Civil Aviation Authority

Economic regulation at Gatwick from April 2014: initial proposals

CAP 1029

Civil Aviation Authority

CAP 1029

Economic regulation at Gatwick from April 2014: initial proposals

www.caa.co.uk

April 2013

ISBN 978 0 11792 823 7

Enquiries regarding the content of this publication should be addressed to:
Regulatory Policy Group, Civil Aviation Authority, CAA House, 45 - 49 Kingsway, London, WC2B 6TE

The latest version of this document is available in electronic format at www.caa.co.uk/publications
Published by TSO (The Stationery Office) on behalf of the UK Civil Aviation Authority.

Printed copy available from:
TSO, PO Box 29, Norwich NR3 1GN
Telephone orders/General enquiries: 0870 600 5522
Fax orders: 0870 600 5533

www.tso.co.uk/bookshop
E-mail: book.orders@tso.co.uk
Textphone: 0870 240 3701

Contents

INTENTIONALLY LEFT BLANK

Executive Summary

Purpose of this document

1. The document sets out the CAA's initial proposals for the appropriate economic regulatory framework for Gatwick Airport Limited (GAL) that will apply when the present regulatory arrangements expire in April 2014. The present regulatory arrangements cover the years 2008/09 - 2013/14, including an additional year of extension, and are known as the fifth quinquennium (Q5/Q5+1). The arrangements to apply beyond this date are commonly known as the sixth quinquennium (Q6) although the length of the period can be more or less than five years.

2. The CAA is making its initial proposals in pursuance of its duties under the Civil Aviation Act 2012 (the Act) and in particular its primary duty to further the interests of users in terms of the range, availability, continuity, cost and quality of airport operation services, and to, where appropriate, promote competition in the provision of those services. Users include passengers and those with a right in cargo. The CAA's duty covers present as well as future users.

3. Please note the **deadline for responses** to this consultation is **25 June 2013**. The CAA cannot commit to taking into account representations after this date. The introduction of this document sets out a number of strategic questions on which the CAA would especially welcome feedback from stakeholders.

4. The CAA would like to thank GAL, the airlines operating at Gatwick airport (the airlines) and other stakeholders for their positive contributions so far to the CAA's review.

Next steps

5. Following the CAA's consideration of responses to this document, it aims to publish its final proposals in October 2013. If a licence for GAL is required, the CAA aims to publish the notice proposing to grant the licence in December 2013, specifying the airport area for which it

is granted and the licence conditions proposed to be included to give effect to the CAA's decisions. Selected draft licence conditions are attached to this document.

The CAA's initial proposals reflect its firm commitment to put users at the heart of airport economic regulation

6. The CAA's review has taken place alongside the government's reforms to the regulatory framework for airports, which culminated in the Act. The CAA fully supported the new legislation as it modernised its regulatory tool-kit in line with other UK economic regulators, specifically by giving the CAA a clear primary duty to further the interests of users and promote competition. It also introduced a flexible licensing regime.

7. Section 1(1) of the Act directs the CAA to carry out its regulatory functions in a manner that furthers the interests of users of air transport services regarding the range, availability, continuity, cost and quality of airport operation services. By "users", the Act refers to passengers and those with rights in cargo.[1] The CAA must further those interests, where appropriate, by promoting competition in the provision of airport operation services. It must also have regard to the need to secure economy, efficiency and the ability of the licence-holder to finance such services.[2]

8. The CAA considers that present and future users' interests[3] are generally best served where they have genuine choice among airports that are competing and innovating vigorously for their custom. Where effective competition between airports is not present, and an airport operator has substantial market power (SMP), the CAA needs to consider necessary and proportionate safeguards for passengers. In doing so, the CAA needs to assure itself that relying on general competition law would not be a more effective safeguard than issuing a licence to the airport operator, and the potential benefits of regulation by a licence outweigh the potential costs. Taken together,

[1]Section 69(1) of the Act.

[2]Section 1(3) of the Act.

[3] Where this document mentions passengers' interests this should also be taken to referring to the interests those with rights in cargo.

these factors form the basis of the Market Power Test (MPT) in the Act that, if satisfied, requires the airport operator to hold a licence.

9. The CAA considers these conditions are likely to be met in the case of GAL. Alongside this document the CAA is publishing a summary of its view that it is 'minded to' conclude that the MPT in the Act for continuing regulation of GAL is met. The CAA's full MPT will be published at the end of May 2013. The CAA's view is subject to consultation and the CAA will review its position later this year

10. The CAA's assessment takes into account GAL's proposed commitments. GAL's proposed commitments would be provided by it to airlines as part of GAL's Conditions of Use and provide commitments on price, service quality and other matters normally covered by a regulatory settlement. GAL considers that these commitments are an alternative to more formal licence regulation.

11. Notwithstanding GAL's commitments, the CAA considers that GAL's SMP and the limited effective choice in practice by users of Gatwick airport (Gatwick) present a number of risks that require continuing economic regulation beyond April 2014. These risks include lower levels of efficiency, higher prices, inconsistent service quality, and sub-optimal investments than may otherwise be the case. These risks directly affect the range, availability, continuity, cost and quality of airport operation services and the adverse effects of those risks are ultimately borne by users. In addition airlines have raised a number of concerns with GAL's commitment proposals.

The CAA has sought to understand users' interests in relation to economic regulation

12. In designing the most proportionate and effective regulatory arrangements the CAA has sought to understand users' priorities. Given that over 99% of cargo traffic at Gatwick travels in the bellyhold of passenger aircraft, the CAA considers that the interests of cargo owners are broadly aligned with those of passengers. Consequently, the CAA considers that cargo owners' priorities are broadly aligned to passengers' priorities. The CAA has identified passenger priorities in three principal ways: through Constructive Engagement (CE) between

GAL and the airlines, independent passenger research and challenge by the CAA Consumer Panel.

Constructive Engagement between GAL and the airlines

13. The CAA oversaw a detailed CE process whereby GAL was required to develop and discuss an initial business plan (IBP) with the airlines. This recognises that airlines' commercial interests often, but not always, align with the interests of their passengers. It also recognises airlines are materially affected by the CAA's decisions.

14. The CAA welcomes the fact that both GAL and the airlines engaged in the process. Progress was made on capital expenditure (capex), with agreement that a number of projects should be further developed. Progress was also made on traffic forecasts and service quality, mainly through developing a greater understanding of the issues and sensitivity to key assumptions. There was less progress on operating expenditure (opex) where GAL did not provide sufficient information for the airlines to feel that they could engage meaningfully. The CAA is disappointed that GAL was not able to provide the requested data to airlines so that they could have a better informed view of GAL's proposals. Nevertheless, the CAA considers that CE has produced benefits in terms of a better understanding of the issues as an input for the CAA's initial proposals.

CAA independent passenger research

15. The commercial interests of the airlines may not always align with the interests of passengers. Hence, it is important for the CAA to form its own view on passengers' priorities to influence the CE discussions and validate the outcomes.

16. The CAA has undertaken considerable primary passenger research and surveys to inform its views as well as evaluating the stock of research it has access to from third parties such as the airport operators, airlines, and independent agencies. The CAA has been able to draw some key themes to influence its initial proposals.

17. Survey evidence suggests that the quality of the airport itself ranks significantly behind passengers' primary concerns of ease of access to the airport, the availability of airline routes, and the price of the air fare. That said, passengers' satisfaction at Gatwick is relatively high and has increased over Q5 and is broadly consistent across the two

terminals. Most passengers, on most journeys, say they have a "good" or "excellent" experience. There is some variation in satisfaction across passenger groups, with leisure passengers more satisfied than business passengers, and departures more satisfied than arrivals. Passengers' priorities for investment also vary with central security the top priority for departing passengers and baggage reclaim the top priority for arrivals. GAL's research into passengers' willingness to pay for improvements indicated relatively high values for things like segregated zones (e.g. quiet or children's zones), however, values varied widely across passengers, with airline research showing a lower level of willingness to pay for modest improvements.

Challenge from the CAA Consumer Panel

18. The CAA has sought scrutiny from its Consumer Panel of its approach to understanding passengers' priorities from airport operation services. In particular, the Consumer Panel has agreed that there is evidence to suggest that GAL's current service quality is generally satisfactory, but the Consumer Panel encouraged the CAA to consider the needs of different sub-groups and the importance of performance during times of disruption.

19. Against this background of its research on passengers' interests, the CAA has developed a number of initial views in relation to service quality:

    - a need to maintain current levels of service provision;
    - any proposed passenger improvements should focus on areas where passenger benefits demonstrably outweigh the costs; and
    - measures are needed to strengthen GAL's preparedness to help reduce the risk of negative impacts on passengers from service disruption.

20. The CAA has taken into account these issues when developing its initial proposals.

CAA's assessment of a fair price

21. The CAA has set out in its market power assessment it is 'minded to' view that, notwithstanding the commitments offered by GAL, the

benefits of regulation through a licence are likely to outweigh the adverse effects. In order to assess the most suitable and effective form of regulation (whether by licence or commitments or otherwise), and as the basis for its initial proposals, the CAA has considered what would be a fair price to be paid by airlines in terms of airport charges.[4]

Calculation of a fair price

22. The CAA's calculation of a fair price is derived on the basis of a single till Regulatory Asset Base (RAB) model – the same methodology that is used to calculate the present price cap. This approach is designed to balance the needs of passengers today and in the future in terms of airport charges being no more than the minimum needed to remunerate an efficient airport operator, whilst ensuring a fair return on investments. The CAA has considered a fair price over five years, consistent with the typical duration of a RAB-based price cap, and seven years, for consistency with GAL's proposed commitments.

23. The assessment of a fair price has been conducted in accordance with the CAA's statutory duties under section 1 of the Act. In addition to the CAA's primary duty to further users' interests and, where appropriate to promote competition, this includes compliance with the better regulation principles, the need to ensure that the airport operator can finance its provision of airport operation services and the need to promote economy and efficiency.

There are stark differences between GAL and the airlines across a range of components for calculating the price caps

24. Despite the progress made in CE, the views of GAL and the airlines are significantly different on what represents an acceptable price profile for Q6. As part of its revised business plan (RBP), GAL stated that, under a RAB-based price cap over Q6 it would like to raise prices by 6.9% per year above the retail price index (RPI) for the next five year control period, Q6, and increase prices in line with RPI (RPI+0%)

[4] In this document, the term airport charges in relation to an airport means :

a) charges levied on operators of aircraft in connection with the landing, parking or taking off of aircraft at the airport (including charges that are determined by reference to the number of passengers on board the aircraft), including any separate charge for aerodrome navigation services; and,

b) charges levied on aircraft passengers in connection with their arrival at, or departure from, the airport by air.

for the following five-year control period (Q7). GAL's proposed commitments provided a discount on its view of the RAB-based price, with prices increasing by RPI +4% per year over seven years. The airlines put forward an alternative business plan, which had a forecast price cap of RPI -9% per year for Q6, based on different assumptions for some key components of the price cap.

25. The differences were particularly marked across four components of the price cap: traffic projections, opex, capex and GAL's weighted average cost of capital (WACC).

There is potential for GAL to outperform its traffic forecasts

26. GAL is forecasting that its traffic will grow from 33.8 million passengers per annum (mppa) in 2012/13 to 35.9 mppa in 2018/19 and 37.2 mppa in 2020/21. The airlines on the other hand consider GAL's traffic will reach 37.6 mppa in 2018/19 and 39.5 mppa in 2020/21. The differences rest in part on different underlying economic growth assumptions.

27. The CAA has reviewed GAL's and the airlines' forecasts and undertaken its own analysis based on airline plans over the next three years, supplemented by forecasts based on underlying economic growth for the following period.

28. The CAA considers that over the next three years there is scope for GAL to outperform its forecast (the airlines used the same three year forecast). Traffic for 2012/13 was around 34.2 mppa, already above GAL's forecast, and the traffic and capacity plans provided by airlines to the CAA on a confidential basis were higher than those used by GAL.

29. The CAA also considers that the economic assumptions used in the GAL forecasts were at the low end of a range of independent forecasts over the short- to medium-term. This conservatism seems to be unwarranted.

30. Allowing for these changes, the CAA's initial projections for traffic are 37.6 mppa in 2018/19 and 39.3 mppa in 2020/21, similar to the forecasts made by the airlines.

While GAL has improved opex efficiency, its future plans are insufficiently challenging

31. GAL projects opex will increase by 1% in real terms over the course of Q6 (i.e. RPI+1%). This is a higher rate of growth in opex than in the Q6 business plans submitted by Heathrow Airport Limited (HAL) and Stansted Airport Limited (STAL).

32. The CAA has undertaken its own detailed scrutiny of GAL's opex projections for Q6. It has completed several pieces of research itself as well as commissioning several independent consultants' reports to benchmark GAL's opex projections. This has covered issues such as employment costs (including pension costs), central services and maintenance functions. The consultants identified significant potential cost savings. These reports have been published alongside this document and, where data has been provided by GAL, the CAA shared drafts for comment with GAL prior to publication, although it should be recognised that the findings have not been agreed.

33. The overriding message from this body of analysis is that, despite the efficiencies that GAL has achieved over recent years, there remains a significant difference in GAL's Q6 projections and what might be considered a level representing an efficient airport operator.

34. The judgement for the CAA, having established a gap between GAL's actual performance and a notional efficient level of performance, is how best to incentivise GAL to improve its opex efficiency through setting Q6 price caps. In particular, there are judgement calls regarding how much of the risks and costs of making up that shortfall, and over what time frame, should be borne by GAL or passed on in the form of lower charges. Put more simply, how much of this shortfall is reasonable for shareholders to fund rather than users.

35. The CAA recognises that it is not reasonable to expect GAL to move to the efficiency frontier overnight since there are legacy issues in GAL's cost base that will take time to work out. That said, passengers would expect GAL to be making all reasonable efforts to become more efficient. In making its judgement, the CAA recognises that reducing opex may in some cases impose other risks to passengers especially if GAL's reaction is to respond with service reductions or inferior performance and unwind the advances it made during Q5.

36. The CAA has been able to derive a range of potential efficiency savings in Q6 from its independent consultants' studies of a real cost reduction of 0.8% to 2.0% per year, compared to a 2013/14 cost base and GAL's forecast for a real 1% per year increase. The CAA's initial projections set its assumptions at the lower end of this range, 1.1% per year, in part to reflect that CAA expects traffic to be higher than GAL's forecasts. This gives a total opex reduction of 7% over Q6 compared to the GAL forecast. This approach has regard to the need to protect passengers from continuing to pay for GAL's inefficiency; giving GAL a strong incentive to improve further its performance; while recognising that the CAA must take into account the practical difficulties of GAL transitioning to more efficient operations.

The capital plans of GAL and the airlines represent different visions for the airport - the CAA considers that most of GAL's proposed schemes have passenger benefits although costs need to be reduced

37. As part of its RBP, GAL put forward a capex plan of £0.9 billion for Q6. The airlines only supported £0.4 billion of this expenditure as either projects did not produce a commercial return in Q6 or did not provide a value for money enhancement to the passenger experience.

38. The CAA commissioned independent consultants to review GAL's capex plans. These reports indicated that it may be possible to reduce the costs of GAL's asset stewardship and development capex plans by around 8%. Furthermore, the consultants identified a number of areas where lower cost solutions may be beneficial. Given the difference of opinion over the justification of some schemes, the CAA has reviewed whether schemes are in the passengers' interest, in particular by examining willingness to pay research. In general the CAA found that the majority of schemes were in the passengers' interest, although the costs of some schemes would need to be reduced, in particular the cost of maintaining 95% pier service.

39. In total the CAA has assumed a capital allowance of £0.8 billion in assessing a fair price for Q6, but would look to GAL and the airlines, as far as possible, to agree the capital programme going forwards. For calculation purposes the CAA has assumed GAL's capital plan for the first two years of Q7.

40. GAL has also argued that the regulatory process may make it more difficult to undertake certain investments to attract new airlines and future users, who are not strongly represented by current airlines. The CAA does not accept this. The CAA does not rule out such investments from occurring if they are in the passenger interest and there is a demonstrable business case. This avoids passengers rather than GAL's shareholders bearing the risk of speculative investments. The CAA has also raised the option of GAL's shareholders funding certain investments at risk, with compensating adjustments to the single till. GAL has not pursued this option.

Weighted average cost of capital

41. The WACC is a critical element of the price cap because it acts to reward past investment – as represented by GAL's RAB of over £2 billion – and provide sufficient, not excessive, incentives for capital providers to fund future investment in Gatwick.

42. Expressed in pre-tax real terms, GAL has argued for an increase in the WACC to 7.1% compared to the Q5 settlement of 6.5%.[5] GAL argued that its risk profile had increased considerably since Q5, from the change in ownership leading to more airport competition and more flexible airline business models. GAL also considered that risks were negatively skewed at Gatwick, with negative shocks to traffic having a greater impact than positive ones, and the increasingly competitive environment meant greater uncertainty on whether it could price to the level of a RAB-based price cap.

43. BA commissioned research suggested that GAL's WACC should be reduced compared to Q5 and would be in the range 4.5% to 5.5% - in the same range as for HAL. The main difference between the BA and GAL assumptions was over the cost of equity.

44. On behalf of the Gatwick Airline Consultative Committee (ACC), easyJet estimated GAL's cost of capital to be 4.2%, based on a reduction in corporate tax rates and a reduction in the cost of equity and debt, due to a decrease in yields on UK gilts and bonds.

[5] The Q5 headline rate was 6.5%. This was adjusted downwards to 6.3% to reflect the timing of cash flows and it was 6.3% that was applied to the Q5 RAB to calculate the price cap. The CAA has used a similar concept to select its point estimate for the WACC from a rage identified by its independent consultants.

45. The CAA commissioned an independent assessment of GAL's WACC. This did not find that GAL should be viewed as more risky compared to the Q5 assumptions made by the CAA and the Competition Commission (CC). However, it did find that the cost of debt has fallen significantly as interest rates have declined to record low levels. In addition, the corporation tax rate has been reduced significantly compared to Q5 and the government has signalled it will reduce it further. Taking these factors into account the CAA's independent consultants recommended a range for GAL's WACC of 4.5% to 6.1%. The CAA's consultants have used a notional gearing of 45% equity finance and 55% debt finance.

46. The CAA's judgement of where in this range it should set its assumption has been informed by many factors. The CAA recognises there are risks to passengers in how it sets the WACC within a given range. Too high a WACC risks passengers paying more than may be strictly necessary to reward capital providers. However, a WACC too low would mean GAL was unable to raise sufficient capital to modernise and upgrade its facilities in the long term interests of passengers.

47. Experience of what happened in Q5 is useful in calibrating the CAA's judgement for Q6. Despite the very challenging macroeconomic environment for aviation over this period, GAL was able to raise significant debt finance during the period and also was able to sell equity stakes at around its RAB value.

48. It is important that once the level of the WACC is set, GAL is able to achieve this if it meets the other assumptions in the price cap. The CAA notes that actual returns to equity were low compared to the Q5 assumption. However, this mainly reflected a variance in actual traffic to the traffic forecast used for Q5. The CAA considers that its traffic forecasts for Q6 are reasonable, given that traffic is already outperforming GAL's forecasts despite the current poor economic environment. The new licensing framework also enables the CAA to revisit the price control within the period if key assumptions such as traffic do start to get significantly out of line with projections.

49. Taking all these factors in the round, the CAA's initial projections for the GAL WACC are to set it at 5.65% pre-tax real, and to apply this to the RAB. The CAA has taken into account determinations made by other economic regulators. The CAA notes that its WACC assumption

places GAL slightly above the assumption Ofgem used recently for electricity distribution and transmission companies, but below the level Ofcom has recently adopted for BT's wholesale business.

CAA’s initial projections for a fair price

50. The CAA has had to reach some judgements on other items that contribute to the price cap, such as the level of commercial revenues. The CAA’s initial projections in these areas contain some changes from the GAL business plans.

51. Taking all the inputs together, the CAA’s initial projections for a fair price are equivalent to RPI+1.0% per year in Q6 and RPI+0.0% per year over the seven years of the GAL commitments.

52. The CAA considers that this projection is consistent with its statutory duties in section 1 of the Act, including, amongst other matters, the need to secure that licence holders can finance their provision of airport operation services. To that particular end, the CAA has, as a precautionary measure, cross checked its initial projections for Q6 prices with a series of financeability ratios consistent with GAL continuing to maintain a solid investment grade credit rating.

53. The CAA has used its calculation of a fair price to assess the most reasonable and effective form of regulation, whether through commitments, or by means of a licence, and as a basis for setting its initial proposals.

CAA has considered a wide range of options for the regulation of GAL

54. The overall model or form of economic regulation for GAL should reflect the degree of market power of the airport operator and the potential risk for abuse of that position and be designed in a manner that furthers the CAA's statutory duties.

55. The CAA recognises that regulation can entail additional costs and hence it is important that its form – or model – of regulation safeguards passengers’ interests from the risk of abuse of SMP in a

manner that does not stifle or frustrate the development of effective competition or lead to unnecessary regulatory burdens.

56. Aside from an evaluation of possible regulatory options against its primary duty, the CAA has formulated a number of other evaluation criteria related to its wider statutory duties and international obligations (the evaluation criteria). These include, amongst others, the promotion of economy and efficiency and the ability of an efficient business to finance its provision of airport operation services. Consistent with the Better Regulation principles, the CAA has considered whether the options are transparent, accountable, proportionate, consistent and targeted only at cases in which action in needed. The CAA also has to avoid the imposition of unnecessary regulatory burdens on airport operators[6]; and also that the options are practical and have stakeholder confidence.

57. The CAA has therefore first considered whether GAL's commitments are sufficient that no licence-based framework is required at all. This question is primarily addressed in the MPT with regard to GAL.

58. GAL has proposed that the commitments would be combined with bilateral contracts. While bilateral contracts would not be precluded under licence regulation, they may be more likely to occur with the commitments in place, for example they would also reduce the risk for GAL and the airlines concerned that the terms offered in a typical 10 year bilateral might not be consistent with regulation over more than one control period. Given the diverse mix of airlines at Gatwick, it is unlikely that one size would fit all and the commitments may provide benefits over licence regulation in the form of additional flexibility, for example from the greater potential for bilateral contracts. However, the CAA does not consider that GAL's commitments as currently drafted would provide sufficient protection to passengers. The CAA's concerns include the following.

- Enforceability of the commitments: GAL is apparently able to make unilateral variations or contract out of the terms, and the commitments are enforced by airlines rather than passengers, where their interests may not always align. The CAA has no direct route of enforcing the commitments or sanctioning their breach.

[6] Section 104 of the Act.

- Price: The price offered in the commitments of RPI+4% per year over seven years is significantly in excess of the CAA's view of a fair price of RPI+0.0% per year.
- Efficiency: The inclusion of the full cost pass through of changes to security requirements (current regulatory arrangements only allow 90% of cost to be passed through), taxation changes and the development costs of a second runway could adversely affect efficiency.
- Service quality: The level of rebates and bonuses in the service quality scheme could allow service quality to be reduced and could allow GAL to achieve bonuses without improving performance. The commitments do not provide protection against repeated failures to meet service quality targets and airline service quality targets may have the potential to distort competition between airlines.
- Capex: The commitments do not provide any guarantee that the outputs from the GAL capex plan, beyond those reflected in the service quality scheme, would be delivered.
- Consultation: The requirements for consultation are in line with those in the Airport Charges Directive (ACD) that were implemented in the UK through the Airport Charges Regulations (ACR). This is unlikely to be sufficient for airlines to provide properly informed views on the capital programme and how decisions have been made.
- Transparency: The commitments do not provide sufficient information to airlines to allow airlines to understand whether charges are reasonable.
- Operational resilience: The commitments do not provide clarity on what GAL will do and how it will interact with other service providers 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 do not provide clarity on what GAL will do to ensure its financial resilience and continuity of service.

