

## Gatwick response to “Proposed licence conditions under section 18 of the Civil Aviation Act 2012 in relation to price commitments”

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### Introduction

This document sets out the response of Gatwick Airport to the CAA’s letter dated 8 July 2013 consulting on proposed licence conditions in relation to Gatwick’s proposed Commitments.

As the CAA will be aware Gatwick does not consider that the available evidence supports the CAA’s ‘minded to’ conclusion in relation to the Gatwick Market Power Test under section 6 of the Civil Aviation Act 2012, and therefore considers that regulation by a licence is not needed at Gatwick. Accordingly, Gatwick’s comments on the form of the light licence that might be employed in conjunction with the Commitments should not be seen as its acceptance that such licence is necessary. Gatwick remains of the view that Commitments without any regulatory licence can provide legally binding obligations which address the key interests of airport users including the range, availability, continuity, cost and quality of airport operation services.

In so far as the CAA believes that a licence is required to complement Gatwick’s Commitments, the CAA must consider carefully, in line with its statutory duties, just how much regulation is required in addition to what are legally binding Commitments. In general, Gatwick considers that what the CAA proposes is unduly and unnecessarily interventionist. It also introduces in certain respects a degree of regulatory uncertainty that risks effectively undermining the purpose of the 7 year term, which is to encourage commercial relationships with airlines to develop and to give Gatwick the time and certainty required for investment and for operational and commercial improvement. In Gatwick’s view the CAA’s proposal therefore requires substantial change and slimming down.

The remainder of this document sets out our specific comments on a number of issues arising from the consultation. In addition to these comments we are attaching a revised draft Conditions of Use, which include the Commitments<sup>1</sup>.

### Comments on CAA paragraph 9:

The CAA states that it is not sufficiently convinced that the terms of the Commitments would provide better protection to passengers and cargo owners than the security offered under a licence. This is an erroneous interpretation of Test C of the market power test and inconsistent with the principle of regulatory restraint in s.1(4)(b). The CAA’s approach suggests that regulation is the

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<sup>1</sup> The attached Conditions of Use are in Draft form. The final Conditions of Use will be consulted on in due course.

starting point and that the onus is on Gatwick to persuade the CAA to depart from that starting point. In our view, the onus under test C is clearly on the CAA to establish that, taken as a whole, the benefits of regulation are likely to outweigh the adverse effects and under s.1(4)(b) regulatory intervention must be limited to “cases in which action is needed”.

**Comments on CAA paragraph 10:**

The CAA states that “...enforcement concerns could be addressed through the scope for enforcement under a licence where Commitments were not delivered as expected.” GAL remains firmly of the view that the amended Commitments and the related contractual enforcement rights render regulation through a licence superfluous.

**Comments on CAA paragraph 11:**

a) – The CAA indicates that a licence would include a condition that would enable the CAA to take enforcement action in the interest of end users, rather than simply airlines. Gatwick notes that under our Commitments airlines have direct contractual enforcement rights, and we remain of the view that enforceability is not an issue: see detailed comments in response to CAA paragraph 14 below. Furthermore GAL’s success in a competitive airport market will be dependent on its ability to operate and develop the airport in the interest of end users<sup>2</sup>.

b) – The CAA notes that a licence would prevent Gatwick from altering or withdrawing the Commitments without good reason. Gatwick has undertaken in the revised Commitments that it will not, throughout the seven year term, amend Commitments relating to price, service, continuity of service, financial resilience, investment and consultation and dispute resolution. This obligation will be included in the Conditions of Use and be enforceable by the airlines. Furthermore any attempt by GAL to withdraw from the Commitments would provide a change in circumstances entitling users to request or the CAA to implement a market power test afresh.

c) – The CAA appears to envisage having the right to direct changes to Commitments in response to a dispute where the Commitments are operating against the user interest. We are unclear as to exactly what the CAA envisages. A dispute in relation to the Commitments would be subject to the adjudication provisions in the Conditions of Use. The Commitments provide a default for those airlines not entering into contracts with the GAL. The whole basis of the Commitments would be undermined by the ability for airlines to seek their amendment by the CAA. We also note that airlines will of course continue to have the ability to seek redress for breaches of the Airport Charges Regulation or the Groundhandling Regulations.

