basis of extended bilateral agreements encompassing the development of a second runway.

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Nevertheless, it must be recognised that the level of uncertainty surrounding the second runway development - not least the timing of any Government decision - is likely to affect the negotiation timetable for such contracts. In this context, the R2 Commitments play an important role in the near-term in providing sufficient certainty (to the airport, Government, passengers and airlines) to progress the planning and development of the second runway.

Further, business models of airlines have evolved in recent years and, in a competitive airline market, they are extremely cautious around providing absolute volume guarantees and/or entering into fixed price arrangements of any meaningful duration. But, medium to long-term contracts with year-by-year incentives to maintain and grow passenger volumes are certainly achievable. Such arrangements, while not fully mitigating long-term traffic and market price risks for the airport, will remain important as a means of accelerating traffic growth and building the airport's market share at a predictable price. In this context, R2 Commitments will play an important role in providing a framework within which multi-year contracts can be put in place and extended and replaced over time.

In structuring the R2 Commitments, we propose to put in place an overarching framework to ✂ provide the airport with the necessary confidence to bear long-term traffic, market price, and construction risks, while encouraging commercial negotiations with airlines.

### Key elements of the R2 Commitments

Set out in the following paragraphs is a summary of the principal terms of the R2 Commitments.

#### Form of R2 Commitments

The existing Commitments are a 7-year contractual undertaking between Gatwick and its airlines, backed by a licence issued by the CAA. Bilateral agreements of similar duration have been negotiated between Gatwick and individual airlines, within the framework of the existing Commitments.

The level of capital expenditure planned within the existing Commitments period is sizeable, being approximately £150m p.a., with a balance between replacement and expansionary expenditure. However, the development of a second runway requires much more substantial investment and is a project of much greater national significance. ✂

The R2 Commitments ✂ will establish a long-term framework for the expansion of the airport, the specification of service standards, and the setting of airport prices. ✂

It is expected that over time we will seek to renew or renegotiate the bilateral contracts already signed with certain airlines, and enter into new agreements with other airlines seeking to access the airport. These contracts would sit within the longer-term R2 Commitments framework.

#### Duration of the R2 Commitments

The existing Commitments have a duration of 7 years, with potential for extension. This was appropriate in the context of a relatively mature business with a capital programme of c. £150m p.a. on average over this period, and a balance of expansionary and replacement projects.

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A much longer duration is required to accommodate the transformational expansion of Gatwick with a second runway, reflecting: the long-lived nature of the assets; the time taken to fully utilise the new capacity; ⌘ and the need to match the tenor of the financing.

The R2 Commitments are envisaged to extend to ⌘, effectively ⌘ years from opening the second runway, and ⌘ years from recommendation by the Airports Commission.

### **Infrastructure development**

The cornerstone of the R2 Commitments will be an undertaking by Gatwick to complete the second runway and initial phase of the third terminal by the end of 2025 (“Phase 1”), subject to completion of the necessary planning process by no later than December 2019. ⌘ Gatwick is committed to delivering this at a price range of £12 to £15, which can be set today (see “Price” section below). We will continue to refine these development proposals through consultation with representatives of passengers, the CAA and airlines, and through the planning process involving local authorities and the general public.

Gatwick has also set out in considerable detail for the Airports Commission its plans for further terminal capacity increases (Phases 2, 3, 4) in the 2030s and 2040s. However, the timing and scope of these subsequent developments are naturally less certain, and will be defined and delivered at such time as required to meet passenger demand and the then prevailing passenger service standards. ⌘

### **Service**

The existing Commitments specify airport-wide core service standards that Gatwick undertakes to meet, and the rebates paid in the event that it fails to do so. The standards encompass a range of matters relevant to passenger service (e.g. reliability lifts & escalators, security clearance times, pier service) and availability of equipment for use by the airlines (e.g. outbound and inbound baggage systems), and includes the results of a qualitative passenger survey.

These standards will be replicated in the R2 Commitments. However, given the extended duration of the R2 Commitments and the likelihood that passenger and airline requirements will evolve over time, we believe there should be provision for a periodic review of these airport-wide service standards. It is envisaged that the CAA would be best placed to represent the general passenger interests in agreeing any such changes.