59. The commitments could have benefits over a licence approach, in that they would avoid the direct costs of staff and consultancy associated with a regulatory review, although these costs may be reduced under alternative forms of regulation. Commitments themselves are unlikely to be costless and potential cost savings could be significantly reduced if there is not effective partnership working between GAL and the airlines. The reaction from airlines on the commitments has been mixed, with much turning on airlines' views on whether the price is fair and concerns with the enforceability of the commitments.

60. Were airlines to have confidence in the contents and form of the commitments, the commitments could generate benefits in terms of avoiding the potential distortions from RAB-based regulation. For example they would avoid management distraction, as the enforcement of the commitments would be linked to commercial negotiations and remove some perverse incentives that may occur under a regulatory regime, for example potential distortions to capex incentives under a RAB-based framework, or the potential for 'regulatory gaming'. They could also avoid potential distortions to competition, for example a price cap set too low could distort charges and investment at other airports. In such circumstances, assuming the substance and form of the commitments were reasonable and effective for, airlines and their passengers, GAL’s commitments could, in principle, be a vehicle for future airport development, which could better serve passengers' interests than more detailed regulation.

61. Taking these factors together, the CAA remains optimistic about commitments as a core element in the regime, but the CAA cannot see how the enforcement framework around the commitments can be strengthened sufficiently that relying on commitments alone would enable the CAA to provide assurance that passengers’ interests will be promoted. It may well be that the right commitments, backed up with a light-touch licence, could be the preferred option; but this needs to be compared to other possible licence-based frameworks. The CAA has therefore considered what form of regulation should be implemented under a licence.

62. Due to the concerns listed above, the CAA has considered a combination of commitments backed by a licensing framework. The licence could include provisions that enable the CAA to enforce the commitments, prevent GAL from altering or withdrawing the

commitments, direct changes in response to a dispute and allow the CAA to freeze prices if it is undertaking an investigation. This would address the enforceability concerns with the commitments. However, the concerns with the terms in the commitments would remain. If the CAA's concerns are addressed by GAL and the revised commitments are reasonable and effective, then the CAA would reconsider. The CAA hopes that a commitments and limited licensing framework could be the preferred solution, as it may help to encourage greater airport-airline dialogue and negotiation in setting airport charges in a context of diverse airline business models.

63. The CAA used a RAB-based approach to set price caps for GAL in Q5. Many other regulators use a RAB-based approach to set price caps. A RAB-based approach is well understood at Gatwick and there is less uncertainty on individual building blocks, in particular traffic, than at Stansted. The CAA acknowledges that there are drawbacks from a RAB approach as it can be costly and time consuming and distort investment incentives and can introduce rigidities into the system. Nevertheless, the CAA considers that it may be possible to overcome some of these issues through a more flexible RAB-based approach. Consequently, a RAB-based approach could continue to be appropriate to GAL.

64. The CAA has considered in detail a range of other potential options. The CAA has looked at whether setting price caps with reference to long-run incremental costs (LRIC) would be a more appropriate option. This has the conceptual benefit of being linked to a notion of future competitive prices. However, its input assumptions require significant judgement. Different inputs could lead to starkly different pricing profiles, with the variance measured by multiples of the current price in some circumstances.

65. The CAA has also considered options that would link Gatwick prices more clearly to a benchmark index of peer group airport charges. This has the potential advantage of linking prices to what might be considered a market based competitive price. However, it suffers the drawback of inviting considerable debate over the composition of the index, the equivalence of comparators, the frequency of adjustment, etc. It is unclear whether such an index would be appropriate to draw a point estimate for a price cap calculation rather than provide a range upon which to judge the reasonableness of GAL's prices.

66. For these reasons, the CAA does not propose to pursue either LRIC or benchmarking against a peer group index as a preferred candidate for the Q6 regulatory model. Nevertheless, the CAA does consider that they could be used as context or reference points to assess the reasonableness of its preferred option, taking into account the issues identified above.

67. The CAA has considered the option of setting a default price cap. This sets a price based on a minimum level of service quality, where airlines can then seek to negotiate variations (above and below the default) with GAL. Given that the price cap needs to be calculated, it may face the same pros and cons as other options to the extent that its calculation is based on a complex calculation such as RAB or LRIC.

68. A price monitoring and transparency regime would not set a price cap upfront but would provide clear expectations on how behaviour could trigger an investigation by the CAA. It could include obligations on GAL to make certain information available to airlines beyond the basic requirements in the ACR. Thus, it could provide a backstop for regulatory action along with useful and timely information for airlines to help them hold GAL to account. It may have the advantage of encouraging greater discussion between the airport operator and airlines on developing longer-term commercial relationships as well as facilitating flexibility, compared to establishing a fixed price cap in advance. However, price monitoring requires the risks of abuse of market power to be low and hence it is more suited to an airport operator where there is a lower degree of market power. If market power is abused then significant passenger detriment could occur until tighter regulation was subsequently introduced. Consequently, the CAA would want assurance that there is a reasonable prospect of the airport operator working together with airlines. The evidence highlighted in the market power assessment, for example GAL's views of the competitive price, its willingness to negotiate with its customers, together with its views of an appropriate price and terms under its commitments, does not provide the CAA with sufficient assurance that price monitoring would be an effective form of regulation for GAL.

69. The CAA has also considered whether a system of price monitoring backed by commitments could be an effective form of regulation. However, much of the burden from preventing abuse would rest on

the terms in the commitments, and unless these are incorporated within a licence (as under the commitments and licensing framework described above), then this option is likely to suffer from many of the same problems as commitments alone, albeit with some improved transparency. Consequently, this option is likely to be less beneficial than a commitments and licensing framework on grounds of enforceability and there would be additional costs from the production of the annual monitoring reports.

70. Based on its assessment against the evaluation criteria drawn from its statutory duties, the CAA hopes that a commitments and limited licensing framework could be the preferred form of regulation for GAL. This would be on the basis that the enforcement concerns about the commitments concept was addressed through enforcement under the licence; and that the commitments were amended to address the other concerns outlined above, so that they are reasonable and effective. In the absence of a satisfactory proposal for commitments, and due to the concerns raised around the other potential options, the CAA considers that it would be most appropriate to base its initial proposals on a RAB-based framework.

71. The CAA has carefully considered GAL's argument that the prospect for airlines agreeing to commitments or bilateral contracts is frustrated by the CAA's regulatory process. The CAA does not accept this. GAL indicated at the start of 2011 that it wanted to agree bilateral contracts in that year. The CAA structured its process so as to allow time for these negotiations to take place. The CAA said it would take into account any progress in reaching bilateral agreements. Over two years have now elapsed and no bilateral contracts have been concluded. The CAA therefore does not consider it is in passengers' interests to delay issuing its initial proposals. Nothing in these proposals rules out GAL continuing to negotiate and secure bilateral contracts both in the lead up to April 2014 and after this date.

The CAA's initial proposals for a RAB-based price cap

Initial proposals for a price cap

72. The CAA has based its initial proposals for a RAB-based price cap on its analysis of a fair price. While GAL has offered commitments for

seven years, the CAA's initial proposal is to continue with a five year control period, given the greater need in a RAB-based framework to define investment needs in advance. Consequently the CAA's initial proposals are for a price cap of RPI+1.0% over 5 years. The CAA acknowledges that the price cap could be profiled in alternative ways through the course of Q6 and shall consider this further in the lead up to its final proposals.

Initial proposals for minimum service standards passengers can expect from GAL

73. GAL has made considerable progress on improving service quality since the start of Q5. Its passenger satisfaction scores (measured by GAL's own Quality of Service Measure (QSM) index) have increased over the period. For example, in the first quarter of 2008, GAL's average QSM score was regularly around 4 (out of 5). Since then, it rose steadily over Q5 to be over 4.2 by the end of 2012.

74. GAL has also improved its performance against the CAA's regulatory standards under the Service Quality Rebate (SQR) scheme. This has especially been in the areas of security queues and other passenger facing measures such as cleanliness and wayfinding. GAL's performance has improved so much that from a position of paying £5 million in rebates in 2008/09 it has so far not paid any rebates in 2012/13 and has instead received bonuses of over £1 million.

75. GAL has proposed that the service quality scheme for Q6 should be based on that for Q5, with an extension of bonuses to cover all elements of the regime, and an increase in the money at risk for bonuses so that they are consistent with those for rebates.

76. The airlines had a range of views, from those wanting incremental improvements to the service quality scheme, to those that wanted a move to a more focused service level agreement (SLA), which concentrated on a few key measures.

77. Based on its passenger research, the CAA considered that:

- there was a need to maintain consistent delivery of current levels of service quality provision; and

- any proposed improvements should be focused on areas where passenger benefits demonstrably outweigh the costs which would potentially impact all passengers.

78. In summary, the CAA's initial proposals are to retain the SQR scheme for Q6, but to improve elements of the scheme, where there are likely to be clear passenger benefits.

79. The CAA proposes that the level of the rebates to airlines allocated to GAL's performance will remain the same as Q5 at 7% of airport charges per year. However, the CAA proposes to reconfigure the way bonuses are paid to avoid GAL receiving bonuses from the start of Q6 but providing it with such an opportunity should it achieve an acceptable minimum baseline of performance across both terminals.

80. The CAA proposes to remove bonuses from two SQR elements where GAL has been able to easily meet the standard and further improvements could add disproportionate costs. This reduces the overall bonus potential from 2.2% of airport charges per year to about 1.4%.

81. In response to improved performance over Q5, the CAA proposes to reallocate some of the rebate for central security to a daily event based measure where rebates would be paid if queues were longer than 30 minutes.

82. The CAA is inviting views on whether to redeploy the bonuses removed from the two SQR measures. The CAA is also inviting views on whether and how the allocation of bonuses and rebates should be reallocated during the Q6 period.

83. In terms of standards for the other SQR elements, such as those related to passenger satisfaction levels with certain issues such as wayfinding, cleanliness, and flight information, the CAA proposes that these should in the main reflect the performance levels GAL was able to achieve in December 2012. This will help consolidate the improvements GAL made in Q5.

84. The CAA proposes to maintain the existing level of publication of service quality performance on GAL's website but to focus publication in terminal on a more limited passenger facing subset of this information, including passenger satisfaction with security (rather than the queue measurement measure included in the SQR scheme).

85. GAL and the airlines agree that the SQR scheme should include a new measure based on outbound baggage availability. The CAA proposes a measure based on the time available across the month and invites views on how this might be augmented with an event based measure.

86. Airlines have indicated that they consider that the current aerodrome congestion term (ACT) is overly complex and ineffective and propose a measure for the non-availability of runways and terminals. In response GAL has proposed an airfield availability metric. The CAA welcomes GAL's proposals to introduce some form of airfield availability metric and invites views on how such a metric could be constructed.

87. GAL has also proposed the inclusion of two measures on airlines: on check-in queues and arrival bags wait times. GAL proposes that each airline would pay a small surcharge (~3 pence per passenger) which would fund a rebate to airlines that met the minimum standards. The CAA considers that differentiation on check-in and baggage can be an important choice consideration for passengers. However, such differentiation should be within reasonable limits and it is in principle reasonable for GAL to indicate baseline levels of service, provided this does not unduly restrict passenger choice and airline competition. Overall the CAA considers further work would be required on issues of measurement and incentives before airline measures could be introduced. The CAA will also need to consider whether such measures should be governed by the GAL licence or alternative arrangements, including voluntary arrangements.

88. GAL proposes the publication of two further measures, for monitoring purposes only with non financial incentives: UK Border Force (UKBF) immigration performance, and Airport Service Quality (ASQ[7]) ranking versus other European airports. The CAA welcomes transparency of performance from all stakeholders, although the CAA notes that GAL's own QSM survey is likely to be more statistically robust and publication might therefore be preferable to the ASQ survey. The CAA sees merit, outside of the SQR, in GAL aiding transparency for

[7] ASQ is an international customer satisfaction survey of over 200 airports, conducted locally, but overseen by consultants DKMA on behalf of Airports Council International.

passengers and other stakeholders by publishing information related to third parties operating at Gatwick.

The CAA's initial proposals include measures to strengthen GAL's operational resilience to help reduce the negative impacts on passengers from service disruption

89. The passenger experience from service disruption is one area not covered well by the existing SQR scheme and it is not covered in depth by existing passenger survey research. Nonetheless, passenger experience at Gatwick has, at some times when faced with some adverse weather events such as snow, fallen short of what some passengers might reasonably expect. This is a significant risk at Gatwick given it is operating close to full capacity at peak periods and so bottlenecks can quickly result from even short-term service disruption. The CAA therefore proposes to use GAL's licence to strengthen its approach to planning for service disruption and its response to passengers in the event of service disruption.

90. The CAA recognises that operational resilience and dealing with passenger disruption is a responsibility that goes beyond GAL and includes responsibilities on airlines and other parties such as groundhandling agents, retail concessionaires, NATS Services Limited, and surface access providers. The GAL licence can only impose obligations on GAL as the regulated company.

91. The CAA has developed a draft licence condition that embodies the following principles to ensure that GAL:

- has effective plans in the event of service disruption, no matter what the cause, that have been drawn up with relevant third parties;
- ensures it has effective collaborative and governance mechanisms to work with third parties in the interests of passengers; and
- manages the impact of disruption on passengers by providing relevant and timely information.

Incentives to enhance capital efficiency

CAA review of GAL's capital efficiency in Q5

92. The CAA commissioned a study to examine GAL capex efficiency on a number of key Q5 projects. Broadly speaking, the report found that GAL's approach was reasonable in a number of areas. However, it did identify issues with two projects: North Terminal Extension, where £4 million of expenditure may not have followed best practice project management, and Crew reporting, where £7 million of expenditure may not have been consulted on consistent with the requirements of Annex G of the CAA Q5 decision.[8] These issues are relatively small in comparison to an overall capital programme of around £1 billion, and the CAA is seeking further evidence from GAL before this expenditure can be included in the opening RAB for Q6.

Improving GAL's capital efficiency in Q6

93. The CAA is keen to use the new licensing framework to introduce a more flexible approach to regulating capex. Traditionally the entire capital budget had to be known at the start of the price control period despite the capital programmes and projects being at varying levels of maturity in their business case evaluation. This introduced risk and inevitable tension around the regulatory settlement.

94. During CE, the airlines proposed that the future capital programme should be split into core capex, defined at the start of the control period, and development capex which would be schemes that would be less developed and so their costs would only be included in the price cap when they were sufficiently developed to move into core capex. GAL did not support the core and development capex proposal put forward by the airlines, as it considered a veto of capex by existing airlines with the decision confirmed by the CAA would be a move towards, rather than away from, an interventionist regulatory approach. Regardless of this GAL considered that all projects would be sufficiently developed to be considered core.

95. The CAA considers that there is merit in the core and development concept as it would avoid all projects being agreed at the time of the price review. The CAA considers that the overall capex allowance for

[8] CAA, March 2008, Economic Regulation of Heathrow and Gatwick Airports 2008 - 2013 - CAA Decision, available at: http://www.caa.co.uk/docs/5/ergdocs/heathrowgatwickdecision_mar08.pdf

Q6 should be included in the price cap and be split into core and development capex. The core budget would go into the baseline Q6 price cap for projects that are suitably advanced and can be scoped and costed with reasonable confidence. Other projects that do not meet these tests would go into the development budget. Projects would move from the development budget to core budget once the business case evaluation is sufficiently mature.

The CAA's initial proposals include a new economic licence for GAL that will enable the CAA to respond more effectively to passenger risks

96. The CAA has developed a draft licence for GAL to apply from 1 April 2014. This follows on from the CAA's work for the Department for Transport (DfT) on an indicative licence, which was published in January 2012.

97. The draft licence has been prepared by benchmarking approaches in other economic regulated sectors in the UK. It is currently structured as follows.

- Part I: Scope and interpretation of the licence. This includes defining the airport operator, airport area and points of interpretation.
- Part II: Conditions on fees and revocation. These conditions govern the arrangements for payment of fees to the CAA and licence revocation.
- Part III: Price Control. These conditions will give legal effect to the CAA's final decisions on this issue, as well as any relevant conditions on issues such as capital efficiency and transparency/consultation requirements.
- Part IV: Service Quality. These conditions give effect to the SQR scheme and the CAA's policy on strengthening GAL's operational resilience to ensure the passenger impact is managed effectively.

- Part V: Financial Conditions. These conditions relate to GAL's obligations to produce regulatory accounts and certain obligations to improve its financial resilience, such as by maintaining a continuity service plan.
- Part VI: Other Conditions. There may be some potential licence conditions that the CAA could pursue such as provisions to revisit the price control settlement within the period if there is a significant unforeseen change of circumstances.

98. The CAA will develop the GAL licence will be developed over the course of 2013. In doing so, it will work closely with GAL, the airlines and other stakeholders. Unlike the regulatory settlement for Q5, the licence enables the CAA to respond to risks in the course of Q6.

99. The CAA considers that establishing the basic architecture should be the main priority for the licence before April 2014, rather than seek to cover all possible issues. The CAA will need to consider what issues should be regarded as a priority for April 2014 and what issues could be considered after this date.

100. The CAA is required to ensure that any new licence obligations are transparent, accountable, proportionate, consistent and targeted. This includes adopting, where appropriate, so-called 'sunset' provisions to ensure that provisions do not become out of date and can be refreshed, modified or removed in light of the interests of passengers and market circumstances.

A commitment to continue to work closely with all stakeholders

101. The CAA welcomes feedback from stakeholders on its initial proposals contained in this document. It will reflect on this feedback and produce final proposals in October 2013. The CAA recognises that GAL and the airlines bring very different commercial incentives to Q6. The CAA looks forward to continuing to work with them, and other stakeholders, in pursuit of a regulatory settlement that it considers is best calculated to further the interests of users.

CAA, April 2013

Part A: Background

CHAPTER 1
Introduction

Purpose of this document

1.1 This document sets out the CAA's initial proposals for the most appropriate regulatory arrangements for GAL when the present controls expire in March 2014. The CAA is making these initial proposals pursuant to its powers and duties in the Act. Part 1 of the Act came into force on 6 April 2013 and replaces the framework for airport economic regulation under the Airports Act 1986 (AA86) that has governed all previous quinquennial reviews.

1.2 The CAA welcomes views on the initial proposals contained within this document **no later than 25 June 2013**. The CAA cannot commit to taking into account representations after this date. The CAA will also be consulting on its final proposals in October 2013. Given the timescales for the consultation on the final proposals are likely to be short, the CAA would ask stakeholders to ensure that they provide all information that they consider relevant in response to the initial proposals. The CAA reserves the right not to take into account information, or place less weight on information that is provided after 25 June 2013 that could have been provided earlier.

1.3 This document should be read in conjunction with the CAA's 'minded to' position in the market power assessment on whether GAL satisfies the MPT in the Act in relation to an airport area at Gatwick.[9] The CAA has published alongside this document a number of documents that may also be of interest to stakeholders. These include a number of reports that the CAA has commissioned from independent consultants to support its initial proposals. All of these reports, which are summarised below, can be obtained from the CAA's website.[10]

1.4 The CAA has reflected views from stakeholders in this document based on their submissions to the CAA: most of these submissions were in written form and have been published on the CAA's website;

[9] See section 6 of the Act: http://www.legislation.gov.uk/ukpga/2012/19/contents/enacted.
[10] http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=14279.

some submissions have been made in bilateral and multilateral meetings. The CAA has endeavoured to check the accuracy of all these attributed statements. Should any stakeholder consider that the attributed statement does not reflect their previous submissions to the CAA, it is open to the stakeholder to raise this in their response to this document.

1.5 References in this document to ‘the airlines’ mean views submitted to the CAA by the representative body for airlines for the purposes of CE. In the case of Gatwick, it means the ACC. The CAA acknowledges that the views of individual airlines may differ on particular issues.

1.6 This is a redacted version of the CAA's initial proposals. Some information has been removed at the request of GAL on the basis that it is commercially confidential. Redactions are clearly marked. In accepting redactions for the purposes of this document, the CAA reserves its right to revisit its position for its final proposals.

1.7 The price base used in this document is 2011/12 prices unless otherwise stated.

Questions for stakeholders

1.8 The CAA welcomes views from stakeholders on any aspect of the initial proposals contained within this document. It would particularly welcome views on the following four key issues.

- Whether the CAA has drawn appropriate observations for the regulation of GAL from its research into passengers' interests (see chapter 3).
- The CAA's view of a fair price (see chapters 4 to 11).
- The appropriate form of price regulation for GAL from April 2014 and the CAA’s evaluation of the various options (see chapter 12). In particular, the CAA would welcome feedback on the question whether, assuming GAL were to propose commitments that were reasonable and effective, a commitments and licensing framework would be preferable to other forms of licence regulation. The CAA would also invite comments on its intention, in the absence of

reasonable and effective commitments, to base its initial proposals on a RAB-based framework.

- The CAA's initial proposals for the design of a RAB-based price control (see chapters 13 to 17).

1.9 The CAA is currently working with the DfT to assess the effects of the Airport Economic Regulation provisions contained in the Act. In order to assist with this process, the CAA invites views from stakeholders on the following question.

- What do you expect the CAA to undertake for Q6, using its powers under Part 1 of the Act, which it could not have undertaken using its powers under Part 4 of the Airports Act 1986? In particular, are there any benefits/costs in relation to future opex, capex and the WACC?

Contact details for your response

1.10 Please email your response to airportregulation@caa.co.uk. If you would like to discuss with the CAA any aspect of this document please contact Tim Griffiths (tim.griffiths@caa.co.uk).

1.11 Where responses, business plans or other submissions include estimates of the price cap, building blocks or similar financial information, such estimates and information should be expressed in 2011/12 prices.

1.12 The CAA will publish responses to this consultation on its website shortly after the close of the consultation period. If there are parts of your response that you consider commercially confidential, please mark them clearly as such. Please note that the CAA has powers and duties with respect to information disclosure that can be found in section 59 of, and Schedule 6 to, the Act and in the Freedom of Information Act 2000.

Next steps

1.13 Following its review of responses to this consultation the CAA will issue final proposals in October 2013, and then the formal notice in relation to the proposed licence under section 15(1) of the Act by December 2013. Following this the CAA will issue the formal notice granting the licence under section 15(5) of the Act in January 2014 before the new arrangements come into force on 1 April 2014.

1.14 The planned period for representations to the December 2013 notice reflects the extensive consultation that will by that stage have taken place on the substantive content of the licence. CAA would particularly welcome comments within the December 2013 consultation period on whether the licence conditions correctly reflect the final proposals and whether they are workable and clear from a technical perspective. The Act specifies that, if the conditions included in the licence granted in January 2014 differ significantly from those proposed in the notice in December 2013, the CAA must reconsult on the changes. The CAA would expect any changes between the formal notice under section 15(1) and the final licence and conditions in January 2014 to be limited to minor technical changes that may be necessary to make the licence and conditions fully workable. If any substantive changes are required, the CAA would need to reconsult in early January 2014.

