

Initial consultation on future economic regulation of Gatwick Airport Limited

Response to the CAA

Consultation Response | August 2018



As the CAA considers its approach to the economic regulation of Gatwick Airport Limited going forward, we appreciate the opportunity to share our thinking on ways to further improve customer outcomes. We believe the Q6 commitment framework, developed through engagement with key stakeholders, is – in the main – an effective way to encourage a competitive service offer for customers. In the next regulatory cycle, the CAA should develop the commitment framework, so as to better reveal the ‘true’ efficient customer outcomes. It can do this by: (i) taking a long-term view of customer outcomes for investment prioritisation; (ii) benchmarking service quality improvements against other international airports (where feasible); and (iii) planning for, and effectively mitigating, major risk factors.

1. Introduction and context

As per the Civil Aviation Act 2012 (and consistent with its assessment of Gatwick airport’s significant market power in 2014), the Civil Aviation Authority (CAA) is responsible for regulating the services provided by Gatwick Airport Limited (GAL) to passengers and air-cargo providers, in a way that ensures competitive outcomes for consumers.

The current regulatory framework, which covers the period from March 2014 to March 2021, is based on the following commitments:

- **price commitment:** to limit the price increase in the average blended price¹ to RPI+0% and average published price to RPI+1%, over the seven years;
- **service standards commitment:** to deliver agreed standards of service (on measures of passenger satisfaction, security, operations and aerodrome congestion) or face rebates;
- **continuity of service plan, operational and financial resilience commitment:** to prepare and maintain plans on continuity of service and operational resilience;
- **investment and consultation commitment:** to comply with safety/environmental requirements and develop infrastructure worth at least £700 million, to meet service quality targets; and
- **financial information commitment:** to provide statutory accounts to help airlines understand whether charges are reasonable.

As it develops its thinking on the commitments for the next regulatory cycle, the CAA has requested views on: (i) the process and timetable for developing the updated

¹ *The average blended price is calculated using a combination of prices based on discounts agreed in bilateral contracts with airlines.*

framework; and (ii) ways of improving the framework to better protect customer outcomes. The CAA’s current thinking on these is summarised below.

1.1 Process and timetable

The CAA is keen that the process for the development of the next regulatory framework should be driven by the airport, with agreement from the airlines. In order to ensure it delivers the best outcomes for consumers, the CAA will oversee the process; review the outcomes; and ensure the framework delivers to the benefit of consumers. As a last resort, the CAA is willing to step in and arbitrate, if negotiations between the airport and airlines fail.

In order to formalise a regulatory framework by March 2021, the CAA will need to reach a final agreement with the airport and airlines by the end of 2020. Accordingly, it has proposed the timeline set out in the figure below.

Figure 1: CAA’s suggested timetable for formalising GAL’s next regulatory framework



Source: [Future economic regulation of Gatwick Airport Limited: Initial consultation, CAA](#)

1.2 Protecting consumers’ interests

The CAA is looking for ways to improve the framework to better promote consumers’ interests. Above all, it wants the consumer outcomes in the new framework to be based on robust evidence, capturing consumer interests through relevant primary research. In doing so, it wants the airport to garner consumer views, across passenger types, on issues beyond the current service quality standards. In particular, it wants consumer views on longer-term strategic issues. For instance, *how can consumers be better served in terms of resilience in a congested airport?* In relation to this, it is also conscious that the new framework needs to suitably deal with uncertainty around GAL’s future plans, particularly around capacity expansion and to accommodate future traffic growth.

In the above context, we appreciate the opportunity to understand and comment on the CAA’s initial thinking on the future economic regulation of GAL. Our views on the specific questions posed by the CAA are detailed overleaf.

2. Our view on the process and timetable

We largely agree with the process and timetable suggested by the CAA. In particular, we appreciate that the process is customer-focussed and places emphasis on early engagement between the airport and the airlines. We do note, however, that some of our suggestions on 'protecting consumers' interests' (detailed below) may require the CAA to play a more active role - in championing engagement; gathering evidence; and setting outcomes.

3. Our view on protecting consumers' interests

In many forms of economic price regulation, there is a need to balance 'outcomes' against costs of delivery. Accordingly, regulatory frameworks usually specify, or incentivise, the outcomes to be provided, for a given funding package. However, in practice, identifying the 'economically efficient' outcomes package is inherently challenging because: (i) one cannot directly observe customer priorities in monopoly markets; (ii) methods for inferring customers priorities and valuations absent market information are inherently imperfect; (iii) customers themselves may be subject to behavioural biases; and (iv) understanding the 'true' efficient cost of delivery is complex. Consequently, a regulator may 'err' by specifying (or encouraging) outcomes that are either **above** or **below** the appropriate level. For this reason, it is important to see regulation as a means of setting incentives that better reveal the 'truth' over time, rather than a tool to impose a 'best guess' of what the truth is.

We believe that the CAA's current commitments-based regulatory framework is an effective way to encourage engagement between the airport and airlines to provide high-quality customer service outcomes. Nevertheless, in developing a similar framework for the upcoming regulatory cycle, the CAA could consider some refinements, which may help better ensure that the framework acts to reveal the 'true' efficient outcomes that should be delivered. These are set out below.