Of course, the requirements of individual airlines - if different to the airport-wide service standards - can be dealt with separately through bilateral agreements, as is currently the case.

### **Price**

The airport would carry the great majority of the investment risks associated with the expansion, primarily: traffic, construction and market price risk.

We believe that market conditions - currently, and most certainly in the future if there is additional runway capacity at Gatwick or Heathrow - are likely to be such that there is no requirement for the regulation of prices at Gatwick. Nevertheless, we recognise that airlines and the CAA will take

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significant comfort from some form of price oversight. Further, even if such oversight is not imposed at the time that the new runway is open, it may emerge at some later stage when the airport has already sunk significant capital into the airport expansion. This exposes Gatwick to political and regulatory risks, over-and-above the core investment risks noted above.

To address both these concerns, we believe it is essential that the R2 Commitments establish firm boundaries within which Gatwick can exercise pricing discretion. The details of these will need to be refined in due course. However, the key principles are as follows:

- **Real terms:** All prices are quoted in terms of 2014 prices, and will be indexed annually at RPI;
- **Price bases:** The primary price benchmark will be net airport charges per passenger, since this relates to the actual charges per passenger received by Gatwick (after discounts) for the provision of airport core services;
- **Expected price path:** The R2 Commitments will set out an expected net price path, taking into account Gatwick's base case assumptions on traffic, capital expenditure, etc. Actual prices may be higher or lower than this dependent upon market conditions and the crystallisation of risks.

In our submission to the Airports Commission in May 2014 we indicated that net prices are expected to fall in the range of £12-15 per passenger over the duration of the R2 Commitments, building from c. £9 per passenger in 2014/15. This remains our expectation.

Discounts given under the terms of bilateral agreements will generally be applied relative to the published tariff. It is expected that the level of discounts will be higher in the initial years following the opening of the second runway than in the years immediately before, reflecting the tighter capacity prior to the runway opening, and released of capacity thereafter;

- **Firm price limit:** In order to protect airlines and passengers against increases in prices, we propose that a Firm price limit be established, restricting the ability of Gatwick to increase prices above this level, calculated over the duration of R2 Commitments. ✂

Further, we envisage there being provision for possible adjustment of the Firm price limit, but only with the approval of the airlines and/or the CAA ✂; and

- **Price monitoring:** There may be a variety of reasons as to why we find it necessary to increase net prices above the expected price path towards the Firm price limit. To provide even greater assurance to CAA, passengers and airlines, we propose the inclusion of Price monitoring provisions in the R2 Commitments. These will enable the CAA to consider whether Gatwick is pricing appropriately in developing the second runway, while still ensuring there is sufficient long-term certainty to support the initial investment and financing.

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### Relative merits of R2 Commitments compared to a RAB based model

We believe that there are significant benefits of a Commitments approach, compared to a standard RAB based model. During the last regulatory review, we provided the following views about the inappropriateness of the RAB based model for Gatwick's future:

- “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;*
- 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.<sup>4</sup>”*

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<sup>4</sup> Gatwick. “Assessing the Adverse Effects and Benefits of Regulation”. May 2013. Page 18.

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We note that the CAA also concluded the inappropriateness of the RAB based model, with preference to the Commitments model, at the end of the last regulatory review:

*“...Commitments offer a number of benefits over a RAB-based framework from the additional flexibility and greater potential for bilateral contracts which could allow better tailoring to the needs of individual airlines and their passengers. This would not only enhance choice and value to passengers, but would also facilitate airport competition although given that GAL has SMP this is likely to be limited in scope. The commitments would also provide other benefits above a RAB-based framework from:*

- *The greater certainty to airlines and their passengers as they are for seven rather than five years;*
- *The strengthening of the airline and airport operator relationship as the commitments are to airlines rather than the CAA which would reduce management distraction; and*
- *Avoiding some of the distortions to incentives that would be present under a RAB-based framework, for example in relation to investment incentives, and it would encourage rather than crowd out a more commercial approach.*

*A commitments and licensing and monitoring regime would also reduce the direct costs of regulation compared to RAB-based regulation.<sup>5</sup>”*