1.15 In July 2013, the CAA Board will invite GAL and airline representatives to present their views on the appropriate regulatory arrangements for GAL going forward.

1.16 The CAA intends to update its work and commission further consultancy support as required. It will also continue to engage regularly with GAL and the airline community to help improve its understanding of their respective positions.

CHAPTER 2

Background

2.1 This chapter sets out the process that has shaped the CAA's initial proposals, the relevant statutory context under the Act, and the influence of CE on the CAA's thinking.

The process that has shaped the CAA's initial proposals

2.2 The CAA's initial proposals have been informed by a number of factors.

- Previous significant CAA consultations in July 2011 and May 2012 designed to establish the key issues of concern to stakeholders and explore the interpretation of the CAA's new duties under the Act.[11]
- A process of CE between April 2012 and December 2012, overseen by the CAA, whereby GAL and the airlines discussed the main building blocks that could be used to calculate future charges. This process culminated in a report to the CAA approved by the Joint Steering Group (JSG).
- A stakeholder session with the CAA Board in January 2013 at which both GAL and representatives from the Gatwick airline community explained their respective positions on the market power and regulation at Gatwick.
- Written representations received from stakeholders in the course of the CAA's process and regular meetings with stakeholders (most of these meetings were bilateral). Some stakeholders have shared with the CAA consultancy studies they have commissioned.

[11] CAA, July 2011, *Setting the Scene for Q6,* http://www.caa.co.uk/default.aspx?catid=2162&pageid=12352 and CAA, May 2012, *Q6 Policy Update*, http://www.caa.co.uk/docs/5/Q6PolicyUpdate.pdf.

- An IBP (April 2012) and RBP (January 2013) from GAL setting out its view on the main building blocks that could be used to calculate future charges in the period April 2014 to March 2019. The RBP included GAL's proposals for airport commitments as an alternative to licence regulation.
- Several independent studies commissioned by the CAA on the efficiency and appropriateness of GAL's business plan projections and the form of regulation.
- Advice from the CAA Consumer Panel.

Figure 2.1: Independent consultancy studies commissioned by the CAA

Topic	Consultant
Cost of capital	PricewaterhouseCoopers
Scope for future efficiency gains at Heathrow, Gatwick and Stansted	Cambridge Economic Policy Associates
Q6 capex review	Davis Langdon
Assessment of maintenance and renewal costs at Heathrow and Gatwick	Steer Davies Gleave
Assessment of commercial revenues at Heathrow and Gatwick	Steer Davies Gleave
Potential framework for price monitoring at Gatwick and Stansted	First Economics
Advice on the calculation of long-run incremental costs	Europe Economics
Other operating expenditure at Heathrow and Gatwick	Steer Davies Gleave
Central support costs	Helios
Comparing and capping airport charges at regulated airport	Leigh Fisher
Employment cost study at Heathrow, Gatwick and Stansted	IDS Thomson Reuters
Q5 capex and consultation review, Gatwick	URS

Source: CAA

Statutory context to the CAA's review

2.3 The Act creates a new framework to govern the application of economic regulation to the airport sector. In essence it modernises the previous arrangements and brings the CAA's duties and powers into line with modern regulatory best practice. This includes the CAA having a single primary duty focused on the interests of passengers and those with rights in cargo. The scope of this duty concerns the range, availability, continuity, cost and quality of airport operation services[12] and the CAA must carry out its functions, where appropriate, in a manner that will promote competition in the provision of airport operation services. The CAA must also have regard to a range of matters (figure 2.2). The Act also enables the CAA to regulate through a flexible licensing approach.

Figure 2.2: The CAA's duties under the Act

S1	CAA's general duty
(1)	The CAA must carry out its functions...in a manner which it considers will further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of airport operation services.
(2)	The CAA must do so, where appropriate, by carrying out the functions in a manner which it considers will promote competition in the provision of airport operation services
(3)	In performing its duties under subsections (1) and (2) the CAA must have regard to: (a) the need to secure that each holder of a licence...is able to finance its provision of airport operation services in the area for which the licence is granted, (b) the need to secure that all reasonable demands for airport operation services are met, (c) the need to promote economy and efficiency on the part of each holder of a licence...in its provision of airport operation services at the airport to which the licence relates, (d) the need to secure that each holder of a licence...is able to take reasonable measures to reduce, control or mitigate the adverse environmental effects of the airport to which the licence relates, facilities used or intended to be used in connection with that airport…and aircraft using that airport, (e) any guidance issued to the CAA by the Secretary of State..., (f) any international obligation of the United Kingdom notified to the CAA by the

[12] Airport operation services are further defined in the Act at section 68.

S1	CAA's general duty
	Secretary of State..., and (g) the principles in subsection (4).
(4)	Those principles are that - (a) regulatory activities should be carried out in a way which is transparent, accountable, proportionate and consistent, and (b) regulatory activities should be targeted only at cases in which action is needed.
S104	Regulatory burdens
	The CAA also has a duty not to impose or maintain unnecessary burdens while performing its regulatory functions under Chapter 1 of Part 1 of the Act.

Source: The Act

Note: In performing its duties under section 1(1) and 1(2) of the 2012 Act the CAA must have regard to any international obligations of the UK notified to it by the Secretary of State. On 12 April 2013 the CAA was notified of the following international obligations, as they affect charges on airlines: Article 15 of the Chicago Convention; air services agreements in force between the EU and its member states and any third country or countries; and air services agreements in force between the UK and any third country or countries. These same obligations applied to the CAA in previous price control reviews conducted under the AA86.

Who should be regulated?

2.4 The Act prohibits an operator of a dominant airport area at a dominant airport from charging for airport operation services unless it has a licence granted by the CAA. An airport area is dominant if the CAA determines (and publishes) that the MPT is met in relation to the area by the relevant operator. The MPT has three parts:

- Test A: the relevant operator has, or is likely to acquire SMP in a market, either alone or taken with such other persons as the CAA considers appropriate;
- Test B: that competition law does not provide sufficient protection against the risk that the relevant operator may engage in conduct that amounts to an abuse of that SMP; and
- Test C: that, for users of air transport services, the benefits of regulating the relevant operator by means of a licence are likely to outweigh the adverse effects.

2.5 The CAA has published a summary of its 'minded to' position in relation to the MPT alongside this document. The CAA considers that the MPT is likely to be met by GAL in relation to, at least, the core area of Gatwick and this is likely to endure over the period 2014 to 2019. As a consequence of the CAA's 'minded to' position that the MPT is met, GAL will require a licence from April 2014 to lift the prohibition on levying charges. The CAA will publish its full market power assessment at the end of May 2013.

2.6 GAL has offered voluntary commitments by way of alternative to a licence. Further detail on the CAA's consideration on whether it can accept GAL's proposed commitments instead of requiring formal licence regulation is included in Test C of the MPT, and is summarised in chapter 12 of this document.

Licence regulation

2.7 The CAA may include in a licence such conditions that it thinks are needed to prevent the risk of abuse of market power as well as any other condition that it thinks are necessary and expedient[13] to secure its statutory duties in the Act, including those which further the interests of users of air transport services or (where appropriate) promotes competition in the provision of airport operation services.

2.8 A licence must specify the airport area and the airport for which it is granted and it must include any price control conditions that the CAA decides are required, as well as provisions for revoking the licence.[14] In addition, the licence may include obligations requiring payment of fees to the CAA.[15] Licence conditions can also include provisions relating to activities carried on outside the airport area for which the licence is granted.

2.9 In January 2012, and at the request of the Secretary of State/DfT to assist parliamentary scrutiny of the Act, the CAA published an indicative licence setting out the types of licence conditions that it might include. The initial proposals of the licence conditions that the CAA considers are required in the GAL licence are set out in

[13] Section 18 of the Act.

[14] Section 17 of the Act.

[15] Section 20 of the Act.

Appendix B.

2.10 GAL and airlines have rights to appeal the CAA's final decision on the inclusion, or absence, of licence conditions to the CC subject to certain qualifying criteria being met.[16] In the event an appeal is made that meets the qualifying criteria the CAA's decision will stand until the CC determines the appeal – unless it has granted interim relief or the appeal relates to specific financial arrangements. While CC appeals should normally be determined within 24 weeks, this can be extended if a relevant appeal to the Competition Appeal Tribunal (CAT) is ongoing.[17]

Influence of Constructive Engagement

2.11 The objective of CE was for the airport operator and the airlines to work together to try and agree inputs to the CAA's setting of the price control for Q6 – or else be very clear where differences of opinion lay.

2.12 The CAA established a formal process for CE by issuing a detailed mandate in April 2012.[18] The CAA conducted a mid-CE review in October 2012 and issued further guidance to the parties for the remainder of CE.[19]

2.13 One of the requirements of the mandate was, to extend the scope of CE from Q5, so that all elements of a RAB-based price control should be within scope of CE.[20] The calculation of the price cap is based on a number of regulatory 'building blocks', as shown in figure 2.3. The current RAB approach is based on a single till, where other revenues are netted off costs to calculate the net revenue requirement to be recovered from airport charges.

[16] Section 24 of the Act. The appeal body will be the Competition and Markets Authority from April 2014.

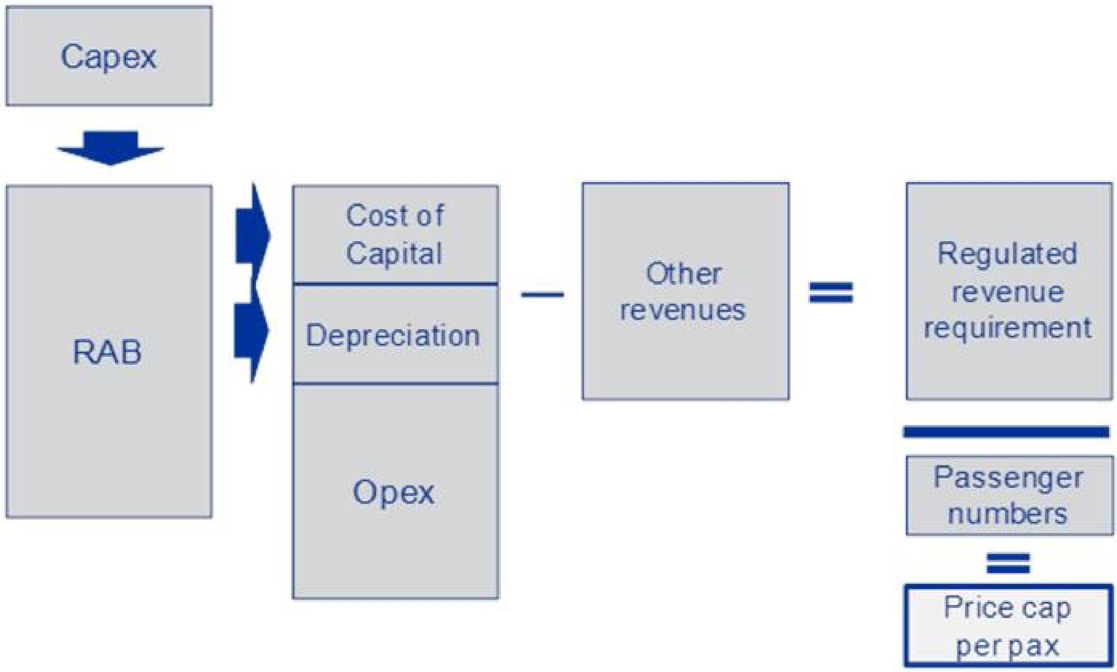
[17] Details of the CC appeal process are set out in Schedule 2 to the Act.

[18] CAA, April 2012, Mandate for Constructive Engagement at Gatwick. This document can be accessed at: http://www.caa.co.uk/docs/5/GatwickCEMandate.pdf.

[19] CAA, October 2012, Gatwick Airport Mid Constructive Engagement (CE) Review. This document can be accessed at: http://www.caa.co.uk/docs/5/121005LGWKCJSG.pdf .

[20] Mandate for Constructive Engagement at Gatwick, page 12.

Figure 2.3: Price cap building blocks



Source: CAA

2.14 In January 2013, the GAL and ACC co-chairs of the JSG, provided the CAA with a detailed CE report which has been published.[21] The CAA held post CE discussions in January 2013 with both GAL and the airlines. Subsequently GAL also produced its own RBP in January 2013 which was informed by CE.

2.15 GAL and the ACC agreed a simplified consultation framework, with weekly CE meetings feeding into a monthly JSG. The JSG was the only decision making forum and was jointly chaired by GAL and the ACC. There was also agreement on a facilitation process and a facilitator for this process, although it was not found necessary to activate the facilitator during the CE period.

2.16 During the course of CE, there were 33 weekly meetings of the CE working group (CEWG). Meetings covered each of the building block areas of traffic, service quality, capex, opex and other revenues. There were also a number of sub-group meetings into pier service, asset stewardship and service standards which fed into the main group.

[21] Constructive Engagement Working Group, End CE Review: Joint Submission to the CAA, January 2013, available in Appendix 2 of the GAL RBP.

2.17 While discussions through CE have been wide ranging there has been a lack of agreement between parties on individual building blocks and in particular the overall level of price for the next control period.

2.18 On **traffic** forecasts, while the ACC agreed with the GAL central forecasts from the IBP, the ACC did not agree to the updated forecast in September 2012, although it did acknowledge that the forecasts should have reduced given the worsening economic outlook since April 2012. GAL has used the high case forecast to drive capital planning, although the airlines did not agree.

2.19 On **service quality**, GAL shared the sensitivity of the cost of different levels of service quality and changes in traffic forecasts. In response the ACC shared some early thoughts on its priorities for Q6 and agreed some improvements to the existing scheme. The ACC indicated it would like to continue discussions on the SQR scheme during 2013.

2.20 On **capex**, progress was made during the CE period and agreement has been reached to take forward a number of projects for further development to feed into a GAL business plan update in July 2013. GAL and the ACC also agreed on the funding of consultants so that airlines could provide expert input into project development. GAL and the airlines did not agree proposals on a core and development capex programme. In the CE document GAL stated that it did not support the split capital discussion document put forward by the ACC, as it considered that a veto of capex by existing airlines, with that decision then confirmed by the CAA, would represent a move towards more rather than less regulation.

2.21 On **opex**, there was no agreement. While GAL noted that it had provided more data to airlines than previously, the ACC considered that the level of detail was insufficient for meaningful engagement to be possible.

2.22 On **other revenues**, GAL provided detailed data to the ACC's consultants (but not the airlines) on retail, car parking and advertising.

2.23 There was a fundamental difference of opinion between the airlines and airport operator on **price**. The GAL IBP included a forecast real price increase of RPI+5.5% per year during Q6.[22] The airlines

[22] The RBP included a real forecast price increase of RPI+6.9% per year during Q6.

considered that a real terms price reduction could be achieved for Q6 which allowed for efficient investment.

2.24 Subsequent to CE, the ACC produced its own business plan, which included a forecast price cap of RPI-9.0% per year. This was based on:

- higher traffic forecasts, based on different Gross Domestic Product (GDP) assumptions;
- lower opex, with savings from reduced staff and security costs and other costs held constant;
- lower capex with a reduction in renewal unit costs and removal of a number of capex schemes that the airlines considered were not proven to be required;
- higher commercial revenues based on higher retail, car parking and advertising forecasts; and
- a lower cost of capital due to a lower corporate tax rate and cost of debt.

2.25 GAL has challenged the assumptions underpinning the ACC analysis.

2.26 The CAA acknowledges that CE has involved significant work from both GAL and the airlines. A large number of airlines participated in CE and it has provided an important input into the CAA's initial proposals for Q6. The CAA welcomes the progress that has been made on capex and the greater understanding that has come from the airport operator sharing detailed information on traffic forecasts and service quality. The CAA places significant weight on agreements reached by the parties during the CE process. The CAA is disappointed that GAL was not able to provide the desired level of detail on opex. However, CE is not a compulsory process, nor is there a statutory basis for the CAA to broker agreement where fundamental differences remain and ultimately the regulator must determine these components of the price control.

Structure of the rest of this document

2.27 As part of the RBP, GAL put forward proposals for airport commitments as an alternative to licence based regulation. These commitments which GAL is proposing to include in its conditions of use set out caps on airport charges, a service quality regime and commitments on consultation, investment, and operational and financial resilience.

2.28 Since 2009 the CAA has been undertaking work on possible alternative forms of regulation. As part of this work the CAA has identified that voluntary commitments or agreements could be part of a future regulatory framework. Against this background, the CAA has welcomed the fact that GAL has offered to make such commitments, and the CAA has encouraged airlines and other stakeholders to look carefully at GAL's proposals. The CAA has set out in the market power assessment its minded to view that, notwithstanding the commitments, the benefits of regulation through a licence are likely to outweigh the adverse effects. However, the CAA also recognises that commitments that are reasonable and effective could be a vehicle for future airport development that served passengers' interests better than detailed regulation. The CAA has therefore considered: whether the commitments are reasonable and effective, compared to a regulatory settlement; how the commitments would relate to a licence; and, to the extent that the commitments offered so far are not fully reasonable and effective, what price control the CAA would set in place instead from April 2014.

2.29 This document is structured as follows:

a) Part A: Background:

- Chapters 1 - 3 covering introduction, background and the passengers' interests;

b) Part B: Calculation of a fair price:

- Chapters 4 - 11: based on individual RAB-based building blocks;

c) Part C: Form of regulation:

- Chapter 12: discusses GAL's commitments and the most appropriate forms of licence regulation; and

d) Part D: CAA's initial proposals for a RAB-based price control

- Chapters 13 - 17: covering regulatory incentives, price control issues and the regulatory price cap.

CHAPTER 3

Passengers' interests

Introduction

The CAA duties under the Civil Aviation Act 2012

3.1 The new Act gives the CAA a primary duty to "carry out its functions […] in a manner which it considers will further the interests of users[23] of air transport services". Alongside this statutory duty, the CAA has a strategic objective of improving choice, value and fair treatment for consumers[24] at all UK airports, and is committed to ensuring that consumers get the best possible outcomes in terms of their aviation journey and experience.

3.2 The CAA's primary duty includes furthering the interests of those with rights in cargo. Over 99% of the cargo by weight that is flown in or out of Gatwick is carried in the bellyhold of passenger carrying aircraft.[25] The interests of passengers and those with rights in cargo are, therefore, closely aligned as much that affects the cost or quality of services provided to passenger aircraft, such as the provision of runways, taxiways, air traffic services and aircraft stands, would have an impact on both passengers and those with rights in cargo.

3.3 In 2012 there were virtually no cargo-only flights at Gatwick.[26] In the light of these characteristics, the CAA's analysis of users' interests as part of its primary duty is focused on the interests of passengers. Consequently where this document refers to passengers' interests it should also be taken to encompass the interests of cargo owners, and present and future users.

3.4 GAL's pricing, service and investment decisions have a significant impact on overall passenger outcomes, and the impact on

[23] The Act defines "users" at section 69 of the Act as passengers and those with a right in property carried by the service. Section 69(2) of the Act explicitly states that "users" includes future users.

[24] This includes passengers and those with a right in cargo, current and future, as well as those purchasing an aviation service.

[25] CAA Airport Statistics.

[26] CAA Airport Statistics.

passengers’ interests has been given primary consideration throughout the development of these initial proposals for the Q6 price control.

Scope of Q6 at Gatwick

3.5 The formal scope of the CAA’s powers for Q6 is set by its functions relating to the development and enforcement of licence conditions for any airport operator that passes the MPT in the Act and the need to do so in the way that discharges its primary duty under section 1 of the Act. As indicated above, this will influence an important (but limited) subset of the activities that comprise the value chain for the end-to-end passenger experience. There are some important activities in the passenger journey where the licensed airport operator is not the provider of the service – rather these may be provided by the airlines (e.g. check-in and baggage reclaim) or by a third party such as UKBF (immigration and customs). The CAA cannot impose licence conditions and obligations on third parties.

3.6 "Airport operation services" are defined in section 68 of the Act as services provided at an airport for the purposes of:

- the landing and taking off of aircraft,
- the manoeuvring, parking or servicing of aircraft,
- the arrival or departure of passengers and their baggage,
- the arrival or departure of cargo,
- the processing of passengers, baggage or cargo between their arrival and departure, or
- the arrival or departure of persons who work at the airport.

3.7 The Act explicitly identifies groundhandling services; facilities for car parking; and facilities for retail businesses as airport operation services. Excluded are air transport services, air traffic services and services provided in retail businesses.

The CAA’s approach to ensuring Q6 is passenger-focused

3.8 The CAA’s Q6 Policy Update set out its intended approach to ensuring Q6 is passenger-focused. A key aspect of the CAA’s role has been to understand what the passengers' priorities in the context of the airport experience are, through the use of research and evidence.

3.9 Given the competitive market in which they operate, the CAA places a substantial weight on the airlines' understanding of passengers' priorities. Their combined views provide a way of integrating a lot of information around a complex market, but are not an infallible guide to what is in the passengers' interests. There are a number of areas where the CAA is mindful that the airlines' interests may not fully align with those of their passengers - for example, in situations of airline market power, or where the passengers' ability to act in the market is hampered (e.g. by information issues). A passenger group who may have interests which are not articulated by airlines currently operating at the airport may be future passengers.

3.10 The CAA's initial proposals have been developed in the context of the CAA's understanding of the consistent themes emerging from this work. Broadly speaking the process the CAA followed took the form of:

- an initial review of available passenger research in mid-2012;
- use of CAA passenger satisfaction data;
- further CAA stand-alone research into the airport experience (referred to as "CAA Q6 research");
- sense-checking insights with stakeholders’ own research; and
- seeking the views of the CAA Consumer Panel and GATCOM (Gatwick Airport Consultative Committee).

3.11 The CAA has been able to use research material from stakeholders that has been fully shared with it (allowing the CAA to validate its methodology); but if research cannot be fully shared with all stakeholders, the CAA places less weight on it since it has not been fully tested.

3.12 The Consumer Panel has encouraged the CAA to rely only on fully published material; and whilst the CAA agrees with this approach as an aspiration, considers there is also value in reviewing research for consistent messages even if sponsors are unwilling to see it published. For future regulation, the CAA would encourage full publication of evidence by stakeholders to inform discussions and widen the knowledge base of all interested parties.

