

**VAA response to the CAA's consultation: Proposed licence conditions in respect to price Commitments**



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## **Summary**

This response outlines VAA's feedback on the revised commitment terms issued by GAL and the proposed licence conditions set out by the CAA.

While the majority of the modifications the CAA has made to the licence have been welcomed, VAA still has a number of outstanding issues. Moreover, VAA does not believe that the modifications GAL has made to the terms of the proposed Commitments go far enough to remedy the risk of the airport exercising its significant market power to the detriment of passengers.

Finally, the Commitments currently proposed, are a long way off the terms VAA would expect in a normal commercial relationship. We, therefore, currently do not view the creation of such Commitments as an effective remedy for the substantial market power that Gatwick continues to hold and it is difficult to see what benefits they offer passengers over RAB regulation.

We remain open to working with the CAA to further develop this proposal however, given the relatively limited timescale until the start of Q6, and the significant issues that need to be overcome, the VAA believes RAB regulation is more appropriate and in the best interest of the passenger. If the CAA is going to further explore the potential for price Commitments it will need to be clear and precise about the requirements and benefits of any commitment regime. In addition, it is vital that airlines are fully involved in any further development work on Commitments.

## **Introduction**

VAA welcomes the opportunity to respond to the CAA's consultation letter of the 15<sup>th</sup> July on price Commitments. VAA continues to believe that GAL holds significant market power. Despite this, we have been continually open to considering the concepts being explored around alternative forms of regulation and in particular contracts and Commitments at the airport. However, as they were initially proposed by GAL we did not see these as a sufficient remedy to GAL's substantial market power.

As such, VAA provided detailed responses to the initial Commitments proposal put forward by GAL. We welcomed the extent to which some of these comments had been addressed by the CAA in its initial proposals. In particular that GAL's Commitments would need to be based on a lower price (although VAA believe it should be lower than proposed by the CAA) and that a regulatory back-stop, in the form of a licence would be needed.

Since the publication of the CAA's initial proposals, GAL has published an updated version of its Commitments and the CAA has provided more detail of how GAL's proposed Commitments would operate within a regulatory licence. It is worth noting that while VAA believe, like the CAA, that a regulatory licence would be necessary if they are pursuing GAL's proposal on Commitments, this is not currently part of GAL's proposal.

We note the CAA has asked for feedback on two main questions:

- a) The CAA's proposed licence for a Commitments model;
- b) Whether GAL's revised Commitments proposal addresses concerns that terms in the Commitments would not be in the interest of end users.

This response addresses these two questions in turn. Whilst this response focuses on the licence proposals put forward by the CAA, the 'Minded to' publication on market power at Gatwick by the CAA is important context. VAA has responded separately to this consultation.

## Background

The CAA's initial proposals expressed a preference for a 'Commitments' based regulatory model for GAL in Q6, with some suggested modifications from the proposal put forward by GAL in its business plan in February. If these modifications cannot be agreed the back-stop regulation will be a traditional RAB based mechanism.

VAA welcomed the assessment from the CAA that there were a number of issues with GAL's proposal. In particular the CAA highlighted that the enforceability and the terms of the Commitments are such that they do not offer sufficient protection to be in the passenger interest. VAA agreed that the Commitments proposal previously put forward was not workable and provided evidence on this in previous submissions.

The CAA suggested a number of changes, in their initial proposals, that would need to be made to the Commitments proposals to make them a workable solution to protect passengers from GAL's market power in Q6. The first set of changes was new licence conditions that would need to be introduced to ensure the regulatory back-stop provided enough protection.

VAA agreed with the CAA's assessment that any Commitments framework should be backed up by a regulatory licence. However, evidence was provided on the workability of the proposed approach.