d) – The CAA is proposing an ability to freeze charges for up to 18 months if it is undertaking an investigation. Such a price freeze would undermine the basis of the Commitments. It would create fundamental regulatory uncertainty not present in the current regulatory model. It would create an incentive for airlines to lobby the CAA to open an investigation and freeze charges (a large prize for the airlines) rather than operating the commitments as a contractual arrangement between the airlines and GAL. Effectively, GAL would be making a 7 year commitment but other parties would

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<sup>2</sup> [snow equipment, working with border force + something about CAA not supporting our SQR proposal for airlines]

not; at any point the CAA could issue a Temporary Price Control Notice (there is no limitation on the CAA's discretion to do so in Condition 3.11(c) of the draft) depriving GAL of the ability to raise prices as agreed under the Commitments and potentially leading to the imposition of a fresh price control. The CAA will recall that a main driver for a 7 year term was to provide certainty for GAL in making investment decisions. The CAA's proposal to retain the right to intervene significantly reduces that certainty and reduces the normal free market incentive to invest. In any event, a price freeze is unlikely to provide a useful remedy to any alleged detriment to end users as the CAA has accepted that changes in airport charge are unlikely to flow through to end users. In addition to this we do not understand why a price freeze is required for licence modifications or a market power assessment. The Act provides a mechanism for licence modifications which contains no such provision for price freeze.

**Comments on CAA paragraph 14:**

The CAA highlights that one of its main concerns with the Commitments is that they are enforceable only by airlines and that this is a problem because the interests of airlines are not always aligned with those of passengers and cargo owners. The CAA therefore considers that enforcement by passengers and cargo owners should be possible directly or by the CAA itself exercising step-in rights. Gatwick makes three points in relation to this proposal:

(1) The CAA does not intend to make a finding that Gatwick holds market power in the provision of cargo services. Since the CAA must have regard to the principle of regulatory restraint under s. 1(4)(b) (namely to target regulatory activities only at cases "in which action is needed") it ought not to be concerned with the position of cargo customers since they are protected by competition in the market. (See also s. 104.)

(2) Turning to passengers, the interest of passengers and airlines will often be aligned. However any solution to protect the passengers' interests where they might not be aligned with the interests of passengers should be proportionate and have regard to the fact that Gatwick will be competing for passengers and thus incentivised to ensure that the service provided by Gatwick to their passengers best suits the interests of those passengers. GAL's proposals in relation to the role of the Passenger Advisory Group below is a proportionate response to the risk identified by the CAA. It should also be noted that enforcement by any single airline will be sufficient to ensure compliance.

(3) The CAA accepts that if passengers were able to enforce the Commitments directly there would be no need for the CAA to have step-in rights. It is difficult to think that any individual passenger would in reality be interested in taking enforcement action personally against Gatwick: if they were that unhappy about the service offered by Gatwick, they would switch to another airport. Gatwick believes that the interests of passengers are best served by practical rather than theoretical options.

In the light of the above points, GAL proposes that the role of the Passenger Advisory Group is reinforced. To this end GAL proposes to increase the role of PAG such that they are consulted formally on airport development projects, thus providing a direct passenger voice into the current

and future performance of the airport. GAL has committed to continue to consult the ACC on capital development and proposes that the PAG group be included in those formal consultation meetings. This goes much further than today and enables PAG to input into airport strategic discussions as well as the more informal, tactical level involvement they have today.

[Comments on CAA paragraph 15:](#)

The CAA comments that it would normally expect the airlines to manage their contractual relationships themselves and that the CAA would get involved only if it considered that there was detriment to end users that was not being addressed, or if it was clear the Commitments were not working as expected. Gatwick is of the view that contractual enforcement by the airlines is the appropriate remedy if the airlines consider Gatwick to be in breach of its clear obligations under the Commitments. The adjudication process Gatwick has suggested is intended to provide a rapid process for the airlines to obtain redress while not taking away their right to have the matter determined by the courts. The airlines are not required to go through the adjudication procedure if they believe urgent injunctive relief is required. We concur that leaving the airlines to seek redress under the contractual route will be more efficient than a CAA investigation.