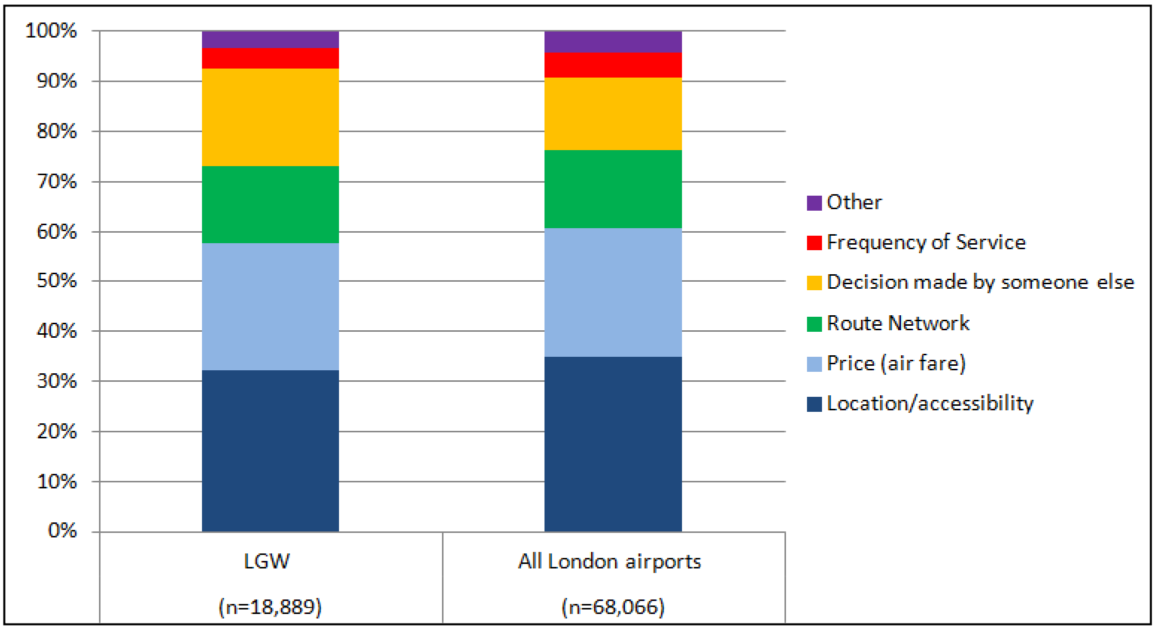
Review of available passenger research

3.13 The initial review of available passenger research in mid-2012 has enabled the CAA to identify consistent themes; discuss these findings with stakeholders and the CAA Consumer Panel; and identify any gaps where further evidence would be useful.

3.14 The key findings from this review are set out below.

- Airport service quality is not a key driver behind passenger airport choice (see figure 3.1). As part of the "other" category, it is rated significantly below location and accessibility of the airport, the air fare and the route network available.
- At the airport, the overriding concern for the departing passenger is that they depart on time, and for arriving passengers that they leave the airport promptly once arrived. This is consistent with feedback received from the airlines from their own research.
- A number of the services that the airport operator provides to airlines are necessary to deliver passenger satisfaction through on-time performance, but the passenger themselves may not be aware of them.

Figure 3.1: Drivers of airport choice



Notes:

1. Responses to the question, "Why did you choose to fly from this airport today?"

2. London airports = Heathrow, Gatwick, Stansted, Luton and London City

Source: CAA Passenger Survey, provisional results 2012

CAA passenger satisfaction data

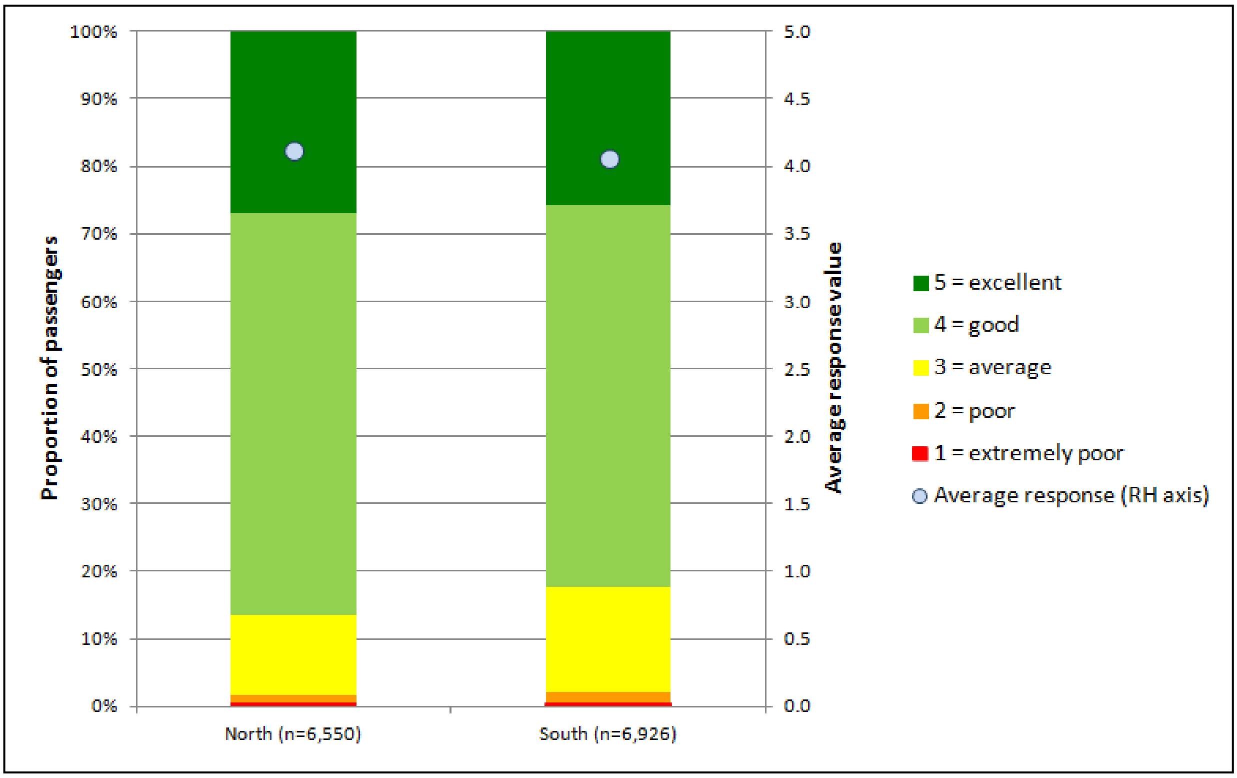
3.15 In July 2012, the CAA added a question to its ongoing Passenger Survey which asked passengers "How would you rate your overall experience in the airport terminal today?".[27] The question is structured in an identical fashion to GAL's own QSM question, and allows the CAA to gather independent evidence on passenger satisfaction in a comparable way across a number of UK airports. For 2012, the CAA collected 13,476 responses, and the findings by terminal are shown in figure 3.2. This question will continue to be asked and over time will become a useful dataset which will enable users to identify trends in satisfaction and use as a comparator to other data sources.

3.16 The provisional results for the second half of 2012 indicate that the majority of passengers rate their experience as “good” or “excellent”.

[27] With responses on a scale of 1 -5, where 5 = excellent, 4 = good, 3 = average, 2 = poor, 1= extremely poor.

This proportion ranges from 82% in the South Terminal to 86% in the North Terminal.

Figure 3.2: Passenger satisfaction at Gatwick, 2012



Note: Responses to the question, "How would you rate your overall experience in the airport terminal today?"

Source: CAA Passenger Survey, provisional results 2012 (question asked from July – December)

Further CAA research into the airport experience

3.17 Alongside its ongoing Passenger Survey, the CAA carried out further research in winter 2012/13 at Heathrow, Gatwick and Stansted. The purpose of this work was to inform Q6 by updating some of the previous research available[28]; to collect more evidence on the relative experiences of arrivals, connectors and departures; and to investigate passenger perceptions of queue times at various points in the passenger journey. This took place at the airport and differed from the CAA's main survey in that:

[28] For example, CAA, March 2009 *The Through Passenger Experience*: http://www.caa.co.uk/docs/33/Passenger_experience.pdf

- arriving passengers were also targeted (the CAA ongoing Passenger Survey only interviews departing passengers); and
- passengers were asked open-ended questions about any sources of dissatisfaction to allow for recording of qualitative data (this was to avoid prompting of responses and potential biasing of data); and
- passengers were asked about perceived actual and acceptable maximum queue times for various airport processes to help understand whether passengers' experience differed from what they felt was reasonable, and by how much.

3.18 The key findings from the responses collected at Gatwick were as follows.

- High levels of satisfaction across the airport, with slightly more departing passengers (88%) rating the airport as "good" or "excellent" than arrivals (83%) or connectors (82%).
- Passengers travelling for business are relatively less satisfied[29] than leisure passengers (78% compared with 87%).
- When asked whether there were aspects of their experience they were dissatisfied with, connectors were more likely to cite examples of dissatisfaction than other passengers (47%, compared with 29% of arrivals, and 34% of departures). Consequently across the airport, two-thirds of respondents gave no specific cause of dissatisfaction.
- The single issue most frequently cited by passengers as a cause of dissatisfaction was waiting times for various processes (8% of respondents), followed by walk times (5%).
- The maximum acceptable queue time for processing (check-in, bag drop, security, immigration and baggage reclaim) is in the range 11-16 minutes, and the majority of passengers (86% or higher) spent less time queuing than the maximum they thought reasonable.

Airport research

3.19 GAL carries out ongoing monitoring of service quality through its QSM

[29] For these purposes, those passengers rating the airport as "good" or "excellent" are considered to be satisfied.

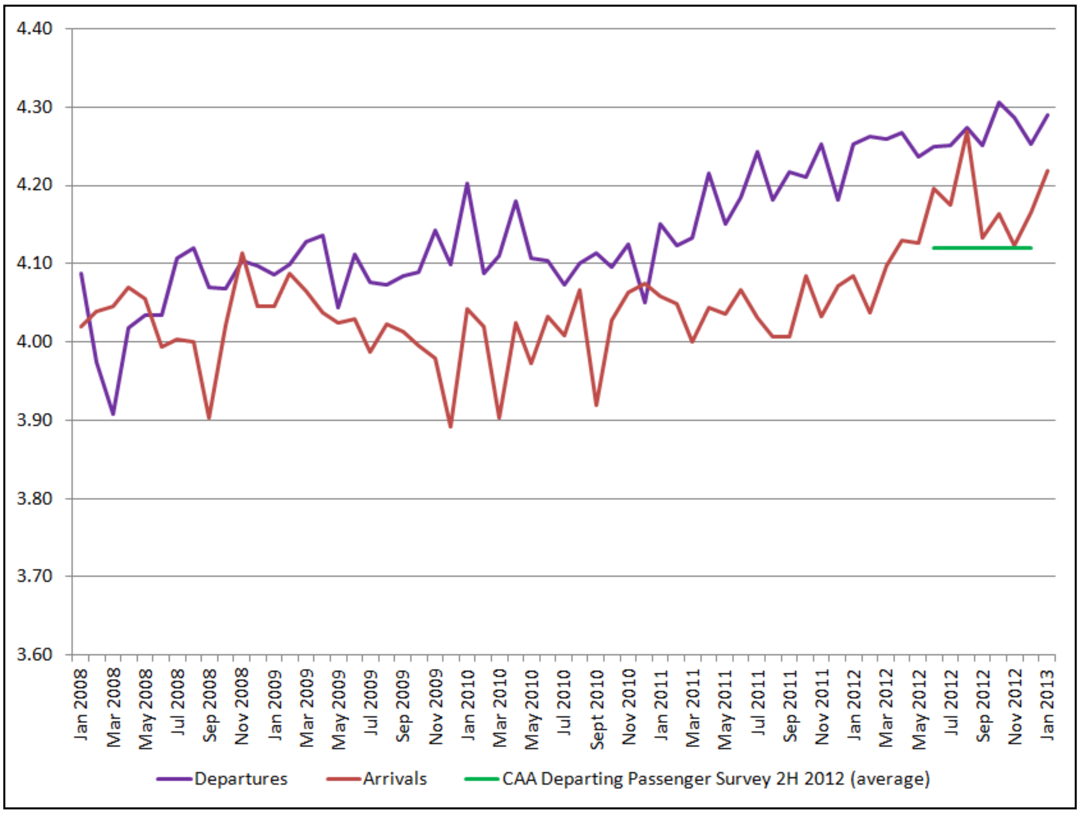
survey. This survey consists of approximately 23,000 interviews per year (14,500 departing passengers, 8,500 arriving), and has been running for several years.

3.20 A number of specific performance measures from this survey are used within the SQR scheme (see chapter 13), and indicate that there have been some notable increases in passenger satisfaction in certain areas (e.g. departure lounge seating availability).

3.21 The QSM survey also includes the question “How would you rate your overall experience in the airport terminal today?”. Reviewing the time series of the average responses, figure 3.3, indicates that there has been a steady increase in the level of passenger satisfaction since early 2008.

3.22 However, the data also indicates a persistent trend for arriving passengers to be less satisfied than departing passengers. This may be due to a difference in passenger perceptions of time at the airport - on departure, the passenger is already at the airport with a fixed departure time; on arrival any time spent queuing delays the passenger in leaving the airport.

Figure 3.3: Passenger satisfaction with Gatwick



Source: GAL QSM data (monthly scores), CAA Departing Passenger Survey, July – December 2012 (provisional).

3.23 In the run up to, and during CE, GAL commissioned a substantial amount of research over and above its ongoing QSM survey. The main projects were:

- YouGov (October 2011) – responses related to all London airports (appendix 16 in CE report);
- YouGov (September 2012) – responses specific to Gatwick (appendix 5 in RBP); and
- Accent (November 2012) – Willingness to Pay (WTP) around specific improvements at Gatwick (appendices 17 and 18 in CE report).

3.24 These reports provide useful comparison to other research findings, and the CAA welcomes the work undertaken by the airport operator, the transparency of both the methodology and planning, along with the sharing of the results. Three key themes of interest are:

- drivers of airport choice;
- investment priorities at the airport; and
- passenger expectations of queue times.

Drivers of airport choice

3.25 The YouGov report in appendix 5 of the RBP shows that convenience and accessibility of the airport are primary drivers of airport choice. Figure 3.4 is taken from page 256 of appendix 5 of the RBP. This indicates the relatively lower importance of the airport facilities in the passenger decision. It is worth noting that the answers respondents were presented with did not include the flight availability (either due to route network or timing) or the air fare. These are both factors that feature highly in CAA research (which records open responses to this question).

Figure 3.4: Reasons for airport choice

Source: GAL RBP (Public Version), January 2013 - appendix 5, page 256

3.26 "Past good experience" of an airport is second on the list. This response could encompass any of the other aspects listed, so is not clear what the good experience relates to, and could indeed relate to the journey to the airport. This is not a response which featured in the

CAA's open responses from passengers.

Investment priorities at the airport

3.27 The same YouGov report also gives some indication of the investment priorities of passengers at (non-specific) airports. By asking passengers to tick their three highest priorities for investment from a list, the report identifies security as the top priority for departing passengers, and baggage reclaim for arrivals. Both are cited by approximately 60% of passengers.

3.28 This question presented respondents with a pre-determined list, and conditions the answer on some investment taking place (i.e. there is not an option for no investment needed). The CAA Q6 research around areas of dissatisfaction asked nearly 1,000 respondents at Gatwick what single improvement they would like to see at the airport. Of those who answered the question (852), 60% responded with "no improvements required". This proportion varies by flow however, with around 71% of arrivals suggesting no improvements, compared with 50% of departures.

3.29 Where respondents to the CAA Q6 research did specify improvements, waiting at security and baggage reclaim were the first and second most cited areas respectively for departures and arrivals. However they represented only a small proportion of passengers (~5% of each flow). This is, in part, a reflection of the level of variety in the answers given.

Passenger expectations of queue times

3.30 Research carried out in November 2012 by Accent on behalf of GAL focused on WTP for various specified improvements, along with a number of questions around queue time expectations and experiences at the airport.

3.31 This research was made up of 750 respondents who were interviewed online who had travelled within the previous six months, and 250 respondents who were interviewed at the airport. Significantly longer queue times (for bag drop, check-in and security) were recalled by those responding online. This may be due to recall bias, or possibly the time of year of travel. The CAA's own passenger research (where the survey interview took place at the airport) gives lower estimated queue times than the averages reported by Accent.

3.32 For each process investigated, the vast majority of people interviewed indicated that the queue time they experienced was less than or the same as expected. This aligns with findings from the CAA's Q6 research that the majority of respondents felt the queue time they experienced was reasonable, see figure 3.5.

Figure 3.5: Summary of queue time research findings

	Accent for GAL			CAA Q6 Research		
Process	**% saying queue was longer than expected**	**Average queue time reported**	**Sample size**	**% saying queue was longer than reasonable**	**Average queue time reported (CAA survey – Nov 2012)**	**Sample size**
Airline check-in desk	13	13 mins	n=279	5	6 mins	n=217
Fast bag drop	16	8 mins	n=350	13	7 mins	n=118
Security	10	12 mins	n=1,060	7	6 mins	n=487
Passport control	25	15 mins	n=799	3	3 mins	n=431
Baggage reclaim	21	13 mins	n=799	14	8 mins	n=430

Source: GAL CE Report, Appendix 18; CAA

Willingness to Pay

3.33 The work carried out by Accent for GAL also explored the WTP by passengers for a suite of potential improvements.

3.34 The results indicate that the WTP values estimated are highly variable by a number of key (and related) dimensions: ticket price paid by passenger, the airline type used, the class of travel and distance travelled.

3.35 The average value reported for the entire set of improvements is £11.94, however, around 90% of passengers would only pay £1 or more extra for the improvements tested. The WTP by passenger sub-groups varied substantially.

3.36 The estimated values for WTP by attribute are set out in figure 3.6, along with comparative figures (where possible) which have been derived from the CAA's own stated preference work which was carried out in 2011.

Figure 3.6: Estimated Willingness to Pay for various attributes

GAL research, by Accent (fieldwork September 2012) - based on changes to Gatwick			CAA research, by Accent (fieldwork March 2011) - based on general airport choice	
Attribute tested	**Estimated WTP**		**Attribute tested**	**Estimated WTP**
Segregated zones (e.g. quiet, outside space)	£2.85		n/a	-
Greater variety of seating	£1.58		n/a	-
Covered walkway from gate to plane	£1.51		n/a	-
Drop off luggage up to 12 hours before	£1.39		n/a	-
Drop off luggage up to 18 hours before	£1.37		n/a	-
50% more catering outlets	£0.39		To move from 10-30 to >30 shops	£0.23
Reduce immigration queue time (per minute)	£0.35			-
Reduce check-in and bag drop queue time (per minute)	£0.24		Reduce check-in queue time (per minute)	£0.40
Reduce security queue time (per minute)	£0.17		Reduce security queue time (per minute)	£0.55
Reduce baggage reclaim wait time (per minute)	£0.03			-

Source: GAL CE Report, appendix 18; Accent research for the CAA, published December 2011

Airline research

3.37 The ACC submission[30] states that the most important measures for passengers are ones that ensure they can get through the airport efficiently.

3.38 Discussions with the airlines indicate that they consider the reliability and efficiency of the passenger journey to be of primary importance to passengers in the context of airport operation services. This is the outcome of both passenger processing at the airport, along with airline on-time performance.

3.39 easyJet commissioned a piece of market research (carried out by Impact Research Limited) to help them understand better what they consider to be the passengers' priorities at the airport. A consistent theme emerging from their qualitative work[31] was that "efficiency and speed are the most important characteristics that customers want Gatwick airport to deliver on".

3.40 This research also incorporated a quantitative survey of approximately 1,000 passengers, who were interviewed online having used the airport in the last 6 months, rather than whilst in the process of using the airport. Almost half of the passengers interviewed said that Gatwick was "good as it is" or "exceeded my needs". 9% of passengers said that Gatwick needed major improvements.

3.41 A key finding of the Impact Research stated preference survey is the variability in WTP values estimated, which in the context of an airport charge applying to all passengers is highly relevant. This finding indicates that it may be more appropriate to consider percentiles along the WTP distribution, rather than the mean (e.g. 90% of respondents). This finding is consistent with the airport operator's own research.

3.42 The results indicate average WTP levels of £1.45 for departing passengers, and £1.12 for arriving passengers to bring service levels up to a "middle" level of service.[32] However, it is notable that three-

[30] Page 46 of the ACC Report on Gatwick Airport Business Plan for Q6 (2014 to 2019).

[31] Four focus groups of 7-8 passengers who had used Gatwick within the past 6 months.

[32] "middle level" of service is defined in the report according to a number of aspects of the airport service (check-in, security, departure lounge, gates, passport control, gates, and arrivals). Service level examples include security queues of 15 minutes, a good choice of shops and restaurants in the departure lounge, etc.

quarters of those surveyed believe Gatwick is already at this level and therefore presumably would not be willing to pay any extra. The quantitative work carried out indicates the current contribution various aspects of the airport experience make to the passengers' overall satisfaction or dissatisfaction. This helps identify priority areas for improvement. Key areas contributing to dissatisfaction were security and immigration, which were each cited by around a quarter of the passengers as being their main reason for dissatisfaction. In both cases, the time taken was the main factor.

Passenger sub-groups

3.43 In general, the CAA looks to the market (and therefore to airline views) to integrate the preferences of different kinds of passengers. However, it is not realistic to expect the market to fully represent the needs of vulnerable passengers who may have different requirements to the main airport population. To ensure that proposals in terms of capex and opex do not impinge on these groups, it is important that these passenger groups are identified where possible and their needs considered.

3.44 In September 2011, GAL set up its own Airport Passenger Panel (APP) made up of independent experts representing a number of passenger sub-groups. These were: leisure travellers, business travellers, families, passengers with reduced mobility (PRMs) and shoppers.

3.45 The airport published a short report on the findings of the APP in December 2012.[33] Some of the key recommendations were around provision of and access to information, facilities for family groups, and design considerations for PRMs. In the report, GAL also highlights a number of initiatives it has undertaken to help address specific concerns. For example, assistance lanes in security for families or other passengers requiring support, and dedicated seating for PRMs.

3.46 As part of the RBP, GAL stated that it was proposing to introduce a dedicated PRM drop off/pick up lounge before March 2014, and as part of the capex plan for the next five years has included a Disability

[33] Commissioned by Gatwick Airport, December 2012, *The Airport Passenger Panel Report*, , http://www.mediacentre.gatwickairport.com/imagelibrary/downloadmedia.ashx?MediaDetailsID=713&SizeId=-1&SizeID=-1

Discrimination Act (DDA)[34] compliant scheme to improve access to public transport on the A23 through the provision of lift access and covered walkways.

3.47 The YouGov research carried out on behalf of GAL in September 2012[35] considered the needs of the airport's passengers broken down into premium, business, family and core passengers. These segments were developed from previous qualitative work and indicated the importance of speed and efficiency for the premium and business passengers, and for segregated areas for the family groups.

3.48 The CAA's own Q6 research was augmented with over 130 qualitative interviews of the over-65s at Heathrow, Gatwick and Stansted. These interviews gave the CAA assurance that the views of respondents on the airport experience were consistent with those of the wider population in terms of current levels of satisfaction.

3.49 The CAA welcomes the work done by GAL in considering the needs of all its passenger groups, and considers it is important to ensure ongoing research is designed such that the needs of passenger sub-groups can continue to be explored, and where issues arise, that these can be identified.

Conclusions from research

3.50 Although the research is informative, the CAA acknowledges the limitations of inferences drawn. Due to the nature of the airlines operating at Gatwick, the range of potential passengers' interests is somewhat wider than at other airports, and the CAA is mindful of the heterogeneity of passengers' needs and preferences. Even the same person may have different requirements depending on the nature of the journey they are on.

3.51 Clearly, there is a practical challenge in attempting to trade-off the interests of different groups to define a coherent single 'passenger interest'. However, the work the CAA has done indicates that the consistent themes in terms of passengers' priorities tend to override the areas where there is greater variation. For example, in terms of airport choice, the main reasons a passenger cites are the airport's

[34] Disability Discrimination Act 1995.

[35] GAL RBP (Public Version), January 2013 - appendix 5, page 256.

location and accessibility, the air fare and the route network available (figure 3.1 above).