Other than the regulatory licence, the CAA's initial proposals also raised a number of other issues with GAL's proposals. These are around:

- **Price:** The CAA would want the Commitments to offer a price that is fair.
- **Efficiency:** The amendment of the full pass through of the costs of changes to security requirements, to something similar to the Q5 arrangements, the removal of the pass through of taxation changes, and the removal of the pass through of development costs of a second runway.
- **Service quality:** The level of rebates and bonuses in the service quality scheme should prevent service quality from being reduced and provide bonuses only where there is significant outperformance of existing levels of service quality. The Commitments should also include protection against repeated failures to meet service quality targets. Airline service quality targets should also not distort competition between airlines.
- **Capex:** A commitment to deliver any outputs resulting from the capex plan that are over and above the outputs that would be reflected in the service quality regime.

- **Consultation:** The Commitments should include consultation requirements beyond those required by the Airport Charges Directive (ACD) and address the significant information asymmetry between GAL and the airlines;
- **Transparency:** The Commitments should provide sufficient information to airlines to allow them to understand whether charges are reasonable.
- **Operational resilience:** The Commitments should provide clarity on what GAL will do and how it will interact with other operators at Gatwick to ensure the availability and continuity of airport operation services to further the interests of passengers, particularly during disruption.
- **Financial resilience:** The Commitments should provide clarity on what GAL will do to ensure the financial resilience and continuity of service.



GAL shared an updated version of its Commitments on the 7<sup>th</sup> June 2013. As this came relatively late in the consultation period, and did not include a revised price, VAA simply provided some initial points about the updated proposal from GAL in its response to the CAA's initial proposals:

- GAL maintains that a regulatory, licence back-stop is not needed and as such this is not included in their updated Commitments. VAA continued to believe that a licence is essential to provide sufficient protection for passengers;
- GAL has not included an updated price in its proposals – this makes it impossible to assess the commercial viability or value to passengers of any proposal;
- There remains significant uncertainty around future charges; for example, from potential runway 2 costs and service bonuses; and,
- There remains service standards on airlines which VAA does not believe are appropriate, given the current SQR regime.

We, therefore, currently do not view the creation of such Commitments (as proposed by GAL) as an effective remedy for the substantial market power that Gatwick will continue to hold over the next regulatory period.

Since the responses to the initial proposals feedback was provided, GAL has released an updated price for its Commitments and the CAA has revised its licence proposal. This response focuses on these elements. ✂

## **The CAA's proposed licence for a Commitments model**

VAA appreciates the efforts made by the CAA to address concerns raised by airlines with the licence framework for the proposed Commitments approach. However, we do have a number of remaining concerns on the detail of the proposed licence framework and on the terms and conditions of the proposed Commitments. These concerns are set out in detail below and support the points discussed in the ACC response to this consultation.

### **Comments on the licence framework**

#### **Enforcement of the Commitments**

VAA support Condition 3.1 as a necessary and effective licence term, incorporating the Commitments into the licence. A breach of a commitment would therefore represent a breach of a licence condition and all the enforcement powers under the Civil Aviation Act 2012 (the "Act") would be available to deal with it.

Condition 3.2, requiring compliance in a manner designed to further the interests of users of air transport services in specified particulars, is also a positive move that should have the effect of filling unintended gaps in the Commitments and minimising the risk of unfavourable interpretations of them by GAL. As a drafting point, we consider that Condition 3.2 needs to be modified to say, "*In complying with the Commitments and this Condition 3...*" as we are not convinced that the existing drafting is sufficient to have the intended effect. Condition 3.1 turns the Commitments into licence conditions but it is not obvious that it makes them part of "*this Condition 3*".

Conditions 3.1 and 3.2 successfully address our objection that it could be considered unlawful to impose obligations in a form that were not capable of being enforced under the Act.

#### **Modification of the Commitments**

The CAA's draft licence conditions make good progress in addressing many of our previous concerns about modification of the Commitments.

In particular, the CAA's revised proposal addresses the concern that GAL could alter or withdraw from the conditions of use, by making the Commitments conditions of the licence. As such, none of the Commitments can be varied unless the subject of a specific exception allowing variation in particular circumstances. We consider that this is an effective mechanism.