We agree with those sentiments and highlight, in the particular circumstance of capacity expansion, that a Commitments approach is even more preferable over a RAB based model because:

- **Value creating opportunities:** As mentioned above, the existing Commitments have generated the opportunity to develop win-win contractual arrangements between airlines and the airport. This is creating value, compared with the one-size-fits-all lowest common denominator encouraged by the RAB based approach. These opportunities will be even more important in a future with expanded capacity; and
- **Risk allocation:** We believe that in the context of long term and substantial capacity development, risk allocation can be decided at the outset. R2 Commitments gives certainty to users and to the Government that risk can be allocated to the airport, while still ensuring that the expansion is delivered, for a capped price. ✂

These difficulties with a RAB based approach underline the significant advantages of the R2 Commitments model.

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<sup>5</sup> CAA. “Economic regulation at Gatwick from April 2014: notice of the proposed licence”. January 2014. Page 295.

## 4) Applying the policy framework for economic regulation of new runway capacity

### Introduction

We note that the CAA's policy document does not try to set out the detailed features of a regulatory model, which would be applied to the recommended expansion scheme. We agree that it is too soon to make such a decision, at a detailed level. This section sets out our views as to how the CAA's policy on risk allocation can best be reflected within the AC's process; as well as commenting on the CAA's proposal to assess a commercial approach around six months after a Government decision.

### How the CAA's policy is reflected in the AC's assessment

We believe that the AC needs to take into account the allocation of risk implied by the different schemes that it is considering. ✂

### How commercial negotiations may be expected to develop

We welcome the CAA's recognition of the benefits of commercial contracts between airlines and the airport. We believe that significant benefits for both parties could be derived through such contracts, at a time at which it is realistic to expect their negotiation. Our current Commitments framework is evidence of the opportunity to create and grow flexible win-win bilateral relationships, replacing a multilateral, one-size-fits-all approach.

We believe that runway expansion does not change the need for, or the opportunities from commercial contracts. Further, we believe that the reversal of a contractual approach at the end of the current Commitments period would be a value-reducing retrograde step for the CAA to take.

We also believe that contracts between the airport and airlines are no less feasible in an expanding Gatwick; in contrast, we believe that the opportunities delivered by new capacity would grow the benefits of contracting, for both the airport and airlines.

We note that the CAA proposes to review whether a commercial approach could support capacity expansion, given the uncertainty of whether commercial deals are possible, around 6 months after a Government decision<sup>6</sup>. We see three considerations with a contractual approach, which the CAA needs to take into account in setting its policy:

- 1) **Timing of contracts signing:** Currently, we are in discussion with a number of airlines about Gatwick's expansion. However, the CAA's policy should be realistic and take into account the length of time needed for contracts between the airport and airlines to be signed, because:
  - It remains uncertain which airport will be selected, thereby potentially reducing the level of engagement from airlines;

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<sup>6</sup> CAA. "Economic regulation of new runway capacity - a draft policy". October 2014. Paragraph 3.24.

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- There are already contracts in place which run to 2021, so there is a weaker commercial imperative to put in place new contracts;
- There are significant uncertainties around an individual airline's need for capacity, given the length of time before capacity would come online; and
- R2 Commitments would be established ideally, as a baseline against which contracts would be compared, to enable contractual negotiations to conclude.

Therefore, we would conclude that the CAA's assessment for the prospects of commercial contracts within a commercial approach around 6 months after a Government decision could be premature. Nevertheless, we will seek to develop contracts in discussion with airlines and should any progress be made, we will update the CAA and the AC;

- 2) **R2 Commitments need to be assessed in isolation from contracts:** Given the potential length of time needed to agree contracts and the uncertainty around this timing, we believe that the CAA should consider initially the benefits of R2 Commitments in isolation from contracts. ✕ The assurances provided by R2 Commitments deliver significant benefits compared to a regulatory approach, as discussed above. Given that contracts are likely to be dependent on R2 Commitments and they are unlikely to be signed immediately, we would suggest that the CAA conducts its future assessments on the basis on R2 Commitments; and
- 3) **Financing does not require airport/airline contracts:** Finally, we note that the CAA implies that airport/airline contracts are needed to finance expansion. Given the R2 Commitments proposal, we have analysed the projected market and risk profiles and we consider that expansion can be financed under the R2 Commitments framework, without the need for airport/airline contracts, although clearly, contracts would provide additional benefits to all parties concerned. However, we would reiterate the need for long term regulatory certainty made possible by R2 Commitments, as described above.