[Comments on CAA paragraph 17:](#)

The CAA is including a licence condition which requires Gatwick to comply with the Commitments in a manner which furthers the interests of passengers and cargo owners with regards to the range, availability, continuity, cost and quality of airport operation services. GAL has two concerns about this proposal:

- (1) The duty in s. 1(1) of the Act on the CAA is not unqualified. It is subject to the remainder of s. 1. If the duty in s. 1(1) is placed on Gatwick, it could lead to absurd results. The interests of users might be furthered by vast capital expenditure or large price reductions yet, even in a fully licensed world, the CAA would never require Gatwick to make such investments or cuts in its prices, not least because of the obligation in s. 1(3)(a) to have regard to the need to ensure that Gatwick is able to finance its provision of airport operational services.
- (2) The Commitments which will be included in the Conditions of Use are drafted as clear contractual obligations which can be interpreted and enforced by the courts and in a 'Commitments supported by a licence' scenario, by the CAA. Gatwick will either be in compliance or not. If the meaning of the Commitments is subject to an obligation on GAL to comply with them in a manner which furthers the criteria in s. 1(1) of the Act, there will be no certainty about their terms for two reasons. First, the main terms of the Commitments and the s.1(1) term will be potentially at odds with one another. Secondly, the objectives in s. 1(1) will frequently be at odds with one another (better service may come at a cost etc.) and a Court would not be in a position to judge how the trade-offs should operate. The CAA's proposal, if implemented, would mean that the Commitments were unenforceable as a matter of contract law, an outcome that nobody wants.

Gatwick suggests that the correct approach is for the CAA to examine the draft Commitments taking account of its duties under s. 1 of the Act (including the duty of regulatory restraint in s. 1(4)). The Commitments were framed to further the interests of users of air transport services regarding the range, availability, continuity cost and quality of airport operation services. If the CAA agrees, then the Commitments stand on their own terms without any need to superimpose a reference to s. 1(1) of the Act: that review will have been done when approving them in the first place.

The CAA expresses a concern that GAL may breach its service standards and pay rebates to airlines, which may make business sense to GAL but would be contrary to the interests of customers. This concern is mistaken. The obligation to pay rebates is intended to create an incentive on GAL to comply with the service standards: it is therefore an enforcement mechanism intended to further the interests of users. The issue is not whether a further means of enforcement is required but whether the rebates are set at a level which provides the right incentives for Gatwick. Gatwick believes that they are but has nevertheless added an escalator to the SQR rebate to provide confidence that it has no intention of paying rather than complying with its service commitments.

[Comments on CAA paragraph 19:](#)

We are providing a revised draft of the Conditions of Use which includes the Commitments with this submission as an appendix.

[Comments on CAA paragraph 21, 22 and 23:](#)

Regarding the proposed modification procedure: We believe the CAA may have misunderstood how the modification provisions in the Commitments are intended to operate. The price Commitment and service Commitment may be amended only where the requisite majority of airlines has consented. This will be a question of fact. The adjudication procedure is not intended to resolve whether a modification should or should not be made. Likewise, in a licence regime, neither the airlines nor GAL would be able to seek a determination from the CAA that a modification should be made if the requisite majority has not been obtained. In these circumstances the party would need to rely on the modification process set out in Section 22 of the Act.

In para. 23, the CAA proposes to introduce an ability to seek a determination from the CAA which it says "could be helpful". This reflects an erroneous tendency to over-regulate. The issue to be considered under s. 1(4)(b) of the Act is whether "action is needed" not whether the CAA's further involvement "could be helpful".

[Comments on CAA paragraph 26 \(regarding temporary price freeze\):](#)

Please note the points we have already made in response to paragraph 11 d) above. The CAA states that it considers the main risk to end users from the potential abuse of substantial market

power will be around excessive prices, yet elsewhere the CAA has argued that there is unlikely to be any significant pass-through by airlines to passengers of any increase in airport charges. This suggests that, on the CAA's own reasoning, a temporary price freeze will not have the effect of protecting end users.

[Comments on CAA paragraph 32](#)

c) In a typical market in which capacity is becoming highly utilised and demand exceeds supply in peak periods, the expectation would be that prices will rise to signal the need for investment in additional capacity. The proposed adjustment mechanism in the Commitments price seeks to reflect this dynamic, since the long-term nature of the Commitments covers the early development period of the capacity expansion. The increase in airport charges ahead of the opening of a new runway does not represent "pre-funding" - it would be airport charges starting to reflect the real long run cost of the service delivered.

In designing the mechanic for the adjustment of charges, GAL has introduced several elements of conditionality and means of assurance. First, it is subject to Government support for a second runway which we would envisage coming through the adoption of a National Policy Statement following the recommendations of the Airports Commission. Second, the project would be subject to consultation with the ACC and CAA and thirdly costs that can be recovered must be reasonably incurred.