We previously expressed concern that the CAA appeared to envisage GAL having the ability to unilaterally vary at least some of the Commitments where it had an undefined "good reason" for doing so. Whilst we still do not have the drafting for the relevant provisions of the Commitments, it now appears that the only power to vary will be as specified in the Commitments and thus, for example, where there is approval by x% of airlines paying fees

calculated under the Commitments. We consider that this could address our concern (subject to comments below about the particular percentage).

We previously expressed concern that the proposal would remove the statutory processes surrounding the modification of regulatory obligations, including rights of appeal. The CAA has correctly pointed out that section 21(3) of the Act envisages circumstances in which conditions can include powers of modification other than under the provisions of the Act (and, thus, without a right of appeal under the Act). Changes are possible only:

*"if it specifies or describes—*

*(a) the circumstances in which it may be modified,*

*(b) the types of modification that may be made, and*

*(c) the period or periods in which it may be modified."*

We cannot say if these requirements are satisfied until we see the drafting for the variation provisions in the Commitments, but we can see that the conditions could be satisfied. The drafting implies that the power to modify in this way should be limited to a narrow range of situations.

Subject to the drafting of the relevant provisions of the Commitments, the approach suggested by the CAA could be sufficient to overcome our objections based on modification powers to the legality of licence-based Commitments.

We do still, though, have an issue of principle with the modification proposals. We accept that there are circumstances where modifications will be uncontroversial and where there is a good case for some sort of "fast track" procedure. It may be that if there is 100% or close to 100% support by airlines and by GAL for a modification then it is enough that the CAA has a power to intervene of its own relying on Condition 3.2 if it considers that the amendment nevertheless is not in the interests of air transport users. Where, however, there is significant airline opposition (which could be the case with objections from airlines accounting for far less than 49% of fees paid under the Commitments), we do not agree that the rights available under section 22 should be denied, namely:

- a formal explanation of the reasons for making the modification;
- a period for making formal representations;
- a reasoned response to representations; and
- a right of appeal rather than just judicial review.

In the circumstances, we would suggest that the ability to use the section 21(3) route rather than the section 22 route should be restricted to those circumstances where there is unanimity over the proposed modification, 90% support seems appropriate. Of course, the extent of airline support could be something taken into account by the CAA under section 22 where there was a high level of support but less than 90% support.

The other issues with any proposed approach to modification depending on endorsement by a given percentage of airlines paying fees under the Commitments are that:

- there may be issues about how to calculate the relevant percentage, e.g. where an airline pays some fees under the Commitments and some under bilateral agreements or where percentages vary over time. This is only compounded by the fact that support required varies depending on the type of modification; and
- there may be circumstances where it would be legitimate for an airline to object to a modification even if it does not pay fees under the Commitments or otherwise qualify to be counted in the relevant percentage, yet the section 21(3) approach would not necessarily give any prior notice to that airline or any opportunity to make an informed objection.

We therefore propose that the modification process in the Commitments requires the support of airlines representing 90% of passengers, excluding any airlines unaffected by the change. This would at least minimise some of the risks (which we raised in previous responses) in this respect since it would effectively limit use of the mechanism to uncontroversial proposals.

### **CAA resolution of disputes**

We remain unsure what the CAA has in mind in respect of dispute resolution. Paragraphs 22 and 23 of the letter create some confusion.

It appears that the CAA has in mind acting as an avenue of appeal from decisions under the Commitments in relation to proposed modifications. This appears to be based on a misunderstanding of what GAL is proposing. GAL does not appear to suggest that there should be any role for an arbitrator or independent adjudicator in modification of the Commitments. Modification depends simply on numbers of airlines in support - 51% of the relevant airlines. The independent adjudicator role described in the heads of terms for the Commitments appears to be limited to disputes over compliance with the Commitments, not over modification to them. Moreover, the decision of the independent adjudicator is only temporarily binding pending a reference to the courts or mutual agreement, so there is no need for an appeal to the CAA, under GAL's current proposals.

In the circumstances, we consider that draft conditions proposed by the CAA, Conditions 3.4 to 3.6 should be deleted and Condition 3.7 modified to delete reference to Condition 3.5.