## Appendix: Response to specific policy details

### Introduction

This section provides Gatwick's comments against the following remaining specific policy areas contained in the CAA's consultation document:

- Financeability (CAA's Chapter 2);
- Price control structures (CAA's Chapter 4);
- Treatment of lobbying / category A costs (CAA's Chapter 5);
- Treatment of planning / category B costs (CAA's Chapter 5);
- Market power assessments (CAA's Chapter 7); and
- Slot allocation rules (CAA's Appendix D).

### Financeability (CAA's Chapter 2)

#### The need to secure that each licensee is able to finance its operation

We are concerned about the apparent re-stating of the CAA's duty relating to financeability in the policy document. The words of the duty refers to the "need to secure that each holder of a licence...is able to finance" its operations; whereas the policy document states that "*this duty implies that when we act, we do so in a manner that does not undermine the ability of the airport operator to raise finance*"<sup>7</sup>. The CAA's duty refers to a positive action – the need to secure the ability to finance, rather than a passive requirement not to undermine financeability.

Given that the CAA accepts that its regulation plays an active role in the commercial future of the expanded airport<sup>8</sup>, we believe that it is important that the CAA ensures actively that, in performing its duties, it has regard to the ability of Gatwick to finance its operation (both current and future).

### Price control structures (CAA's Chapter 4)

In its draft policy document, the CAA discusses a number of other features. Our positions on these features are:

- **Split RAB/separate RAB for the new runway/special purpose vehicles:** Currently, we see little value in such mechanisms, given the high level of financial and operational interaction between current and future capacity;
- **Project opex treated as capex:** We agree with the CAA that project opex should be capitalised, on the basis that it is confirmed as being related to the project;

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<sup>7</sup> CAA. "Economic regulation of new runway capacity - a draft policy". October 2014. Paragraph 2.20. We have added underlining to emphasise the difference in language.

<sup>8</sup> CAA. "Economic regulation of new runway capacity - a draft policy". October 2014. Paragraph 3.18: "*in general, airlines and/or airport operator may consider that a more favourable outcome could be achieved through regulation*".

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- **Sculpted depreciation:** We cannot see a justifiable reason at this stage to purposefully increase overall project risk, and hence charges, through delaying the recovery of depreciation charges, without a commercial rationale. As indicated in chapter 3, Gatwick foresees the need to discount charges most when excess capacity is greatest. While this may have the same effect as delaying recovery of depreciation, the key difference is that it will be decided commercially and according to market factors rather than a predetermined regulatory formula;
- **WACC related to the conditions faced over the duration of the period:** While we do not see a regulatory WACC as component of the R2 Commitments proposal, if the CAA chooses to calculate a WACC, then we believe that this calculation needs to take into account the project lifetime risk. The WACC will tend to be highest in the early years of the project when risks are greater. Therefore, any consideration of the WACC over the lifetime of the project needs to take proper account of, and give proper weighting to, the variation of the WACC over time; and
- **Duration of price controls:** We believe that the CAA has omitted a significant benefit to a longer control period: a reduction in regulatory risk. Regular regulatory decisions grow the opportunity for changes in regulatory policy, thereby raising regulatory risk. Our R2 Commitments proposals features a 3 year period from the opening of capacity, to account for the recovery of project costs, in which regulatory risk can be avoided, in order to lower overall project risk and the cost to passengers.