3.52 In terms of aims for Q6, the insights as understood by the CAA can be translated into:

- a need to maintain current levels of service provision around the critical aspects of the airport experience, for example queue times; and
- that any proposed improvements should be focused on areas where passenger benefits demonstrably outweigh the costs that would potentially impact all passengers.

Gatwick Airport Consultative Committee (GATCOM)

3.53 The airport's consultative committee responded in July 2012 to the CAA's May 2012 Policy Update. This response indicated that GATCOM considered that "the overall passenger experience at Gatwick has significantly improved".

3.54 GATCOM further considered that the publication by the airport operator of third party performance (e.g. airline baggage delivery and UKBF queue times) had significantly improved performance.

3.55 Subsequent to the publication of GAL’s RBP, GATCOM has provided initial comments to the CAA, particularly in respect of the draft Airport Commitments Framework proposed by GAL. Key points arising from these comments are that GATCOM welcomes:

- the continuation of the SQR scheme, alongside potential bonuses; and
- the proposed extension of service quality incentivisation to other areas of the passenger journey not under GAL's direct control.

Consumer Panel views

3.56 The Consumer Panel agreed that the CAA’s overall approach to understanding the passengers’ interests for the purposes of the price control, through both CE and the use of passenger research, was robust. The Panel considered that in the delivery of airport operation services, there is generally a reasonable alignment of airlines' and passengers' interests, however there were areas where this may not necessarily hold which the Panel asked the CAA to consider further (for example, passenger welfare in times of disruption).

3.57 In terms of the CAA's review of research, the Panel agreed there is evidence to suggest that on average, current service quality is generally satisfactory, but encouraged the CAA to consider the needs of different passenger sub-groups in its survey work (for example, PRMs). The Panel also noted the importance of performance specifically in times of disruption as well as on average, and encouraged the CAA to consider how performance at these times might be targeted.

3.58 The Panel broadly supported the development of the Q5 SQR as the basis for service quality regulation in Q6. It felt that the targeted use of bonuses was not necessarily inappropriate, and suggested the CAA consider some flexibility in the elements which they applied to. The Panel also suggested the use of reputational incentives as well as financial incentives, and suggested the CAA look at whether there are some metrics where publication and monitoring of performance would act as a sufficient incentive without the need for a rebate/bonus.

Part B:
Calculation of a fair price

Part B: A fair price

The following chapters (4 - 11) constitute Part B of this document. This sets out an analysis of what the CAA considers to be a fair price, based on a RAB-based methodology.

The CAA has used a single till approach to calculate a RAB-based price. This has merits based on policy consistency and with how competitive airport operators make price offers to airlines – effectively taking into account retail and other revenue in deriving a net revenue requirement for airport charges.

The CAA has undertaken a 'minded to' assessment of the market power that GAL holds for airport operation services[36] in the core airport area. The core airport area is defined by the Act as the "land, buildings and other structures used for the purposes of the landing, take off, manoeuvring, parking, and service of aircraft at the airport, the passenger terminals and the cargo processing areas".[37] This includes airport charges and other aeronautical services the detail of which is set out in the product bundle of the GAL market power assessment.[38] If an airport operator has SMP over the core airport area, it would therefore have SMP over airport charges and other aeronautical services, the detail of which is set out in the product bundle of the GAL market power assessment. The CAA is not required to cover all airport operation services in its assessment. However, using a single till approach, the CAA would seek to take account of revenues from all services in setting regulatory controls on airport charges as it does at present.

Under its general duty[39] the CAA must carry out its functions in a manner that it considers will further users' interests. Where a licence is issued the CAA can include such other conditions that it considers

[36] As defined in section 68(1) and section 68(3)(a) of the Act.

[37] Section 5(4).

[38] The CAA's summary of its 'minded to' view on whether GAL passes the MPT can be obtained from the CAA's website: www.caa.gov.uk.

[39] In section 1(1) of the Act.

necessary or expedient having regard to its general duty[40] and provisions relating to activities carried on outside the airport area for which the licence is granted.[41] These conditions and provisions do not need to be supported by a separate market power assessment under the Act.

There has been significant debate during previous regulatory about the use of the single till. The CAA continues to consider that the single till methodology appears to be in the users' interests and is consistent with principles of good regulation.[42]

Estimates of a fair price, using a single till RAB-based approach, have been provided over five years, consistent with a typical duration of a regulatory price control, and seven years, for comparison with GAL's seven year commitment proposals. Part B does not include proposals, but provides a basis for assessment of alternative forms of regulation (Part C) and also for the CAA's initial proposals (Part D).

[40] Under section 18(1)(b) of the Act.

[41] Under section 21(1)(f) of the Act.

[42] More detail for this is given in the Gatwick initial proposals document.

CHAPTER 4

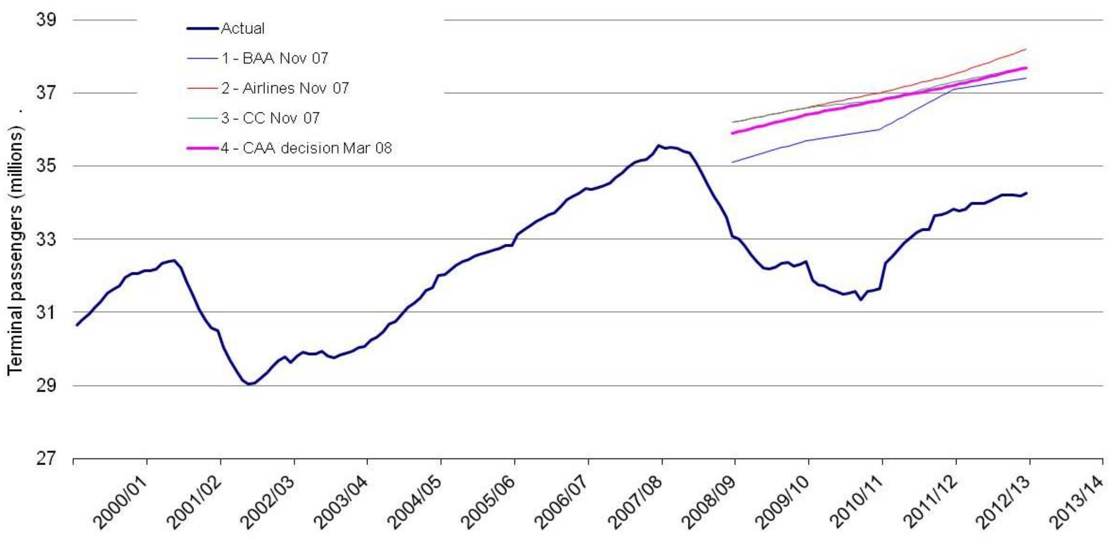
Traffic

4.1 This chapter discusses the CAA's traffic forecasts for Gatwick. It sets out the background to the forecasts, the discussions during CE and reviews GAL's forecasting methodology. The chapter concludes with the CAA's initial projections for the traffic forecast that contributes towards the assessment of the fair price.

Background

4.2 In its Q5 price control decision, the CAA used traffic forecasts which predicted a total of 184 million passengers over the five years between 2008/09 and 2012/13. This was slightly higher than the final traffic forecast proposed by BAA and lower than the traffic forecasts provided by the CC and the airlines. Figure 4.1 shows that all these forecasts were well above actual passenger traffic at Gatwick over Q5.

Figure 4.1: Gatwick Q5 passenger traffic forecasts (million), 12 month rolling average



Source: CAA

4.3 Gatwick's traffic in Q5 was significantly impacted by the worldwide economic downturn beginning in late 2008 with the recovery of traffic further hampered by the closure of airspace due to volcanic ash in April 2010. However, annualised traffic at the airport has been on an upward trend since the beginning of 2011, albeit it is still well below its peak in 2007/08.

GAL's forecasting methodology

4.4 GAL's forecast of passengers and air transport movements (ATMs) up to 2036/37 was provided by consultants ICF SH&E (SH&E). SH&E used two distinct approaches to produce the forecasts: a 'bottom-up' short-term forecast for the first three years (2012/13-2014/15) and a 'top-down' forecast over the medium and longer terms.

4.5 The short-term forecast was based on information relating to airlines' capacity plans, fleet acquisition and replacement programmes, as well as the route level demand outlook over the next three years. This information was supplemented by, and cross checked with, other sources such as slot information from Airport Coordination Limited and information on planned scheduled flights from OAG. SH&E made further assumptions regarding airlines' route plans, aircraft size (seats per ATM), load factor and flight frequency based on historical performance and market trends.

4.6 GAL invited airlines to provide forecasts of their own capacity and traffic plans at Gatwick, to be treated in confidence by SH&E and used to inform the bottom-up forecasts, without disclosure to GAL or other carriers (for obvious commercial confidentiality reasons). A number of carriers provided projections but not all.

4.7 In contrast with the short-term bottom-up forecast which was mainly supply-side led, the GAL forecast of total unconstrained London traffic over the medium and longer term was driven by demand factors and based on a top-down regression approach. Under this forecasting approach, time series data of passengers by segment (long haul, short haul and domestic) for the total London market between 1990 to 2011 were regressed against a number of potential explanatory variables such as GDP, average fares, oil price, volume of imports/exports and consumer spending. The estimated long-term relationships between the segmented markets and their underlying demand drivers formed the basis for the 'unconstrained' traffic forecast for the London market up to 2036/37.

4.8 The constrained forecast for Gatwick, which took into account capacity constraints in the London airport system, was derived from the top-down unconstrained London forecast based on additional assumptions regarding market maturity rates, the ability of Gatwick to gain market share of London traffic given its location and demand profile, capacity constraints and the allocation of any spill traffic in the London system.[43]

Constructive Engagement and forecasting output

4.9 Traffic forecasts were discussed as part of the CE process. There was no major disagreement between the ACC and GAL on the principle of using a combination of bottom-up and top-down approaches, as described above, to forecast traffic at Gatwick. However, there was no agreement on the RBP traffic forecasts.

4.10 The GAL RBP forecasts were a refresh (made by SH&E in September 2012) of its IBP forecasts taking into account actual traffic outturns for the first five months of 2012/13, submissions from airlines regarding their capacity and route plans at the airport for the next three years, and an assessment of the prevailing economic trends at the time.

4.11 The ACC expressed concern about the lack of transparency of the short-term assumptions and the medium-term adjustments made by SH&E in its September 2012 refreshed forecast. The ACC therefore felt unable to assess the robustness of the assumptions and forecasting output (partly due to the commercial confidentiality of each airline's data).

4.12 The ACC regarded the use of a particular Economist Intelligent Unit (EIU) GDP forecast, instead of an average of a range of independent forecasts, in the refreshed September 2012 traffic forecast as unjustified, particularly as the EIU forecast was at the lowest end of the forecasts collected by SH&E. Consequently, the ACC asked for

[43] Spill traffic is traffic which moves from its preferred airport to an alternative due to capacity constraints.

the traffic forecast to be recalculated based on the HM Treasury independent GDP forecast and the same averaging forecasting methodology used by SH&E for its forecasts used in the IBP. The differences in the GDP assumptions and forecast outputs are highlighted in figure 4.2 below.

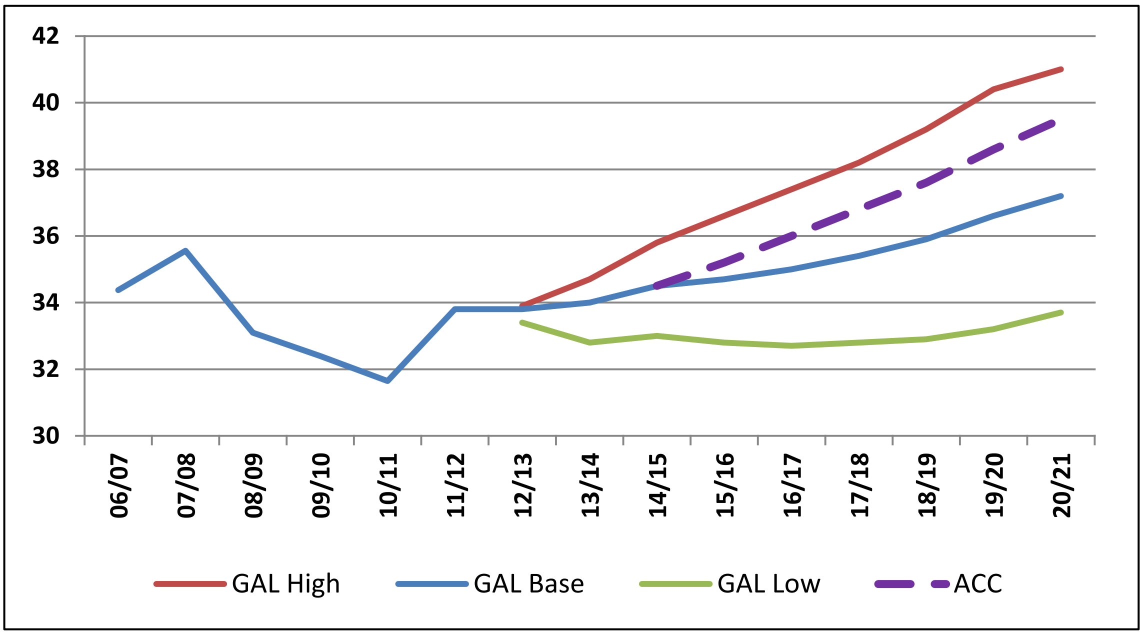
Figure 4.2: GDP assumptions and passenger forecasts

	Passengers (m)		GDP assumption	
	GAL Sept Base	ACC	GAL Sept Base	ACC
2012/13	33.8	33.8	Bottom-up	Bottom-up
2013/14	34.0	34.0	Bottom-up	Bottom-up
2014/15	34.5	34.5	Bottom-up	Bottom-up
2015/16	34.7	35.2	1.2%	2.0%
2016/17	35.0	36.0	1.0%	2.1%
2017/18	35.4	36.8	1.3%	2.1%
2018/19	35.9	37.6	1.6%	2.2%
2019/20	36.6	38.6	1.9%	2.3%
2020/21	37.2	39.5	2.1%	2.2%
2021/22	38.1	40.6	2.3%	2.3%
2022/23	39.0	41.5	2.4%	2.1%
2023/24	40.1	42.0	2.4%	2.1%

Source: SH&E

4.13 Figure 4.3 shows both the ACC recalculated forecast and the high, base and low forecasts from the RBP.

Figure 4.3: Gatwick passenger actual and forecast (million), 2006/07-2020/21



Source: SH&E

4.14 The GAL RBP base forecast represented a 1.4 million reduction in passenger numbers by 2018/19 compared to the IBP forecast – a setback in growth of approximately 3 years.

4.15 Under the ACC higher GDP assumptions, traffic at Gatwick was forecast to grow to 37.6 million passengers by 2018/19 compared to 35.9 million passengers for the GAL RBP base case. SH&E did not consider that the ACC forecast is a credible base case forecast, citing further downward revisions in GDP forecasts by the International Monetary Fund (IMF) and Organisation for Economic Co-operation and Development (OECD) in October/November as justification for a more cautious outlook.[44]

4.16 The CAA notes that these recent economic downgradings by the IMF and OECD apply to 2013 and 2014 only and that the first three years of the ACC forecast are the same as the GAL's RBP forecast as the airlines did not have access to the detailed confidential airline commercial information used by SH&E in its bottom-up analysis.

4.17 The ACC disagreed with SH&E over the assumptions used to derive

[44] ICF SH&E, 30 November 2012, *Response to airline questions received 26 and 27 November*.

the high case forecast and felt there were significant risks to the forecast.

CAA's View

4.18 The CAA considers the use of a bottom-up supply-led and a top-down demand-driven modelling approach taking into account the impact of capacity constraints is a reasonable forecasting methodology for projecting Gatwick's passenger volumes in Q6 and beyond.

4.19 The CAA recognises the concerns raised by the ACC regarding the lack of understanding in SH&E's bottom-up analysis and the impact of a sharp reduction in their refreshed GDP outlook on the traffic projection. The CAA has sought further information from SH&E on the input assumptions used in the short-term forecast and has verified their validity with individual airlines that have independently submitted confidential information to the CAA regarding their latest capacity plans and traffic forecasts. Information available to the CAA to date suggests that SH&E's base case is likely to understate the short-term traffic outlook at Gatwick.

4.20 The econometric model used by SH&E is based on a regression model estimation of the relationship between passenger volume and economic data. This model provided the basis for projecting demand for the total London traffic in the long haul, short haul and domestic segments. In the model only the GDP and oil price variables were found to be significant in explaining variations in traffic; with the air fare coefficients either insignificant or having an unexpected positive sign. An analysis of the model's predictive performance using the last five years of data suggests a tendency to underestimate unconstrained long haul traffic and overestimate short-haul and, in particular, domestic markets.[45] It is plausible that the exclusion of air fares as an explanatory variable within the model due to its statistical insignificance could have contributed to such biased results

4.21 Figure 4.4 shows the constrained forecast for Gatwick by market segment, which suggests a relatively modest average growth rate of

[45] In response to the airlines' query about the model forecast accuracy, SH&E re-run the regression model based on a sub-sample of data from 1990-2006 and compared the model prediction of traffic between 2007 and 2011 with the actual outturns.

1.1% per year between 2013/14 and 2018/19.[46]

Figure 4.4: GAL's constrained forecast of passenger volume by segment (million)

	Long haul	Short haul	Domestic	TOTAL	growth
2009/10	5.2	23.6	3.7	32.4	-2.1%
2010/11	4.9	23.2	3.5	31.7	-2.3%
2011/12	5.1	25.0	3.8	33.9	6.8%
2012/13	4.9	25.1	3.8	33.8	-0.2%
2013/14	4.9	25.2	3.9	34.0	0.6%
2014/15	5.2	25.4	3.9	34.5	1.5%
2015/16	5.2	25.5	3.9	34.7	0.6%
2016/17	5.3	25.8	3.9	35.0	0.9%
2017/18	5.3	26.1	4.0	35.4	1.1%
2018/19	5.5	26.5	4.0	35.9	1.4%
2019/20	5.6	26.9	4.1	36.6	1.9%
2020/21	5.7	27.4	4.1	37.2	1.6%
Compound annual growth rates (CAGR)					
2013/14-2018/19	2.3%	1.0%	0.5%	209.5	1.1%
2013/14-2020/21	2.2%	1.2%	0.7%	283.3	1.3%

Source: SH&E

4.22 The ACC raised concerns that GAL's forecasts seem to overemphasise the potential increase in long haul traffic while underestimating the potential for short haul traffic growth at Gatwick especially given its success in gaining short haul traffic in recent years. This concern appears to be substantiated when the CAA compared SH&E's corresponding forecast for the remaining four London airports, which suggested growth rates of 1.7% per year for the long haul, 1.9% for the short haul, 0.8% for the domestic segment and 1.8% for the overall London market (excluding Gatwick) from 2013/14 to 2018/19.

4.23 The CAA considers that there is scope for higher short-haul and domestic traffic growth at Gatwick than GAL's base case projection. In

[46] These forecasts assumed airport charges at Gatwick would remain flat in real terms over Q6.

particular given development plans by Norwegian Air Shuttle[47] and others at the airport and that any planned reduction in capacity by some airlines is likely to be backfilled by other existing carriers or new entrants given Gatwick's market position and attractiveness within the London system.

4.24 The CAA's view is supported by (a) the higher than expected passenger growth of around 1.1% to 34.2 million passengers in 2012/13[48] and (b) the short-term capacity plan and traffic forecast data that the CAA has received from most of the major airlines at Gatwick.[49]

4.25 Further analysis by the CAA of data supplied by SH&E also revealed an assumption that traffic would not spill from Heathrow until at least 2022/23, whilst traffic spill from Gatwick would not occur until 2025/26 when passengers reached 41.6 million. This was in contrast with the IBP forecast where demand was assumed to spill from Gatwick from 2019/20 when passengers reached 38.1 million.[50] The CAA does not consider the assumption that Heathrow is not subject to excess demand until 2022/23 to be credible.

4.26 The CAA considers that the economic assumptions used by SH&E in the RBP base case (see figure 4.2) appear to lie on the low end of a range of independent GDP forecasts over the short and medium-term. Such conservatism does not seem to be warranted. More recent independent forecasts compiled by Consensus Forecasts (CF) and the Office of Budget Responsibility (OBR) (figure 4.5) suggest a more robust medium and longer-term economic outlook than the base case assumptions although the consensus view on growth prospects for 2013 and 2014 have been more subdued recently given the uncertainty of the global and UK economy. Nevertheless, the OBR and CF projections are significantly higher than those assumed in the RBP base case forecast but they are broadly similar to those assumed by the ACC.

---

[47] Norwegian announced plans to develop Gatwick as a base from 2013, basing 3 or 4 aircraft at the airport. (See Gatwick's RBP to 2024, p.21).

[48] According to CAA airport statistics. This is compared to a forecast of 33.8 million by SH&E.

[49] To date, the airlines that have submitted information to the CAA constitute around 70% of the total passengers carried at Gatwick in 2012

[50] ICF SH&E, 2 July 2012, *Response to airlines' questions in 'Memorandum: Further Forecast Questions'*.

Figure 4.5: Comparison of UK GDP growth forecast (%)

	2013	2014	2015	2016	2017	2018	2019
CF	0.9	1.7	1.9	2.2	2.2	2.2	2.2
OBR forecasts	0.6	1.8	2.3	2.7	2.8	n/a	n/a
SH&E Sept base case	0.5	1.6	1.2	1.0	1.3	1.6	1.9
ACC	--	--	2.0	2.1	2.1	2.2	2.3

Source: SH&E, CF (Feb 2013) and OBR (March 2013)

4.27 SH&E also produced high and low case forecasts to reflect uncertainties over the time period. The high and low forecasts were produced on a scenario basis built up from specific carrier and market assumptions in addition to macroeconomic assumptions about the UK GDP growth and oil prices.

4.28 Although the widening gap between the high and low forecasts reflected increasing uncertainty over time, SH&E considered that there was a 30% chance that the actual outturn may fall outside this range (15% below the low case; 15% above the high case) over the Q6 period.

4.29 The CAA has reviewed the high case forecast, due to its use to drive the development of the RBP capital plan. The CAA considers that the GDP and oil price assumptions underlying the high case forecast are reasonable as a high case scenario over the Q6 period. However, beyond 2019 where GAL/SH&E assume GDP growth of 2.6% to 2.9% per year, the economic outlook might be considered as unduly optimistic when compared with CF projections of a long-term trend growth rate of 2.1% to 2.2% per year.

CAA initial projections

4.30 In light of the above discussion and information available to date, the CAA considers that there is scope for further traffic growth over and above that assumed in GAL RBP base case.

4.31 In contrast with GAL’s base case, the forecast by CAA set out in figure 4.6 below, has a similar profile to the ACC forecasts albeit at a lower average annual growth rate over the Q6 period. The CAA forecast is based on the following considerations: a higher than expected outturn in 2012/13, the latest short-term capacity plans and traffic forecasts by the major airlines at the airport which are higher than suggested by SH&E, higher GDP growth assumptions as indicated by CF and OBR forecasts, more growth opportunity in short-haul and domestic traffic, and Gatwick's ability to capture some traffic spill from Heathrow over the period.