### **CAA power to freeze charges**

The CAA has provided a little more information on how the proposed power to freeze charges would work and why it is limited to charges. This extra information is sensible. We still believe, though, that the power should go further and allow the CAA to reduce charges. At a minimum, we believe that it should allow the CAA to reverse any recent increase in charges not approved by the CAA as our concern is that the Commitments, being novel, may leave scope to GAL to increase prices without prior notice to or approval by the CAA in some circumstances but in a way that is nonetheless seriously detrimental. The CAA needs to have powers to enforce quickly and effectively and it may not always be in a position where it can act before an increase is imposed. Merely freezing prices is not enough, especially as it is not clear whether this would be a nominal or real terms freeze.

### **Licence revocation**

Finally, we also believe the draft licence should be clearer on what would happen in the event of a licence revocation. Presumably GAL wouldn't be able to levy any charges to passengers/airlines in such a situation per section 3 of the CAA 2012. Either way, VAA believe the licence should be clearer on the intended effect of revocation.

## VAA's view on GAL's revised Commitments proposal

### Summary

The CAA has asked for a view on whether GAL's latest proposal on Commitments addresses the concerns raised previously. VAA's view is that the latest version of GAL's proposals are not in the interest of passengers and contain a number of issues and risks.

VAA notes that the revised terms are also a long way off the type of commercial agreements we would normally expect with GAL appearing to 'cherry-pick' elements of a contract it finds attractive whilst offering little or no safeguards to its customers.



VAA's particular concerns are:

- GAL's proposed price remains too high compared to expectations of a fair price and even above the CAA's initial proposals;
- Allowing uncapped premium charges to be imposed by GAL could incentivise the airport to degrade services that we take as standard today to the minimum and to introduce new charges to maintain them at existing levels;
- There are considerable risks to the out turn price to be paid by airlines caused by the CRD, any second runway proposal, generous bonus payments, ancillary service charges and premium service charges;
- The pricing principles that will be used by GAL do not form part of the Commitments and are subject to change. It is not clear what protections there are to stop the airport exercising its market power for example by unreasonably discriminating between airlines or categories of flights;
- VAA considers that GAL's ability to change the terms of the Commitments needs to be more tightly constrained;
- VAA believes there are significant weaknesses with the service quality regime proposed and if Commitments are to be workable, a more commercial, focussed and output based regime needs to be enforced. In particular, with neither Commitments to deliver particular capital projects, nor a strong service quality regime, there is a significant risk that GAL would delay necessary investment or refuse to make investments unless airlines agreed to further price increases. We do not consider that the SQR regime, especially the one proposed by GAL, is strong enough to incentivise GAL to make necessary investments because:

- a) the rebate payments could be small in relation to the cost of the remedy (it would then pay to fail);
  - b) the SQR scheme does not provide cover for all facilities that are necessary, especially on the airfield. For example, if a taxiway was congested or needed resurfacing, the airport would be unlikely to pay rebates;
  - c) under GAL's proposals, rebate payments would be halved from the existing level and could be offset by generous bonus payments, significantly reducing GAL's exposure to financial risk under the scheme.
- It is not clear that airlines would be provided with sufficient information to be able to ensure that GAL's charges were consistent with the price Commitments. Even so, monitoring compliance with the Commitments would be much more complex than monitoring a RAB based price control and there would be significantly less certainty about the price path of airport charges over the period.

There also remains considerable uncertainty over the process beyond the 7 year commitment period both from CAA and GAL perspective as to how market power and the appropriate on-going form of regulation and price will be judged.

Therefore, VAA does not believe that GAL's revised commitment proposals are in the interest of end users.

## **VAA evaluation of GAL's Commitments**

VAA has a number of further detailed points on the revised terms. These are explained in below.