### Treatment of lobbying / category A costs (CAA's Chapter 5)

We are concerned that the CAA's emerging policy could block recovery of some of the costs that are being incurred currently. We believe that many of the costs we have incurred to date cannot properly be characterised as 'lobbying', as opposed to developing and explaining a case as part of a public process, with the benefit that the CAA has previously recognised of creating genuine competition for the development of new capacity. Such competition is clearly to the benefit of users, not least in forcing all parties better to clarify their proposals and to give the AC better information on which to make its decision. Moreover:

- **Such engagement was requested:** The Government, through the AC, has invited parties to engage in the process and to compete to develop the best case; and
- **Expansion efforts have failed so far, so the CAA needs to recognise the validity of the AC process:** We are concerned that the CAA appears to believe that the AC process is "*part of a political strategy to convince stakeholders about the merits of a particular proposal, rather than in delivering capacity*". Far from that, it has been an exhaustive process designed by the AC to create the basis for its decision. Further, we note the difficulty in achieving expansion in the London and South East market, given the number of failed attempts over the last 20 years. We believe that the CAA should not underestimate the benefit of the transparent review process, conducted by the AC in achieving the benefits for passengers from expansion. Therefore, we see the costs of engagement with the AC process as genuinely contributing to the delivery of expanded capacity and the passenger benefits that it will deliver.

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Some of the costs currently being incurred are genuine development costs and would be necessary for a planning application. The AC's process has required the development of detailed plans, costing and financing plans, which will also be needed for the planning process and subsequent development. We request the CAA to allow the recovery of these costs because:

- **Developing the case now allows for faster implementation:** Given the magnitude of the work involved in a planning application, the more work completed sooner, the faster that capacity can be developed. The faster Gatwick's capacity can be developed, the sooner that passengers can benefit from lower fares, through increased competition; and
- **Benefits otherwise delivered to users for free:** If shareholders incur the costs necessary to secure the benefits of expansion for users (as decided by the AC), then they would not be receiving a fair return for their investment.

Therefore, we request the CAA to refine its policy to recognise that many of the costs incurred ahead of the Government's decision on expansion should be recoverable. We propose to work with the CAA to assess those costs that should be recoverable.

### Treatment of planning / category B costs (CAA's Chapter 5)

We welcome the CAA's acceptance that these costs should be charged to users, if efficient. Such costs will be central to developing the new capacity and therefore it is appropriate that these amounts are recoverable. Again, we note that some costs incurred ahead of a Government decision are related to developing a planning application and the CAA should change its policy to allow for these costs to be recovered.

We accept the CAA imperative to ensure that the planning costs incurred are efficient. Our R2 Commitments proposal will contain a new proposed mechanism for dealing with the efficiency of such costs.

### Market power assessments (CAA's Chapter 7)

We agree with the CAA that the timing of the next market power assessment should be closer to the opening of new capacity. However, we see merit in potentially conducting an assessment before the new capacity is opened. This would depend on there being a material change in circumstances (which may not be limited to the opening of new capacity).

For the moment, we do not see value in distracting parties engaged in the AC process with a market power assessment.

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### Slot allocation rules (CAA's Appendix D)

Currently, we offer contracts to airlines and are bound by slot allocation rules. We do not control the slots that would be taken up by expanding airlines, and so we are not able to guarantee slots in a contract negotiation, in exchange for volume guarantees from airlines. Our contracts that are based on volume growth, incentivise the airlines to source all of the necessary means of production (e.g. planes, crew and slots etc.) in exchange for volume based discounts.

Clearly, this model could continue within an expanded Gatwick and we see no absolute barrier to commercial contracts from the current slot allocation constraints; however, reform of the rules would be beneficial. Such rules were invented to break local airline monopolistic services, particularly in cities with a single airport and in a case where there is only incremental airport capacity growth. It is not clear that the rules were designed for an integrated London and South East market, in which more than one airport serves the region; and particularly for the case where significant expansion is possible over a short timeframe. Therefore, reformed slot allocation rules that better suit multi-airport cities, with significant expansion, would aid the development of Gatwick's expanded capacity.

In addition, we believe that traffic from the rest of the UK will be key to ensuring access and competition is developed for passengers outside of London and the South East. We would ask the CAA to consider whether the current rules would pose a barrier to access and if so, how this barrier could be overcome.

Therefore, we would welcome reform of the rules (e.g. the dis-application of the rules to airports with near neighbours), in order to prevent any unnecessary or unbeneficial constraints on the expansion of airlines at a newly expanded Gatwick. This would be helpful in developing the additional capacity, even if this is not strictly necessary for the Gatwick case. We request the CAA and the DfT to pursue this agenda, ahead of the opening of new capacity.

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