We should make clear that the 10 year amortisation period relates only to the planning and early stage development costs that would be incurred as operating costs, and might otherwise be passed through in a single year.

d) Failure to meet service standards results in a material cost to GAL, which we have provided would be further increased if there is a persistent breach of the standards. This is a very significant incentive on GAL to remedy any such breach, over and above the fundamental incentive to ensure that services meet passenger expectations, and support the growth of the airport. Contractual remedies remain available to airlines under the terms of the Commitments should GAL remain in breach or fail to follow an agreed remedial programme.

The draft heads of terms for the Commitments do not set out the procedures for measuring the individual service quality elements. The annexed draft Conditions of Use provide this largely reflecting the drafting of Annex H (as amended during the course of Q5).

e) In its original Commitments proposals GAL did not specify any level of capital expenditure. The Commitments were (and remain) based on a price and service undertaking to users, with GAL retaining the flexibility to manage its capital expenditure and operational activities as required to deliver these outcomes. A concern was aired by the CAA and airlines that there may be a risk of underinvestment without some further assurance in relation to capital expenditure. GAL has proposed several simple means of assurance: first, a minimum level of capital expenditure; second, transparency over the capital programme in particular over changes (if any) from the

capital programme currently set out; and third, a clear set of service quality (i.e. output) measures. To define or micro-manage more prescriptively the delivery of individual components of the capital programme would be to revert to detailed regulation and be utterly inconsistent with principle of the Commitments which is to create a more market based framework (whilst also providing assurances to users over-and-above those that would normally be expected of an airport operating in a purely commercial environment).

f) The Commitments are clear that, in addition to publishing this assessment of the value of its asset base, GAL will also provide the underlying assumptions including the initial asset base, depreciation, additions, disposals, indexation factors and other adjustments that may be relevant. This will enable any interested party - including the CAA - to verify GAL's calculation and, if they so wish, prepare a valuation on a different basis.

g) We question whether a licence condition on resilience will add anything to the good progress Gatwick has made and continues to make in developing contingency plans for, and coordinating responses to disruption and maintaining the operational resilience of the airport. The commercial and reputational impact of failing in this area are likely to render licence conditions superfluous. In recognition of the importance which both Government and the CAA attach to operational resilience, we have provided in the Commitments what we believe to be proportionate obligations in relation to an operational resilience plan and coordination of responses.

h) It is not clear that licence based restrictions are necessary in the light of the "contractual ring fence" provided by Gatwick's debt covenants. In so far as any comfort is required on financial resilience Gatwick can see that additional comfort might be improved by an obligation to give notice of any amendment to the debt covenants pertaining to credit rating. The debt covenants also include restrictions on business activities and, following the same logic, we see no benefit to licence based restrictions. We question the benefit of a parent undertaking particularly with the ownership structure of Gatwick. While in theory we can see the benefit of a continuity of service plan, in practice we are not convinced of its purpose. It is unrealistic to envisage that key operational knowledge will be lost in the event of financial distress. Bearing in mind the requirement for an aerodrome licence, the need to have an aerodrome manual and the business risk contingency plans which are already in existence, we believe any licence condition requiring a continuity of service plan should be very light touch.

#### Comments on other provisions of the draft licence not covered above.

Condition 2: We do not believe the licence should be revocable in the event of Gatwick failing to comply with orders under the Competition Act 1998 or the Enterprise Act 2002. Those Acts contain sufficient enforcement powers, which do not need enhancing by the threat of removal of the licence. We see no reason why Gatwick should be subject to additional and enhanced remedies which other entities subject to those Acts are not exposed to.

Termination of the licence for non-payment of the CAA fees for carrying out its regulatory function and for failure to pay a penalty under section 52(1) or 52 (3) of the Act is wholly disproportionate. The CAA has other remedies available to it in these circumstances.

Concluding remarks

As stated in the introduction to this paper, we continue to maintain that the Commitments provide sufficient protection for airlines, passengers and cargo owners against the potential of abusive conduct by Gatwick without any need for a regulatory licence. In so far as the CAA believes some form of licence is required, then this should be extremely light touch. The draft provided by the CAA includes conditions which are unwarranted and present substantial regulatory risk to Gatwick. Indeed, in certain respects these introduce greater regulatory intervention and uncertainty than under the form of regulation in existence under the Airports Act 1986. We are therefore extremely surprised by the CAA's proposed approach towards licencing in the presence of competition. The novelty of either the competitive market or of the Commitments cannot justify over-cautious, overly intrusive and unnecessary regulation.