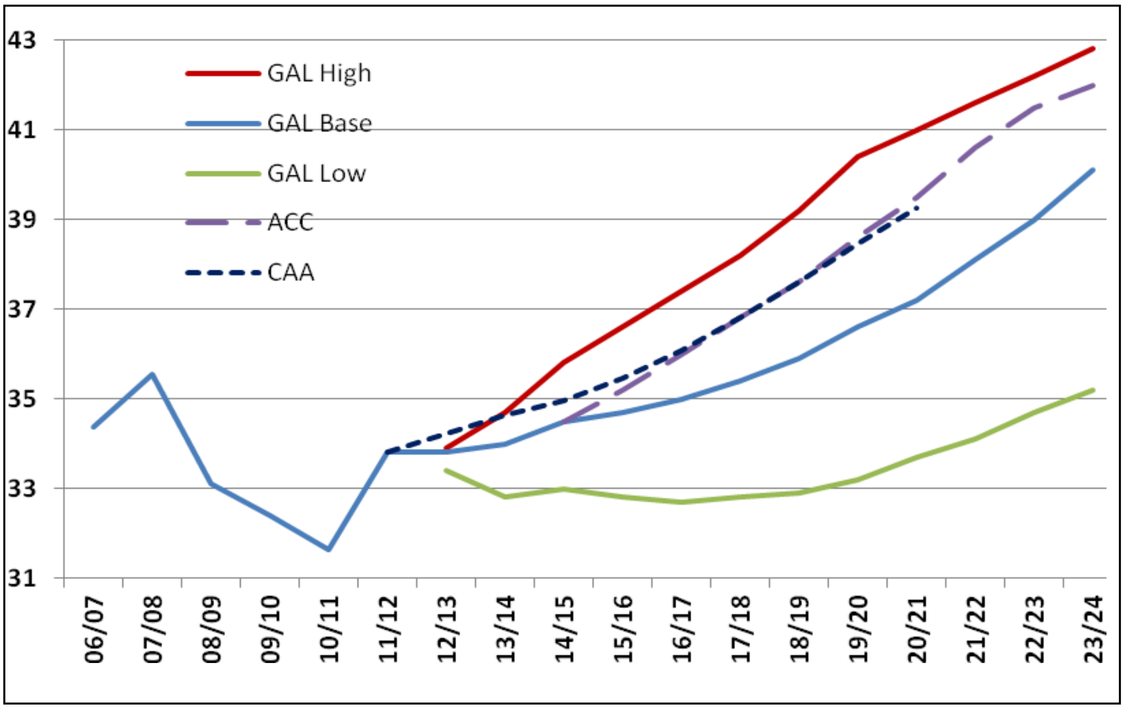
Figure 4.6: Comparison of passenger forecast (million)

	CAA	growth	GAL Sept Base	growth	ACC	growth
2014/15	35.0	1.3%	34.5	1.5%	34.5	1.5%
2015/16	35.5	1.4%	34.7	0.6%	35.2	2.0%
2016/17	36.1	1.8%	35.0	0.9%	36.0	2.3%
2017/18	36.8	2.0%	35.4	1.1%	36.8	2.2%
2018/19	37.6	2.2%	35.9	1.4%	37.6	2.2%
2019/20	38.5	2.2%	36.6	1.9%	38.6	2.7%
2020/21	39.3	2.1%	37.2	1.6%	39.5	2.3%
2014/15-2018/19	180.9	1.9%	175.5	1.0%	180.1	2.2%
2014/15-2020/21	258.6	2.0%	249.3	1.3%	258.2	2.3%

Source: CAA and SH&E

4.32 Figure 4.7 shows the CAA forecasts alongside those of the ACC and GAL.

Figure 4.7: Comparison of Gatwick passenger forecast (million)



Source: CAA and SH&E

4.33 GAL's capital programme is driven in part by the forecast growth in long haul traffic. The CAA has therefore produced an indicative forecast of passengers by segment, shown in figure 4.8. This is based on the CAA's view of airlines' capacity plan and fleet mix, aviation trends, market intelligence, capacity constraints in the London system and Gatwick's historical success in attracting and retaining various types of traffic. The CAA forecast has lower long haul growth than forecast by GAL.

Figure 4.8: CAA forecast of passengers by segment (million)

	Long haul	Short haul	Domestic	TOTAL	growth
2014/15	5.0	26.0	4.0	35.0	1.3%
2015/16	5.0	26.4	4.1	35.5	1.4%
2016/17	5.1	26.8	4.2	36.1	1.8%
2017/18	5.2	27.4	4.2	36.8	2.0%
2018/19	5.3	28.1	4.2	37.6	2.2%
2019/20	5.4	28.7	4.3	38.5	2.2%
2020/21	5.5	29.4	4.4	39.3	2.1%
Compound annual growth rates (CAGR)					
2014/15-2018/19	1.7%	2.0%	1.4%	180.9	1.9%
2014/15-2020/21	1.6%	2.1%	1.5%	258.6	2.0%

Source: CAA

CHAPTER 5

Capital expenditure

5.1 This chapter considers the appropriate level of capex to be taken into account in the calculation of a fair price at Gatwick. These proposals consider both the requirement for individual projects and the expenditure associated with these projects. The CAA's assessment takes into account the outputs from CE, GAL's RBP, the views of airlines and consultancy work commissioned by the CAA.

5.2 It should be noted that the capex will not be fully paid for during a single control period. Under a RAB-based framework, new capex will be added to the RAB. Each year a contribution to prices is made from a capital charge (i.e. the WACC multiplied by the RAB) and a depreciation charge. Therefore although capex will not have a significant effect on the fair price now, it will need to be fully charged to prices over time.

Constructive engagement

5.3 CE involved substantial discussions on the capex programme included in GAL's IBP. The ACC expressed concerns over the size of the initial capex programme, with CE leading to the programme being refined, with a number of projects removed or significantly amended. While the ACC agreed to support the further development of a number of projects, it emphasised that this did not constitute agreement of any particular project or the costs of that project, simply that it required further information on the costs and benefits of individual projects so that it could make an informed judgement on whether it would support them being implemented.

Figure 5.1: Changes to GAL initial business plan capital plan from CE

Changes to GAL initial business plan		
Projects dropped from Q6 during CE following airline feedback		
Pier 3 modernisation	North Terminal energy centre	Long stay car parking
North Terminal short term car parking	South Terminal baggage	Hangar facilities
South Terminal International Departure Lounge capacity		
Additional projects brought to CE		
Stand reconfiguration	Noise attenuation wall (not in FBP)	Potential South Terminal coaching gates (not in FBP)
Gate room seating (not in FBP)	Decade of change	North Terminal arrivals transformation
Projects with significant scope changes during CE		
PTI and Surface Transport has become 2 projects: South Terminal Public Transport; and DDA and North Terminal Coaching Bays	Arrivals Border Zones has been amended to North Terminal Arrivals Border Zone	Runway safeguarding has increased scope to cover development of second runway
Passenger improvements through IT has changed scope to become Business Systems Transformation	Car Rental and Consolidated motor transport project have been combined	

Source: CEWG End of CE review: joint submission to the CAA

GAL's January 2013 Revised Business Plan

GAL's view

5.4 GAL’s RBP set out a revised capital programme, for two options, easyJet remaining split across the North and South Terminals and easyJet combined in the South Terminal. GAL's preferred option was for easyJet to remain split across both terminals. The CAA has therefore used the easyJet split option as the basis for the initial projections.

5.5 GAL calculated the capex for the easyJet split option is £911 million

(2011/12 prices, £964 million in 2013/14 prices). This is made up of:

- asset stewardship - £331 million;
- carry over projects from Q5 – South Terminal Baggage and Pier 1 and Pier 5 - £84 million;
- development projects - £495 million; which included:
  - delivery of 95% pier service in the North Terminal (£166 million), with the Pier 6 south extension providing an additional 15 stands;
  - North Terminal International Departure Lounge (IDL) (£85 million), increasing capacity by 45% and the provision of additional retail space and new passenger zones;
  - upgrade check-in and bag drop (£39 million), reorientation and upgrade of check-in and installation of new technology to permit queue measurement; and
  - North Terminal security (£24 million), transforms North Terminal security to provide an equivalent experience to the South Terminal with 14 smart security lanes (6 already exist) increasing flow rates and improving efficiency.

5.6 Figure 5.2 shows the detailed capital programme for the easyJet split option. GAL considers that the capital programme would enhance the level of service and delivery, significantly improving passenger experience and enhancing the ability of our airlines to operate effectively and attract passengers. GAL considers that all of the projects are supported by passenger research. GAL intends to continue to discuss the capital programme with airlines during 2013 and aims to develop individual projects so that key projects reach tollgate 3 (option selection stage) by the time of the business plan update in July 2013.

Figure 5.2: GAL's proposed capital programme

Project	**Total Cost £ (million)**
Asset stewardship	
Airfield Asset Stewardship	70.94
Facilities Asset Stewardship	155.19

Project	**Total Cost £ (million)**
Commercial Asset Stewardship	35.56
Compliance Risk (decade of change)	37.45
IT Asset Stewardship	32.26
Total Asset Stewardship	**331.40**
Carry over projects	
ST Baggage and Pier 1	83.64
Pier 5	0.75
Total carry over	**84.38**
Development projects	
95% pier service/Pier 6 south (NT)	165.67
NT Security Reconfiguration	24.36
Early Bag Store (NT)	22.66
Upgrade check-in and bag drop (NT)	22.66
Upgrade check-in and bag drop (ST)	16.61
Border Zones (NT only)	16.52
NT IDL reconfiguration & expansion	84.96
Runway 2 presentation	9.44
Business systems transformation presentation	14.91
ST IDL reconfiguration (food court)	12.74
Stand reconfigurations	9.44
Product Development - car parking	4.72
Digital Media	5.00
CIP Departures	2.17
NT Baggage Reclaim	2.64
NT Arrivals Transformation	25.49
ST IDL Capacity	33.04
CIP Arrivals	2.02
Additional NT Coaching Bays	3.49
ST Public Transport & DDA Access	8.68
Consolidated Car Rental and Motor Transport facility	7.55

Project	Total Cost £ (million)
Total Development projects	**494.78**
Total	**910.56**

Source: GAL Revised business plan, CAA conversion to 2011/12 prices

Airline views

5.7 The ACC welcomed the way GAL consulted on its proposed capital plan. The ACC stated that while it could not fully support capital projects until they have reached an advanced stage (potentially tollgate 4, detailed design), the ACC stated that it would potentially support projects that:

- maintain the safety and operating efficiency of the airport;
- complete Q5 projects;
- provide value for money enhancement to the passenger experience; and
- where projects are commercial (justified on the basis of increasing commercial income), they need to be net present value (NPV) positive and wherever possible not increase the price cap in Q6.

5.8 Based on this criteria the ACC indicated support for the projects shown in figure 5.3. On asset stewardship, while the ACC supported the outputs, based on an independent review commissioned by Faithfull and Gould, the ACC considered that the cost could be lowered by reducing on-costs, inflation allowances and moving base costs towards benchmarks.

Figure 5.3: Projects supported by the ACC

Project	Cost £m
Asset Stewardship (incl. Decade of Change)	283.2
South Terminal Baggage & Pier 1	84.0
Pier 5	0.8
North Terminal Security	24.4
Consolidated Car Rental	7.6
CIP Arrivals	2.0

Project	Cost £m
CIP Departures	2.2
Digital Media	5.0
Product Development car parks	4.7
Total	413.8

Source: ACC

5.9 The ACC did not support the other projects in their current form, noting:

- North Terminal IDL reconfiguration: while the project is NPV positive, there is a net increase in charges in Q6 and so ACC did not support the project, although it may support it if returns are profiled so there is not an increase in prices in Q6;
- North/South Terminal check-in: airlines are interested in moving towards more efficient check-in products but the ACC did not consider that the GAL proposal was the right one. Nevertheless a number of airlines are helping GAL with trials of innovations on check-in and this is expected to lead to support;
- early bag store (North Terminal): the ACC did not consider that there was a need for this project, although it noted that a need may occur if there were significant airline moves;
- North Terminal pier service (Pier 6 south): the ACC supported further work on pier service levels and considered that, in the event of a need for further piers, there may be lower cost solutions other than the Pier 6 south extension offered by GAL;
- North Terminal Border Zone: the ACC did not support this project in the absence of an SLA, as the improvements could simply be used by UKBF to reduce manning levels rather than improving customer service;
- South Terminal IDL capacity and reconfiguration: the additional capacity is not required and the project does not generate a commercial return;
- North Terminal arrivals: the benefits are essentially amenity and are not justified by cost; and

- North Terminal baggage capacity is not required.

5.10 The ACC has recently agreed with GAL that work on the North Terminal IDL reconfiguration, North Terminal security and the South Terminal ceilings projects can be started in the current financial year.

Views of passengers

5.11 In its initial response to GAL's RBP, GATCOM has welcomed the investment and emphasis on service quality to both passengers and airlines that the current owners of Gatwick have demonstrated over the past three years. While GATCOM had not had the chance to discuss in detail the projects in the RBP, it expressed disappointment that the plans for a Passenger Transport Interchange at the South Terminal has been replaced by two much reduced projects. GATCOM also expressed concern that the RBP did not acknowledge the need for PRM facilities to keep in step with the growth in passenger numbers generally.

Discussion of key issues

Independent review

5.12 The CAA commissioned two consultancy studies to review GAL capex projections:

- Steer Davies Gleave (SDG) who examined GAL's capex on renewals schemes - schemes that maintain the delivery of the existing outputs, for the RBP this covers schemes related to asset stewardship.[51] As part of this study SDG also examined GAL's maintenance expenditure which is covered in chapter 6 on opex.

- Davis Langdon (DL) who examined GAL's capex on enhancement/development schemes, schemes which deliver increased outputs for example in terms of service quality or capacity.[52]

[51] Steer Davies Gleave, March 2013, *Assessment of maintenance and asset renewal costs at Gatwick*, http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=14279

[52] Davis Langdon, March 2013, *Gatwick Airport: Q6 capex review for the CAA, Phase Two Final Report*, http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=14279

Steer Davies Gleave review of renewals schemes

5.13 SDG reviewed GAL's RBP proposals for renewals (asset stewardship) expenditure. SDG were not provided with data to allow a bottom-up review of base costs and project costs, and so the review focused on a top-down assessment of project risks, overheads and project specifics. SDG took into account the review of renewals costs undertaken by Faithful and Gould on behalf of the airlines. The key findings from the SDG review were:

- GAL had made good progress in gaining certification to PAS55 and independent assessors had found that the airport operator operates an effective asset management strategy, although SDG did point out a number of weaknesses described below;
- the inclusion of unscoped work in project base costs could lead to the double counting of risk, with on average unscoped project costs were (excluding building and civils which appeared to be an anomaly) 16.5% of base construction costs;
- base costs could be double counted due to the potential double counting of project specifics;
- on-costs allowances are too high and are above SDG's benchmark range (22% compared to 13% to 15%);
- project risk allowance is unclear and inconsistent and above SDG benchmark range (23% compared to 11 to 18%); and
- the basis for the project specific allowance is unclear although SDG would expect this to vary across projects and the overall allowance appears reasonable.

5.14 Based on this assessment SDG identified the following potential savings, shown in figure 5.4. The core stretch targets include a reduction to on-costs and project risk allowances. The super stretch targets include a 10 to 20% reduction to base costs to remove the allowance for unscoped work.

Figure 5.4: SDG estimated renewals/asset stewardship forecasts (2011/12 prices)

	Q6 total
GAL forecast	£331m
SDG core stretch target	£299m to £313m
SDG super stretch target	£258m to £292m

Source: SDG, reduced to 2011/12 prices

Davis Langdon review of enhancement/development schemes

5.15 DL reviewed GAL's RBP proposals for enhancement and compliance schemes, in terms of:

- efficiency, by benchmarking unit rates, risk allowances and on-costs against relevant benchmarks; and
- justification given the needs of current and future airlines and their customers.

5.16 In the review of scheme efficiency, DL identified a number of efficiencies based on: unit costs that exceeded those from DL's benchmark range, on-costs that were above DL's benchmark range (DL suggested on-costs should be an average of 17%), risk allowances that were sometimes duplicated within other allowances for individual projects; and the duplication of North Terminal Baggage Scheme costs within the North Terminal IDL reconfiguration project. On this basis DL suggested the GAL's allowance for enhancement/development projects should be reduced from £495 million to £449 million (2011/12 prices).

5.17 DL's review of the justification for individual capex projects focused on DL's views on the business case (based on their technical analysis) and whether there was any support from the airlines. DL did not consider whether schemes were justified specifically from a passenger viewpoint. On this basis DL identified six schemes where the business case appeared to be weak and there was little or no support from the airlines.

- Early bag store - the business case should be reviewed, as most early arrivals are passengers from easyJet who are likely to have a substantially lower hold bag/passenger ratio than IATA benchmarks. DL also noted that most early arrivals were due to surface access concerns. DL suggested that alternative solutions should be considered as part of a combined check-in/bag drop solution.
- North Terminal Border Zone - where DL agreed that the area required a refresh but queried the introduction of new technology without service commitments from UKBF.
- Runway 2 - where DL suggested it was a matter for the CAA whether the costs, in particular those for providing material to the Airports (Davies) Commission, should be capitalised.
- North Terminal baggage reclaim - where DL suggested that given the differences of opinion between parties lower cost solutions such as extending the existing carousel should be considered.
- North Terminal arrivals transformation - while accepting there might be a case for a less ambitious project, DL considered that based on simple arithmetic the scope of the existing project was difficult to justify.
- Additional North Terminal coaching bays - where airlines expressed concern that a facility redeveloped in 2011 is already considered insufficient.

CAA analysis

5.18 The CAA has to make a decision on two issues:

- the schemes to include in the initial projections; and
- the cost of those schemes.

Inclusion of individual schemes

5.19 The CAA welcomes the work undertaken on capex by both GAL and the airlines through CE and subsequently. The CAA is however disappointed that greater agreement could not be reached between GAL and the airlines on which schemes to include in the RBP. The CAA supports further discussions between GAL and the airlines and is hopeful that agreement can be reached on the capital programme to feed into GAL's updated business plan in July 2013.

5.20 On making a decision on which schemes to include in the initial projections the CAA has considered how best to further its statutory duties in particular to further the interests of existing and future passengers, and to do so, where appropriate, by promoting competition. The CAA considers that airlines have an important but not an exclusive role in helping it define how it furthers passengers' interests for the purpose of development proposals for Q6. While airlines do not represent passengers, their interests are broadly aligned. However, as set out in chapter 3, this may not always be the case.

5.21 In addition GAL has stated that the ACC view tends to represent those airlines that are heavily engaged in the process and underweights the views of current airlines that are not as heavily (or not at all) engaged in the process as well as future airlines.[53] The current membership of the ACC covers eleven airlines and all the main business models currently operating from the airport.[54] Together these airlines represent 86% of passengers travelling through the airport.[55] The CAA notes that the following airlines are most heavily engaged in the Q6 process: easyJet, BA, Virgin, Aurigny and Thomas Cook; they represent 64% of passengers and cover the range of business models at the airport. The ACC stated that the ACC's position has been discussed and agreed with members.

5.22 The CAA has stated it would undertake independent validation and assurance to ensure that a settlement is in the passengers' interest, drawing on various sources including passenger research, complaints data and the views of the CAA Consumer Panel.

5.23 Where GAL and airlines have not reached agreement then the CAA has considered independent evidence on whether the proposed outputs are in the passengers' interest, or provide a commercial return

[53] Correspondence from GAL, 11 March 2013.

[54] The current membership of the ACC is Aurigny Airlines, British Airways, easyJet Airlines, Emirates Airlines, Flybe Airlines, Monarch Airlines, Ryanair, Thomson Airways, Thomas Cook Airlines, US Airways, Virgin Atlantic Airways.

[55] Figures based on CAA data for 2012.

over a reasonable time period.[56]

5.24 **NTL IDL reconfiguration** would provide increased circulation space; business, quiet, children's and teenagers' zones; an outside terrace area; and additional retail and catering. GAL commissioned research indicates an average WTP of £2.85/pax for separate quiet, business and child zones and an outside terraced area[57] (noting that around a quarter of passengers would benefit as the improvements are only to the NT and only to departures, although charges would be spread across all passengers.[58] Based on GAL's estimates the project would pay back after 8 years. The project therefore appears to be in the passengers' interest.

5.25 **ST IDL capacity** would provide increased circulation space; business, children's and teenagers' zones; an outside terrace area; and additional retail and catering. The passenger impact of the STL IDL capacity project is similar to the NT IDL reconfiguration. Around a quarter of passengers use ST departures. The project does not have a positive financial impact over the 25 year asset life and would increase charges by around £0.08/pax. As the incremental cost to passengers is less than the WTP of the vast majority of passengers then the project appears to be in the passengers' interest.

5.26 **ST reconfiguration (food court)** would provide additional food and beverage and retail, improved wayfinding and children's and teenagers' zones. GAL already achieves wayfinding targets and children's and teenagers' zones would be provided by ST IDL reconfiguration above. The main additional benefit from this project is therefore likely to be the additional retail and catering units. GAL research indicates a passenger WTP of £0.39/pax for 50% more catering outlets. This project would add 1700m^2 to food and beverage and 1300m^2 to retail. It would be expected that most of the additional WTP would be captured by retailers/caterers and so the CAA would expect to assess whether the project would be in the passengers' interest by examining whether it is commercial. However the project

[56] The ACC criteria were that commercial projects should not increase charges with the control period. The CAA has considered whether payback can be achieved over a longer period.

[57] Figure 33, LGW WTP research final report, December 2012, Accent.

[58] CAA airport data indicates that in 2012 51% of passengers at Gatwick used the North Terminal and 49% used the South Terminal.

has a financially neutral impact over the 15 year project life. DL indicated that GAL anticipates putting forward a financially positive business case in the July 2013 business plan update. If the project produces net financial benefits over a reasonable time period then the CAA considers that it would appear to be in the passengers' interest.

5.27 **NT/ST check-in** would reconfigure check-in to provide facilities at least equivalent to NT Zone A, with new technology and processes to reduce waiting times (to a maximum of 30 minutes) at reduced costs. The project would lead to an increase in airport charges of £0.08/pax over the 15 year asset life. The incremental costs to passengers would be offset, to some extent, by a reduction in airline operating costs although the extent to which is unclear. GAL research indicates that improvements and investment to the check-in process is their second highest priority, with improvements to check-in seen as a priority for 32% of passengers. This has dropped in recent years with the opening of NT Zone A.[59] Passengers have a WTP of £0.24/min for reducing check-in queue times (from an average of around 13 minutes to 10 minutes[60]). The CAA also notes that 47% of passengers thought check-in queues were quicker and 13% thought that they were longer than expected. While the aim of the project is to reduce maximum check-in queues, it is also likely to have an impact on average wait times, with BA wait times around half average wait times[61], although this may be due to staffing levels as well as check-in facilities. Even if check-in queues were reduced by an average of 3 minutes, then taking into account the potential operating cost savings, this project appears to be in the passengers' interest, although given the direct implications for airline operations it is important that the proposed solution has airline buy-in.

5.28 **NT early bag store** would provide a 1,500 early bag store in the North Terminal and a 1,500 early bag store adjacent to the transfer baggage facility. There will already be a facility in the South Terminal delivered through the ST baggage improvements. GAL states that the new facility will allow passengers to check-in baggage 18 hours before departure, with GAL finding that around half of passengers were

[59] Page 50 YouGov.