3.1 Incentivising long-term customer outcomes

Over the last few years, regulatory frameworks across a range of sectors have tended to focus on specifying outcomes informed by primary research on customer priorities. This is intended to ensure that regulators and regulated companies do not operate in a vacuum and instead, deliver outcomes actually required by consumers.

We believe, however, that these concerns need to be balanced against customer's behavioural biases. Specifically, it is inherently difficult to identify customer's actual preferences over complex trade-offs between costs and outcomes based on primary research. More importantly, the challenge of identifying the 'right' consumer outcomes is made more acute in situations where: (i) we care about the welfare of future, as well as current, customers; and (ii) there are material time lags between when investment occurs and when the resultant benefits arise for customers. Under these circumstances, simply asking consumers about their preferences can result in prioritising short-term low-cost outcomes, over outcomes that would be more efficient over the long-term.

Following from the above, we think it is important for the CAA to actively consider how it might evolve the framework to better reveal the 'truth' from a longer-term perspective. This may need a significant shift in regulatory perspective. For instance, it may, in some situations, require the CAA itself to take a more active role in the

collection, interpretation or distillation of customer evidence. Clearly, this is a balance, and equally one should be wary of unintentionally inserting the ‘regulator’s voice’ in place of the ‘customer’s voice.’ Nonetheless, it seems logical that, in some areas, consumers may not be equipped to understand the complex interactions and trade-offs between costs and outcomes over time. Consequently, it seems preferable that the framework evolves to address this, in some way.

3.2 Benchmarking service quality improvements

GAL’s current service quality commitments are based on service quality targets in relation to: passenger satisfaction; security queues; passenger operational measures; airline operational measures; and aerodrome congestion. As per the CAA’s mid-term review,² it has performed well against each of these targets (other than on-time performance, which is not solely controllable by GAL).

While these targets (which are based around customer preferences on service quality measures) appear credible, in the absence of benchmarks, it is hard to know if they are truly efficient. As such, it may be helpful to benchmark them against the service quality standards at other international airports - most notably, London Heathrow, Amsterdam Schiphol and Paris Charles de Gaulle (in a similar way to the benchmarks for opex efficiency considered in the calculation of a ‘fair price’).

However, it is important to properly understand and account for the fact that these airports operate in different demand and supply conditions and regulatory contexts. Therefore, simple comparisons may lead to naïve assessments of targets, which cannot and should not be applied in the context of GAL. We believe that these benchmarks would be most comparable when based on improvements in each airport’s service quality provision, over the regulatory window (rather than being used to define target levels).

In the first instance, this could be difficult to implement, not least because it may require the CAA to undertake joint-working with other regulators (in order to regularly collect benchmarking data, for example). In the long-term, however, it could be helpful in revealing what the ‘true’ efficient target levels should be.

3.3 Planning for uncertainty

Under the current framework, GAL’s price commitment on airport charges is benchmarked against the CAA’s assessment of a ‘fair price’; which is based on forecast traffic and planned investment, among other determinants. It is not uncommon, however, for outturn determinants to be different from forecasts. For instance, recent developments suggest that actual traffic growth (averaging 6.2% per year) has been well above forecasts (between 1.4% to 2% per year).³ This trend can easily be reversed, for instance, if business and leisure travel is dampened after Brexit. The current framework, however, does not allow or incentivise GAL to feedback any risk outturns into its prices over the full regulatory period.

In developing the next regulatory framework, the CAA might consider adopting some of the measures being considered by other regulators, specifically, in the water and energy sectors. In particular, it might consider:

² *Economic regulation: A review of Gatwick Airport Limited’s commitments framework*, CAA. Available at: <http://publicapps.caa.co.uk/docs/33/CAP%201502%20DEC16.pdf>

³ *Future economic regulation of Gatwick Airport Limited: Initial consultation*, CAA.

- developing probability distributions around key risk factors;
- individually assessing the cost and price contribution of each risk factor;
- introducing rewards and/or penalties to incentivise the airport to feed through any developments into the prices; and
- using uncertainty mechanisms to appropriately allocate the risk between passengers and investors.

This approach would ensure a more robust allocation of risk, which in turn should ensure that incentives to deliver the best possible outcomes for all stakeholders are as strong as possible. Importantly, the above would still be consistent with a 'negotiated' approach between GAL and the airlines (i.e. GAL could propose what risk factors should be shared, and how – and airlines could similarly provide their views).

Economic Insight Limited

125 Old Broad Street
London
EC2N 1AR
0207 100 3746
www.economic-insight.com

Economic Insight Ltd is registered in England No. 7608279.

Whilst every effort has been made to ensure the accuracy of the material and analysis contained in this document, the Company accepts no liability for any action taken on the basis of its contents. Economic Insight is not licensed in the conduct of investment business as defined in the Financial Services and Markets Act 2000.

Any individual or firm considering a specific investment should consult their own broker or other investment adviser. The Company accepts no liability for any specific investment decision, which must be at the investor's own risk.

© Economic Insight, 2018. All rights reserved. Other than the quotation of short passages for the purposes of criticism or review, no part of this document may be used or reproduced without express permission.