### **Pricing**

- The Commitments proposal of RPI +2.5% is above the CAA regulated price proposal and significantly above VAA's and the ACC's expectations on price. GAL seeks to advise of a blended yield of RPI +1.5%, which would reflect the average price paid by airlines, it is therefore difficult to assess the price path for individual airlines so we have to assume the price of RPI +2.5%. VAA also notes it will be difficult to monitor compliance with this proposal as other airlines will not be able to see the contracts or the resulting revenues.
- We do not consider that GAL's commitment that specified activity charges should be set at a level which is "fair, reasonable and non-discriminatory" provides any real protection as it is not clear how this would be judged in practice. These charges are not covered by the Airport Charges Directive.
- Allowing uncapped premium charges to be imposed by GAL could incentivise the airport to degrade services that we take as standard today to the minimum and to introduce new charges to maintain them at existing levels.
- The CRD introduces complexity and uncertainty into the Commitments and we do not support it. It would be sufficient for the existing correction factor mechanism to continue.
- Moreover, there is significant risk for airlines that fall outside of any bilateral contracts created by the CRD. Where there is an income shortfall, the non-contracted airlines cannot be expected to make up the shortfall in income. If GAL enter into a contract with an airline that means that specific airline will not be liable for their proportion of the shortfall (under the negotiated terms of that contract), then this proportion must be borne by GAL, not reapportioned to the non-contracted airlines.

### **Second runway**

- VAA believes it is inappropriate for passengers to pay an open ended sum in advance for the development of a second runway. These charges should only be passed on once any second runway is operational.

### **Airline Service Quality**

- VAA continues to have a number of concerns with the airline service standards included by GAL in its draft commitment terms:

- It is not for GAL to set airline service standards. The passenger purchases a ticket with an airline based on the experience the airline has sold to the passenger and that the passenger expects to receive from such airline. The contract is between the airline and passenger only.
- The airlines are responsible to passengers only for airline service quality. Therefore it is not acceptable for GAL to be able to forego rebates to airlines based on the airlines' performance to a passenger.
- In addition, GAL is maintaining a right to unilaterally adjust the standards which is not acceptable.
- Moreover, if these terms are to be included within a regulatory licence it is not appropriate for the CAA to impose economic regulation on airlines that operate in a competitive market.

### **Core Service Standards**

- GAL sets out the ability to adjust core service standards if agreed by airlines that account for 51% of passengers utilising the airport and 51% of airlines responding in writing. This is not workable as Gatwick has a diverse airline base (low cost, charter, leisure, business) and could be discriminatory on certain airline groups.
- A proposal for how to amend this is covered in the licence section of this response.

### **Capex Commitment**

- GAL have said that they are incentivised to deliver capital investment but this has to be backed up with a contractual commitment to deliver. It is not clear how GAL will consult with airlines (who are best placed to represent passengers) on future infrastructure requirements. Combined with a very weak service quality commitment the VAA has significant concerns that this could lead to a degradation of service to passengers. The setting of an arbitrary amount of capital to be invested each year does not solve this issue.
- The revised Commitments on capex are vague and merely state the commitment to :
  - *maintain and develop the infrastructure of the airport to enable the airport-wide service standards to be achieved* – it is difficult to see how this could be enforceable;
  - *maintain the airport to comply with applicable health and safety requirements* – GAL are merely stating they will comply with the law; we would assume that should be taken as a given; and,

- *publish a 5 year rolling forecast for capital investment* – this does not mean GAL is committed to spend/deliver such capex. Moreover the forecast would be volumes rather than output based which would make it difficult for airlines to plan for new infrastructure or disruption from building activity.

### **Contractual Obligations/ General**

- The airlines still remain in the Commitments proposal “the insurer of last resort”. In a standard commercial relationship, the supplier would have a contractual liability for direct costs incurred by the customer through supplier under performance or negligent actions. For example, if GAL closed a runway due to a lack of action within its control, which resulted in the airline having to compensate passengers through hotel accommodation, meal and beverage provision, GAL is not liable for these direct costs. This is unacceptable in a commercial relationship. For the avoidance of doubt a rebate SLA relating to runway availability is not the measure to compensate for direct costs incurred due to GAL’s in action, this rebate is to compensate the customer (airline) for not receiving a service it has paid for.

### **Financial performance and resilience**

- The publication of the airport asset base does not accord with the formula for rolling forward the RAB. A shadow RAB should be reported, using the same calculations.