[60] Accent, December 2012, LGW WTP research final report, December 2012, Figure 14

[61] Accent, LGW WTP research final report, Figure 41 versus Figures 14.

interested in early bag drop off.[62] The project is forecast to increase airport charges by £0.05/pax over the 15 year project lifetime. GAL passenger research indicates a WTP of ~£1.40/pax for early baggage storage (up to 12 hours or more). While an early bag store appears to be in the passengers' interest, DL indicated that a smaller, modular facility could provide a better value solution. The CAA has therefore included DL's suggested costs for such a project.

5.29 **NT border zones** would provide 15 e-gates, 14 manual desks and additional queuing space, queue measurement technology and refurbishment of NT arrivals hall. The project would lead to an additional £0.03/pax over the 15 year project life. Around 60% of passengers identified passport control as the third highest priority for investment[63] with an average WTP of £0.35/min/pax (for reducing average queues from 15 minutes to 10 minutes[64]). However despite the improvements in the Border Zone area, as there is no SLA with the UKBF, there is no guarantee that immigration queues would reduce (the UKBF could use the improvements to improve efficiency). Consequently while passengers would face increased charges, they may not see an improved service. The CAA has not included the full costs of this scheme in its initial projections, pending confirmation that benefits from the scheme would not be absorbed by reductions in UKBF costs. The CAA has therefore included DL's estimate of a reduced scheme, based simply on the refurbishment of the existing area.

5.30 The **runway 2** project would safeguard the area for the potential second runway and fund GAL's input to the Airports Commission. The ACC has suggested that the input to the Airports Commission should only be capitalised once the second runway is delivered. The CAA has considered the approach that it took to the costs of the BAA input to the 2003 government White Paper. At the time of the Q4 review the CAA did not allow initial, or preliminary expenditure in the price controls as the government had not published the White Paper and there was no way of knowing which new runway developments the

[62] At present some airlines already allow early bag to be checked in although bags are not stored in a separate facility.

[63] Page 54 YouGov.

[64] Figure 21, Accent.

government would support.[65] It was only after the government decision was made, and subject to a number of criteria, that the CAA allowed the costs to be added to the RAB.[66] Given this approach and the potential commercial gains to GAL from the development of a second runway the CAA is not minded to allow the input to the Airports Commission to be added to the RAB. On cost of safeguarding, the CAA notes that the costs forecast by GAL appear excessive for something which is essentially protecting the alignment of a runway. The CAA also notes that safeguarding costs are treated as opex in the statutory accounts. The CAA is not therefore minded to include the runway 2 costs in the initial projections without further evidence from GAL that this is in the passengers' interest.

5.31 **NT Pier service (Pier 6 south)** would provide 6 Code E stands (4 could be Code F) and 8 Code C stands to ensure delivery of 95% pier service in the North Terminal. The project would increase airport charges by £0.23 over the 40 year asset life. DL state that while Pier 6 south may be required to deliver the growth forecast by GAL, it considered that lower cost solutions may be available if the long-haul growth fails to materialise. The CAA central forecast for 2018/19 has 0.2 mppa less long-haul passengers than GAL. GAL research indicates a passenger WTP of £1.51 for a covered walkway (i.e. a pier service to passengers). Pier 6 south increases North Terminal pier service from 92% to 97.2% under base case forecasts, meaning that around 0.9 mppa would benefit from pier service, so the benefits can be seen as (£1.51x0.9m=) £1.4 million per year. Given the costs and WTP, this would give a benefit to cost ratio of less than 20%. While the CAA considers that maintaining 95% pier service may be in the passengers' interest, this is not at any cost and the CAA encourages the airport operator and airlines to agree a suitable solution.

5.32 **Business systems transformation** covers a range of projects including passenger tracking, queue measurement, dynamic wayfinding, digital media and asset management and internal

[65] CAA, June 2004, *Regulatory Treatment of initial expenditure on new runway capacity: a consultation document*, paragraph 1.2.
http://www.caa.co.uk/docs/78/regulatorytreatmentofinitialexpenditure040601.pdf

[66] CAA, March 2006, *Regulatory treatment of preliminary expenditure on new runway capacity: a CAA follow-up document*, paragraph 3.
http://www.caa.co.uk/docs/5/ergdocs/preliminary_expenditure_mar06.pdf

reporting improvements. The project would increase airport charges by £0.07/pax over the 5 year project life. While the passenger benefits of some elements of these proposals are clear, for example passenger tracking, the benefits of other elements are less clear. GAL has indicated that that there may be an opex reduction from some projects, but further work is required to demonstrate this. The CAA would therefore look for GAL to work with the airlines to come up with agreed proposals which can be clearly identified to be in the passengers' interest.

5.33 **NT baggage reclaim** would convert the second domestic belt into a 70m international belt. This would avoid the need to split baggage from wide bodied aircraft across two belts at peak times. The project would increase airport charges by less than £0.01/pax. The CAA acknowledges passenger priorities for reducing baggage waiting times[67] while noting that the impact of the project on waiting times is unclear. CAA agrees with DL that given the lack of airline support, GAL should investigate lower cost solutions. The CAA has excluded the separate cost of this project as DL has identified that GAL has already included the costs in the North Terminal IDL reconfiguration.

5.34 **NT arrivals** would provide an additional 1,000m^2 of capacity in the arrivals concourse to meet capacity requirement and provide reconfigured and improved commercial revenue offering. GAL suggests that this would improve QSM scores for cleaning and wayfinding. GAL passenger surveys indicate that the arrivals concourse and processes are often areas of complaint. The project would increase airport charges by £0.05/pax over the 15 year project life. GAL surveys indicate that 10% of passengers suggest that wayfinding needs to be improved (down from 25% in 2009). The CAA notes that GAL is meeting both cleaning and wayfinding targets in the North Terminal. DL suggested the scope of the existing project was difficult to justify and that there might be a case for a less ambitious project aimed at improving the look and feel of the arrivals area. The CAA does not have sufficient evidence to suggest that GAL's proposed project would be in the passengers' interest and has therefore included DL's estimate for a reduced scope project.

5.35 **Additional NT coaching bays** would provide 3 additional bus stops.

[67] Page 51 YouGov.

GAL surveys indicate that surface access and transport links are the sixth highest priority for investment. GAL has also indicated that despite the improvements made in 2011/12 that its demand forecast indicated a need for additional stands. The costs of this facility would be charged to coach operators. GAL has not identified whether coach operators support the project and would be willing to pay for this investment. Given this, the CAA does not have sufficient evidence to include the costs in the initial projections.

5.36 **ST public transport and DDA access** would provide a new lift access from the terminal forecourt and associated covered walkways to the bus stops on the A23. The existing access is uncovered and PRM access to the southbound A23 is difficult involving one road crossing and the use of a tunnel under the A23. Given the additional benefit to passengers with luggage and PRMs, the scheme appears to be in the passengers' interest.

Scheme costs

5.37 For renewals, based on the SDG analysis, the CAA considers that the core stretch targets would be appropriate, as the reductions to the various project add-ons seem broadly based. The CAA considers that the base cost reductions included in the super stretch targets appear, at this stage, to be more speculative. The CAA has used the mid-point of the core stretch target of £306 million and profiled costs accordingly. The CAA may undertake further work in this area before reaching its final view.

5.38 The CAA has used DL's proposals on scheme costs for enhancement schemes, adjusted where relevant for the reduction in scope discussed above.

5.39 It should be noted that both SDG and DL undertook their analysis based using the 2013/14 price base used by GAL. The CAA has converted these costs to 2011/12 prices.

5.40 The CAA notes that GAL has not uplifted for real construction price inflation (COPI) after 2013. The CAA notes that DL forecasts that real COPI will be negative over the next few years and only returning to above inflation in the second half of the Q6 period. At this stage the CAA has not adjusted GAL's assumptions on COPI.

CAA summary

5.41 Figure 5.5 shows a summary of the schemes the CAA has included in the initial projections for the Q6 period. For the period beyond Q6 the CAA has not undertaken a review of capex and simply used GAL's capex forecasts for this period.

Figure 5.5: CAA initial projections by scheme for Q6 (£ million)

	2014/15	2015/16	2016/17	2017/18	2018/19	Total
Asset Stewardship	55.6	56.3	55.8	68.4	70.3	306.4
Carry over projects						
ST Baggage and Pier 1	61.9	21.7	0.0	0.0	0.0	83.6
Pier 5	0.7	0.0	0.0	0.0	0.0	0.7
Total carry over	62.7	21.7	0.0	0.0	0.0	84.4
Development projects						
95% pier service (NT)	16.1	71.9	54.7	9.3	0.0	152.0
NT Security Reconfiguration	2.8	3.5	4.9	4.0	2.8	17.9
Early Bag Store (NT)	0.3	1.2	5.7	4.1	0.0	11.3
Upgrade check-in and bag drop (NT)	0.0	1.7	6.9	7.8	4.3	20.7
Upgrade check-in and bag drop (ST)	1.7	4.3	6.9	2.2	0.0	15.2
Border Zones (NT only)	0.0	0.5	2.0	2.0	2.5	7.1
NT IDL reconfiguration & expansion	2.2	16.6	27.6	38.6	0.0	85.0
Runway 2 presentation	0.0	0.0	0.0	0.0	0.0	0.0
Business systems transformation presentation	2.8	2.8	2.8	2.8	3.6	14.9
ST IDL reconfiguration (food court)	5.9	6.4	0.0	0.0	0.0	12.3
Stand reconfigurations	8.9	0.0	0.0	0.0	0.0	8.9
Product Development - car parking	0.0	0.0	0.0	2.2	2.2	4.5
Digital Media	4.2	0.0	0.2	0.0	0.1	4.5

	2014/15	2015/16	2016/17	2017/18	2018/19	Total
CIP Departures	0.4	0.8	0.6	0.0	0.0	1.8
NT Baggage Reclaim	0.0	0.0	0.0	0.0	0.0	0.0
NT Arrivals Transformation	0.0	0.0	1.5	2.1	2.1	5.7
ST IDL Capacity	0.0	0.0	0.0	5.5	21.9	27.4
CIP Arrivals	0.9	1.0	0.0	0.0	0.0	1.9
Additional NT Coaching Bays	0.0	0.0	0.0	0.0	0.0	0.0
ST Public Transport & DDA Access	0.4	1.2	5.9	0.0	0.0	7.6
Consolidated Car Rental and Motor Transport facility	1.8	2.7	0.3	0.0	0.0	4.7
Total Development projects	48.4	114.6	119.9	80.7	39.5	403.1
Total	166.7	192.6	175.7	149.1	109.8	793.9

Source: CAA

CAA initial projections

5.42 The CAA has used the capex allowance shown in figure 5.6 in the initial projections.

Figure 5.6: CAA initial capital expenditure projections (£ million)

	2014/15	2015/16	2016/17	2017/18	2018/19	Total	2019/20	2020/21
Total Asset Stewardship	55.6	56.3	55.8	68.4	70.3	306.4	83.1	105.1
Total carry over	62.7	21.7	0.0	0.0	0.0	84.4	0.0	0.0
Total Development projects	48.4	114.6	119.9	80.7	39.5	403.1	107.1	125.1
Total	166.7	192.6	175.7	149.1	109.8	793.9	190.2	230.2

Source: CAA

CHAPTER 6

Operating expenditure

6.1 This chapter provides an overview of the airport operator's historical performance in comparison with the CAA's Q5 forecast and describes the projections for the Q6 period contained in GAL's RBP.

6.2 This chapter also contains a summary of the outcomes of CE, the conclusions of various independent consultancy studies and an explanation of how the CAA has used this information to develop an opex forecast for the Q6 period.

Constructive Engagement

6.3 GAL and the airlines were not able to reach agreement over opex through the CE process.

6.4 There is disagreement between the parties over the extent to which GAL has participated in the CE process. GAL state that it has followed the terms of the CE mandate in providing information to the airlines and their consultants. In contrast the ACC state that it has been disappointed by the level of information provided by GAL and that it has not been able to analyse the business plan to the level required by the CE mandate. The CAA is disappointed that GAL was not able to provide the requested information to allow airlines to take a better informed view.

6.5 The ACC also states that it believes that GAL has significantly overestimated its opex requirements over Q6, and that greater efficiencies could be achieved.

GAL's January 2013 Revised Business Plan

6.6 As part of the CE process, GAL published an IBP in April 2012, which provided initial forecasts of opex, GAL's approach to forecasting and key issues that are likely to affect opex over the Q6 period.

6.7 Following the end of CE, the RBP was published in January 2013 providing updated opex projections. Overall the RBP lowered total cumulative opex costs over Q6 by 3% relative to the IBP.

Opex over Q5

6.8 Over Q5 (including the additional year for the extension), total pre-exceptional opex is expected to fall from £324 million in 2008/09 to £286 million in 2013/14, an average rate of -2.4% per year. This compares with overall growth in passengers of 0.5% per year. Based on these projections, opex per passenger is expected to fall from £9.79 to £8.42 by the end of Q5. Total employee man years are expected to rise from 2,393 to 2,440 with falls in ✂ headcount offset by increases in ✂.

6.9 The sale of the airport in 2009 had a significant impact on opex. Maintenance and equipment costs increased to £34 million in 2008/09 to prepare the airport for sale, falling to £23 million in 2011/12. Following the sale intercompany costs were reduced from £47 million in 2008/09 to zero in 2011/12. This was partially offset by increases in IT, non-security staff, and other costs required to set up independent functions in the airport. Other cost lines have generally remained constant throughout Q5 with minor reductions in NATS and police costs for example.

6.10 The RBP provides a description of changes to the management of opex since the airport's sale in 2009. These changes are summarised in the following points.

- Improvements in opex performance through the introduction of new management techniques, improved utilisation of labour, more efficient procurement of goods and services and more effective partnering with other organisations to deliver shared efficiencies.
- Improved security processes achieved through the introduction of flexible rostering for front line staff, an absence management programme and the South Terminal security project.
- Lower levels of security staff, business rates and asset maintenance costs driven by the re-scoping of the capital plan in response to the downturn in passenger volumes. This included delaying some planned investments, which will now be completed in Q6.
- Investment in improved service levels, including customer service training for all security staff and changing the cleaning contractor following an SQR failure in the South Terminal.

- Active management of the estate including the demolition of Hangar 5 and the leasing of Longbridge and Norfolk House reducing rent and business rate costs.

- Reduction in pension costs through the closure of the defined benefit (DB) scheme in 2009 and its replacement with a defined contribution (DC) scheme for new starters. This has reduced the average rate of pension contributions to 11% for new staff, in comparison the contribution rate for staff on the DB scheme is 24% in 2012/13. The overall average contribution rate is expected to fall from 21% to 19% between 2013/14 and 2014/15.

Opex over Q6

6.11 In Q6 opex is expected to increase from £286 million in 2013/14 to £301 million in 2018/19, a growth rate of 1.0% per year on average. This compares with a passenger growth rate of 1.1%. Opex per passenger is expected to fall slightly from £8.42 to £8.39 over the period and total employee man years are expected to fall from 2,440 to 2,388.

6.12 The largest elements of opex over Q6 are security and non-security staff costs, which account for 40% of the total over the period. Rates, electricity, maintenance and equipment costs are the next largest categories each accounting for over 8% of total opex. Rates, gas, electricity and PRM costs are expected to increase over Q6. Slight reductions in cost are expected in security and IT.

6.13 GAL plans to undertake several efficiency initiatives over the Q6 period. These are expected to reduce opex by £11.4 million per year in total. The most significant initiatives are described in the following points.

- The North Terminal security project is expected to replicate the benefits of the South Terminal security project, increasing flow rates and reducing opex by £3 million per year.

- The consolidated security gate project will consolidate external security posts, providing efficiency savings. In addition to these two projects, GAL has included a 1% per year 'stretch' efficiency target for variable security costs, which will reduce costs by £3.9 million per year.

- Moving negotiated pay grades away from an RPI-based system for pay progression to one based on company and personal performance and the introduction of a lower pay grade structure for new employees in negotiated roles. Overall the RBP expects wages to increase by ✂.
- Reductions in IT service costs achieved through a move to 'cloud' based services. Underlying IT opex is expected to fall from £8.4 million in 2013/14 to £6.7 million in 2018/19. This is offset by increased capex of £17.4 million over the Q6 period.

6.14 GAL expects a general increase in business rates liabilities with an increase of 3.2% per year to 2016/17 as a result of increased assets. The two most significant projects are Pier 6 south and the North Terminal IDL, which are expected to increase rate costs by around ✂ and ✂ per year by the end of Q6. In 2017/18 GAL expects that rates will increase by 5% in nominal terms following the planned re-valuation.

6.15 Pension costs will increase from £13 million in 2013/14 to £15 million in 2018/19. The closure of the DB pension scheme to new entrants in Q5 will gradually reduce pension costs through staff turnover, reducing the proportion of staff on the higher cost DB scheme. In 2014/15 the pension contribution basis will switch from an earnings based service cost to a cash contribution basis further reducing pension costs.

6.16 However, these effects will be offset by an increase in the cost of the DB scheme deficit. The RBP includes deficit reduction costs of ✂ from 2015/16. This is required to recover a forecast deficit of ✂. As a result, average contribution rates are expected to increase from 19% to 22% over Q6.

6.17 An appendix of the RBP discusses the treatment of pension commutation payments made by GAL to BAA at the time of the sale. GAL made a commutation payment of £98.8 million which removed its liabilities to employees who did not transfer into the new pension scheme. GAL has not included this cost in its RBP projections but states that it believes it should be entitled to earn a return on this payment in Q6. The CAA's view on the treatment of the commutation payment is discussed in a later section.

6.18 A summary of the RBP opex projections is shown in figure 6.1 showing opex cost lines in real terms 2011/12 prices over the Q5 and Q6 periods.

Figure 6.1: GAL RBP Opex Forecasts

January 2013 RBP Actual and Forecast	Q5					Q5+1	Q6				
£m 2011/12 prices	**2008/09**	**2009/10**	**2010/11**	**2011/12**	**2012/13**	**2013/14**	**2014/15**	**2015/16**	**2016/17**	**2017/18**	**2018/19**
Security staff costs	68	61	57	57	61	63	61	62	62	61	61
Non-security staff costs	45	56	59	62	60	62	60	61	62	63	63
Police	16	14	14	13	12	12	12	13	13	13	13
Rent	1	0	1	1	1	1	1	1	1	1	1
Rates	28	27	23	26	27	28	28	30	30	30	31
Utilities	30	35	29	30	27	28	28	29	30	30	30
Maintenance and equipment	34	28	23	23	25	25	25	27	27	28	27
NATS	20	20	17	17	19	19	19	19	19	19	20
PRM	6	5	5	6	6	6	6	6	7	7	7
Cleaning	9	8	7	8	7	7	7	8	8	8	8
IT	0	5	17	15	10	8	13	12	11	9	7
Other	21	37	28	24	27	28	27	27	29	31	31
Intercompany	47	21	-1	0	0	0	0	0	0	0	0
Total - pre exceptionals	324	316	278	282	282	286	288	294	297	300	301
Exceptionals	-2	131	18	0	0	0	0	0	0	0	0
Total Operating Costs	321	447	295	282	282	286	288	294	297	300	301
Man Years	2,393	2,452	2,394	2,354	2,404	2,440	2,433	2,406	2,401	2,393	2,388

January 2013 RBP Actual and Forecast	Q5					Q5+1	Q6				
Passengers (m)	33.1	32.4	31.6	33.8	33.8	34.0	34.5	34.7	35.0	35.4	35.9
Total Opex / Passenger (pre exceptionals) (£)	9.79	9.76	8.78	8.33	8.35	8.42	8.34	8.48	8.49	8.49	8.39

Source: GAL RBP

Historical performance

6.19 Figure 6.2 below shows GAL's total operating costs in comparison with the CAA Q5 forecasts in real terms 2011/12 prices. The table shows that operating costs were slightly below the forecast in 2008/09, rising slightly above in 2009/10. Costs then fell significantly below the forecast following the sale in December 2009. By 2011/12 total cumulative opex is expected to be 5% below the Q5 forecast.

Figure 6.2: GAL actual opex over Q5 compared to the CAA forecast

£m 2011/12	Q5					
	2008/09	2009/10	2010/11	2011/12	Total	CAGR
CAA Forecast	315	313	314	315	1,257	0.0%
Outturn	312	319	281	281	1,192	-3.4%
Variance	-3	5	-33	-34	-64	-
Variance	-1%	2%	-10%	-11%	-5%	-

Source: Regulatory Accounts

6.20 The main difference between forecast and actual spending was caused by the significant reduction in intercompany costs described above. There were also differences between forecast and actual costs including higher than expected 'other costs', lower than expected staff and rent and rates costs, and the payment of net SQR bonuses.

6.21 Lower than expected passenger numbers have also resulted in lower opex relative to the Q5 forecasts, particularly for security costs which are partially driven by passenger numbers. By the end of Q5, passenger numbers are expected to be 10% lower than forecast. GAL has estimated that this reduced security staff costs by around £10 million relative to the Q5 forecast.

Airline Views

6.22 Following the end of CE, the ACC submitted a report analysing GAL's business plans with alternative proposals. This set out its views on various areas including opex. The report states that it has been difficult for the ACC to analyse the IBP projection due to a lack of information from GAL and that their views have therefore been based on a range of assumptions.

6.23 The main points of the report are that operating costs should remain 'flat in nominal terms'. This position is based on the following points.

- The airport operator should be subject to the same commercial pressures faced by the airlines, which generally seek to operate by keeping operating costs constant in nominal terms.
- There is a lack of efficiency planning in the airport operator's opex forecasts. Economies of scale should be achievable due to the joint ownership of Gatwick and Edinburgh.
- Based on benchmarking of security staff wage rates against five security companies, staff appear to be over paid by around 42%. If wages were brought into line with this benchmark there could be significant savings of around £115 million over Q6.
- The archway metal detectors (AMD) are underutilised due to bottlenecks in the approach queue where passengers load and unload their possessions onto the conveyor belts. This suggests that the airport operator could reduce costs by using one AMD for every two security lanes reducing headcount by around 144. This would reduce total opex over Q6 by £27 million.
- There is an oversupply of car parking at the airport which increases rent and rates costs unnecessarily. This could be addressed by disposing of excess car parking space. Changes to rent and rates costs have been negligible in previous years; it is uncertain why significant increases should be expected over the Q6 period.

6.24 Virgin and easyJet both provided submissions to the CAA broadly supporting the points made in the ACC submission described above.

Discussion of key issues

6.25 The CAA recognises that GAL's opex efficiency is a key component of the calculation of final prices and an area where there is a stark difference of views between GAL and the airlines as to what constitutes an appropriate level of ambition for Q6.

6.26 The CAA has undertaken several pieces of analysis to inform its initial projections. This includes assessing GAL's performance in Q5 against the forecast used to set the price control; commissioning several independent studies of various aspects of GAL's opex projections for Q6; undertaking various benchmarking studies; and developing a comparison of airport and airline cost performance. These analyses are described in the following sections.

Airport Opex Benchmarking Evidence

6.27 The CAA has reviewed several pieces of independent opex benchmarking evidence including:

- Air Transport Research Society 2011 Airport Benchmarking Report;
- Leigh Fisher (LF) 2011 Airport Benchmarking Report;
- Booz Allen 2012 European Airport Benchmarking Report commissioned by Heathrow; and
- SDG 2012 Stansted Mid Q Review Report commissioned by the CAA.

6.28 In each of these studies opex per passenger has been used to assess the relative performance of different airports. Each study uses the airport operator's financial accounts adjusted to calculate an estimate of 'core' opex costs (adjusting for factors such as depreciation and retail costs) to provide a consistent measure of opex performance. The main findings of these studies are summarised in figure 6.3 below.

Figure 6.3: Summary of opex benchmarking analysis

Study / Airport Opex per pax (£)	ATRS 2009	Leigh Fisher 2009	Booz Allen 2011	SDG 2010
Gatwick	8.69	9.20	9.10	9.05
Sample average	7.16	6.00	9.71	8.94
Sample size	141	50	13	10
Average passengers	20.4m	35.1m	30.6m	22.5m

Source: CAA Analysis of ARTS, Leigh Fisher, Booz Allen and SDG reports

6.29 The figure shows that opex per passenger at Gatwick was between £8.69 and £9.20 depending on the study. This indicates that opex per passenger was generally higher than the samples considered in the studies (some of which relate to 2009 prior to the sale of the airport).

6.30 Costs are slightly lower than the average of the Booz Allen study however this study was primarily intended to benchmark Heathrow and the average costs of the sample may therefore be less comparable to Gatwick.

6.31 The CAA is aware that benchmarking evidence cannot take into account all aspects of an airport operator's operation. Differences in airport quality and the types of service provided all have an effect on the level of opex per passenger, as does the choice of exchange rates and conversion factors used to compare costs in different currencies.

6.32 Nonetheless the benchmarking evidence seems to indicate that costs at Gatwick are above the average, which as a conservative measure of the efficient cost frontier suggests that there is likely to be scope for further efficiency. Gatwick scores above the EU average in terms of overall passenger satisfaction. Higher costs per passenger may therefore be partially related to higher levels of airport quality. However, the benchmarks in the analysis include a number of airports[68] with high service quality scores and lower opex per passenger indicating that Gatwick is unlikely to be at the efficient cost frontier.

CAA Benchmarking

6.33 Building on the evidence described above, the CAA has undertaken additional analysis of the relative performance of GAL, incorporating the latest data.

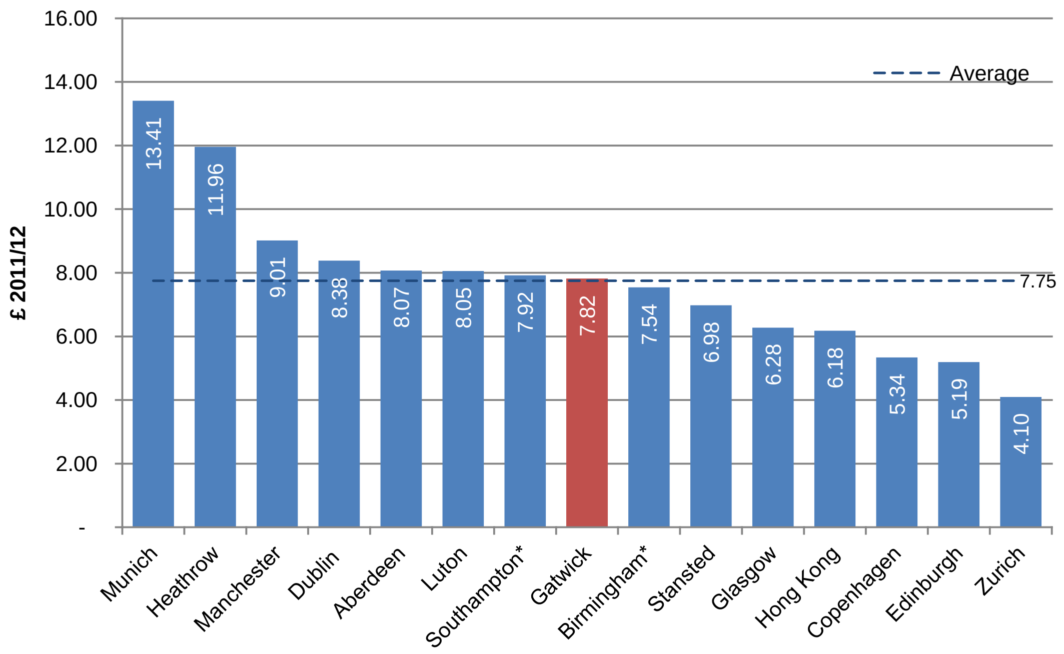
6.34 Based on analysis of financial account data the CAA has estimated the adjusted opex[69] per passenger for a range of airports taking account of differences in exchange rate and general price levels using PPP[70] indices. Opex per passenger across the sample airports is shown below in figure 6.4.

[68] Including Edinburgh, Singapore and Hong Kong, which are identified as best in class in terms of overall passenger satisfaction.

[69] Adjusted opex excludes costs related to depreciation, retail, ANS, rail and losses on asset disposals. The metric is intended to provide an estimate of the 'core costs' of airport operation excluding irregular costs.

[70] Purchasing Power Parity indices indicate the relative price level in different countries.

Figure 6.4: Adjusted opex per passenger with factor cost adjustments



* denotes figures are based on financial calendar periods.

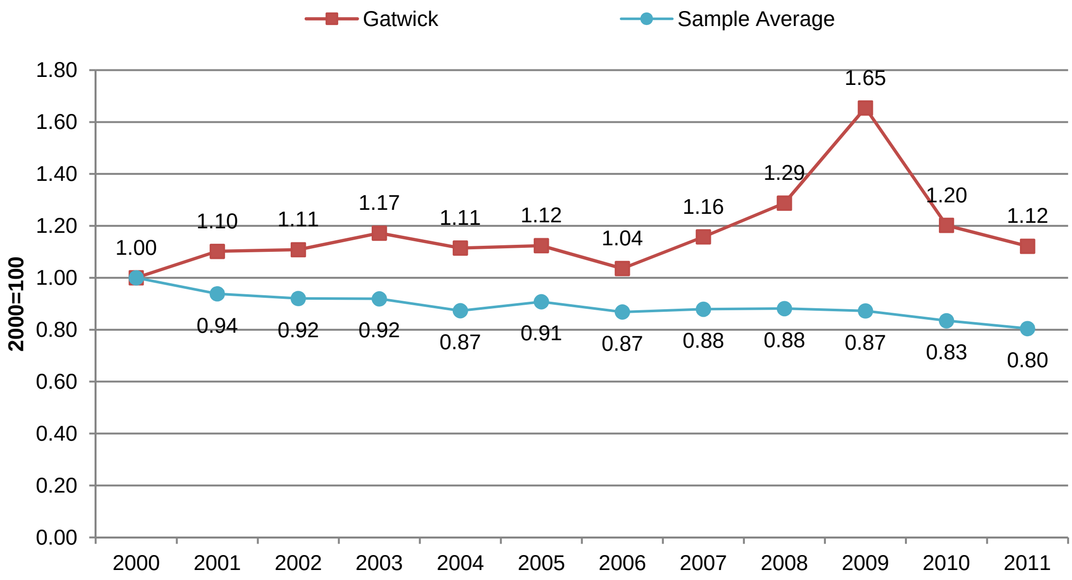
Source: CAA Analysis based on financial accounts

6.35 The analysis indicates that GAL's performance is close to the average, and there are several airports that outperform it on a cost-per passenger basis. This includes airports with high levels of service quality such as Edinburgh and Copenhagen and arguably larger and more complex airports such as Hong Kong, replicating the findings of the previous studies.

6.36 Time series analysis indicates that historically, GAL's costs have tended to rise faster than the sample average. In 2000/01 opex per passenger was £4.07 below the sample average. By 2011/12 opex per passenger had risen to £0.15 above the sample average indicating a relative decline in efficiency compared to the average benchmark. Figure 6.5 shows the historical change in Gatwick's adjusted opex per passenger over time against the benchmark sample.

6.37 Between 2000 and 2011 costs have increased by 12%, in comparison with a decline of 20% in the benchmark sample indicating both an absolute and relative decline in efficiency. There was a notable increase in cost per passenger in 2009, which has been attributed to increased expenditure prior to the sale of the airport. This increase was largely reversed in the following year, with further relative reductions in 2011.

Figure 6.5: Adjusted opex per passenger index 2000-2011



Source: CAA Analysis based on financial accounts

6.38 From this evidence, it is clear that several airports outperform GAL with arguably higher levels of service quality, scale and complexity. Opex per passenger has also grown at a faster rate than the sample average. This analysis suggests that GAL is not currently at the efficient cost frontier in terms of opex per passenger.

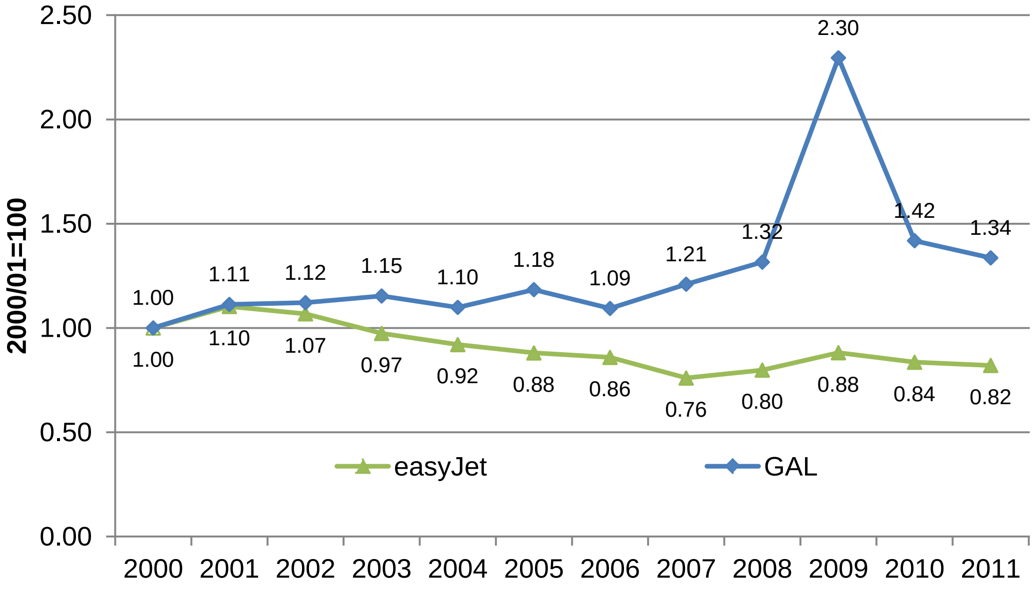
Comparison with airline opex performance

6.39 In order to assess the cost performance of the airport operator against the airlines the CAA has examined the comparative performance of easyJet, the main airline at Gatwick, and GAL, based on an analysis of total opex per pax for the airport operator (without adjustments) and opex per Available Seat Kilometre[71] (ASK) for the airline (including flights from all other airports). Figure 6.6 below shows the relative performance of the airport operator and airline from 2000 to 2011 in

[71] ASKs are often used to benchmark the efficiency of airlines taking account of the total number of aircraft, distances and fuel costs.

terms of these metrics.

Figure 6.6: Total operating costs per passenger and ASK index (GAL and easyJet)



Source: CAA analysis based on financial account data

6.40 The figure shows that in terms of total opex per ASK, the airline has achieved real terms reductions in operating costs of around 18% overall (similar to the reduction in the airport sample described above). This has been achieved despite significant increases in fuel costs over this period.[72] In contrast, opex per passenger has increased by 34% at Gatwick although there have been reductions in 2010 and 2011.

6.41 Comparisons between airlines and airport operators are imperfect. Whilst easyJet and GAL operate in the same industry and are subject to a similar range of technical security requirements and economic shocks, the operations of the airlines are more flexible, enabling a more effective reaction to changes in market conditions through the cancellation of routes or transfer of aircraft for example. Nonetheless, this analysis shows similar results to the previous inter-airport comparisons and shows that there is a significant difference in the

[72] Fuel costs accounted for over 33% of easyJet's total opex in 2011. Statistics from the Department for Energy and Climate Change indicate that the cost of heavy fuel oil has increased by over 270% in real terms between 2000 and 2012.

level of cost control achieved by GAL, other airports and airlines operating in a more competitive market. This tends to suggest that GAL could achieve a greater level of efficiency.

Consultancy Studies

6.42 In preparation for Q6 the CAA commissioned several consultancy studies related to opex, these include the following:

- **'Employee reward' benchmarking study** undertaken by IDS and Hymans. This includes an analysis of GAL's total reward (including pensions) in comparison with industry benchmarks. The study also provided an analysis of other elements of staff costs including roster efficiency and absenteeism;
- **'Review of other operating expenditure at Gatwick' study** covering rent and rates, utilities, air navigation services (ANS), police and other costs, undertaken by SDG;
- **Examination of 'central service costs' study** including HR, Finance, IT costs undertaken by Helios;
- **'Assessment of maintenance and asset renewal costs at Gatwick study** undertaken by SDG. This included an examination of GAL's asset stewardship programme.
- **'Scope for efficiency gains at Heathrow, Gatwick and Stansted airports' study** undertaken by Cambridge Economic Policy Associates (CEPA).

6.43 Each of these studies can be found on the CAA website.[73] The key findings are summarised in the following section.

Employee reward benchmarking study (IDS)

6.44 This study examined levels of pay and historical and forecast rates of

[73] IDS Thomson Reuters, March 2013, *Benchmarking employment costs: A research report for the CAA*, *Gatwick*, http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=14279

Steer Davies Gleave, March 2013, Review of other operating expenditure at Gatwick, March 2013 http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=14279

Steer Davies Gleave, March *2013, Assessment of maintenance and asset renewal costs at Gatwick*, http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=14279

CEPA, March 2013, *Scope for future efficiency gains at Heathrow, Gatwick and Stansted*, http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=14279

wage increases at Gatwick in comparison with the wider economy and benchmarks within the aviation industry. The report also examined the levels of pay of specific job types against equivalents based on skills and job description. The key findings of the study are summarised in the following points.

6.45 Between 2006 and 2012, average basic salaries at GAL increased by 32.6%. This is nearly twice the average rate for the South East as a whole. Wage growth at Gatwick has therefore been very high in recent years in comparison with the general economy.

6.46 On the whole, total cash rewards at Gatwick are ahead of general market benchmarks. 12 of the 19 benchmarked roles were paid 10% or more than benchmarks. Fire Station Managers and Fire Watch Managers are particularly highly paid - around 46% higher than benchmarks.

6.47 The estimated absence rate at Gatwick currently stands at 10.0 days per employee compared with an industry wide average of 6.8 days per employee (2012 Chartered Institute of Personnel and Development (CIPD) Absence Management Survey).

6.48 Overall the report concludes that if rates of total cash reward (basic salary, shift, overtime and bonus pay) at Gatwick were brought into line with the benchmark comparisons, staff costs could be reduced by between 9% and 13%. These savings do not include any savings that could be achieved through changes to pensions.

6.49 Based on the latest data published in the regulatory accounts, in 2011/12 staff costs were equal to £141 million. This implies that if GAL could reduce its staff costs in line with the benchmarks it could reduce costs by between £13 million and £19 million per year.[74]

6.50 The IDS study also benchmarked GAL's pension costs, estimating the cost of servicing the DB and DC pension schemes over 2013. This analysis determined that the future cost of the DB and DC schemes would be around 31% and 10% of pensionable earnings respectively, with a blended average of 24%. The DB scheme contribution rate is

[74] On a total reward basis (including pension costs) staff costs at GAL are even further from benchmarks. The CAA estimates that total reward costs are between 23% and 32% higher than benchmarks on average. This would imply total potential cost reductions of between £32 million and £45 million per year.

significantly higher than equivalent benchmarks which are around 20% for companies of a similar size.

6.51 Based on this analysis, the CAA estimates that if GAL were able to bring its pension costs into line with benchmarks, costs could be reduced by up to £5 million per year.

Pension scenario analysis study (IDS and Hymans)

6.52 In order to assess the ability of GAL to achieve the reductions in pension costs described above, IDS and Hymans undertook four scenario tests based on common changes to DB pension schemes. The study did not seek to assess the difficulty of implementing such changes. The scenarios are described in the following points.

- Increasing the normal retirement age for all members to 65. This would reduce costs from 31% to 24% of total pensionable earnings.
- Using career average earnings rather than final salary in pension provision. This would reduce costs from 31% to 26% of total pensionable earning.
- Changing the accrual rate from 54ths to 80ths for all members. This would reduce costs from 31% to 20% of pensionable earnings.
- The combination of all of the above. This would reduce costs from 31% to 12% of pensionable earnings.

6.53 Based on GAL's cost estimates and contribution rates, the CAA estimates that these changes could result in potential saving of between £2 million and £6 million per year. This suggests that GAL could reduce pension costs in line with benchmarks through implementing one or more of these changes, which have been widely undertaken in other sectors of the economy. The treatment of pension costs is discussed further below.

Other operating costs study (SDG)

6.54 This study examined GAL's RBP opex projections across several categories including rent and rates, utilities, police and other costs. The study's conclusions indicate that there are a number of areas where the cost projections in the RBP could be reduced based on improved efficiency and/or more accurate forecasts. These reductions are described in the following points.

- Reductions in rate costs based on lower inflation forecasts used in the rates calculation (based on official OBR projections).
- Reductions in gas costs based on closer alignment of unit rates with official Department of Energy and Climate Change (DECC) forecasts.
- Reduction in police costs based on lower salary growth expectations based on lower assumptions in Sussex police's own statement of accounts.
- Reduction in ANS costs to reflect the recent contract re-negotiation and the potential for competitive tendering.
- Reduction in cleaning costs in line with comparative benchmarks and a lower estimate of minimum wage inflation, which is a strong driver of cleaning costs.

6.55 Overall the study estimates that opex could be reduced by between £3 million and £4 million per year.

Maintenance and asset stewardship study (SDG)

6.56 This study examined the maintenance and asset costs in the airport operator's business plan. The study undertook a range of benchmarking across eight other airports and concluded that GAL's maintenance costs per square metre were higher than comparative benchmarks. Based on this evidence the study concluded that GAL could potentially reduce its maintenance costs by between £1 million and £4 million per year over Q6.

Central service costs study (Helios)

6.57 This study examined the central service costs of GAL including HR, finance, IT, communications and other functions. This study was not completed in sufficient time to feed into the initial proposals but will be taken into consideration in the final proposals.

Potential for efficiency study (CEPA)

6.58 This study sought to examine the potential for efficiency gains at Heathrow, Gatwick and Stansted over the Q6 period based on two factors; first the potential for 'catch-up' between the airports and a notionally efficient competitive operator at the 'frontier' of cost performance; and second the rate of productivity growth of such a company over time attributable to technological advances and other ongoing improvements - often termed 'frontier shift'. The objective of the study was to provide a benchmark for the level of efficiency saving that should be included in the airport operator's RBP over Q6.

6.59 The study developed several hypothetical benchmarks to estimate a range of efficiency targets for future cost projections. This included estimates of benchmark output prices, Real Unit Operating Expenditure (RUOE), labour productivity, Total Factor Productivity (TFP) and Labour, Energy, Materials and Services (LEMS). The study also refers to productivity metrics developed in other studies. Each of these measures and the estimates of actual and benchmark performance are described below (shown in figure 6.7).

- **TFP** - a measure of total productivity based on the residual output not explained by inputs of capital and labour. Adjusted TFP holding capital inputs constant was also estimated.
- **Output Price Indices** - a measure based on TFP and input prices.
- **Labour Productivity** - defined as passengers per man year. This metric can be used to estimate changes in productivity related to the use of labour, but can be misleading when considered in isolation as a result of capital substitution.
- **LEMS** - a measure of total productivity based on the residual output not explained by inputs of labour, energy, materials and services. This metric takes account of changes to input price inflation.
- **RUOE** - defined as adjusted opex per passenger deflated into a common price base. This metric is widely used by regulators to assess efficiency changes as it captures both labour and capital effects. This metric has been estimated for 10 and 15 year periods.
- **Residual Variable Factor Productivity** - this metric is a measure of productivity relative to the most efficient airport (=1) based on stochastic frontier analysis. This metric is based on a report by the Air Transport Research Society described earlier in this chapter.

Figure 6.7: Productivity growth and cost trend estimates

Measure	Frontier Shift and/ or Catch-Up	GAL	
		Benchmark	Actual
TFP	FS	0.7%	n/a
Adjusted TFP*	FS	0.8% to 1.6%	n/a
LEMS	FS	-0.3%	n/a
Output Price Indices	FS	0.3% to 1.3%	n/a
Labour Productivity	FS+CU	n/a	-0.9%
LEMS Cost	FS	-0.2% to -0.7%	n/a
RUOE (10 years)	FS+CU	-0.5% to 2.6%	-0.7%
RUOE (15 years)	FS+CU	-2.0% to 2.7%	-0.7%
ATRS Residual VFP#	CU	n/a	0.633
Quality Satisfaction			Above average

a figure of 1 represents the most efficient airport.
A negative figure for RUOE indicates a decline in productivity
* adjustment for variable capital
Source: CEPA, Scope for Efficiency Gains at Heathrow, Gatwick and Stansted Airport, pg 74

6.60 The study concluded that based on a comparison of changes in RUOE, GAL is likely to have some scope for catch-up efficiency. It also estimated that an efficient organisation with a cost structure similar to GAL should expect to see net frontier efficiency shift of between 0.9% and 1.0% per year.

6.61 Based on the unallocated efficiency savings of £3.9 million per year described earlier in this chapter GAL has included an efficiency stretch target of around 0.5% within its RBP. This implies that there is likely to be scope for further efficiencies in the RBP, equivalent to around 0.5% per year.

Security Process Efficiency Analysis

6.62 Security costs account for over 20% of total opex, security process efficiency is therefore an important consideration for the Q6 settlement. This assessment can be broken into four elements; security lane flow rate efficiency, staff roster efficiency, absence management and the potential for security outsourcing.

Flow rates

6.63 Peak hour security processing flow rates at GAL are typically over 250 passengers per lane per hour in the South Terminal, with six staff per lane. Rates in the North Terminal are slightly lower at around 200 passengers per lane per hour with seven staff per lane. The RBP includes plans to replicate the South Terminal arrangements in the North Terminal.

6.64 Rates of over 200 passengers per hour are relatively high compared with other airports suggesting that GAL is relatively efficient in this area. However GAL caters to a relatively large number of short-haul leisure passengers travelling with low cost carriers, who tend to apply quite restrictive passenger baggage limits.[75]

6.65 This means that passengers at Gatwick will typically carry less baggage, which will tend to reduce the workload for security staff and increase flow rates at Gatwick in comparison with airports with higher levels of long-haul passengers and less restrictive baggage policies.

6.66 Overall, flow rates at Gatwick appear to be relatively high, whilst this may be partially explained by the nature of airlines and passengers using the airport, the CAA do not have substantial evidence to suggest that there is scope for improvements beyond those included in the RBP.

Roster efficiency

6.67 Since separation from BAA, GAL has implemented a new roster system, which has improved the alignment of security staff demand and supply.

6.68 The IDS study described above undertook some analysis of security staff rostering efficiency and determined that overall the new roster system performed well with an average utilisation of 95% and 93% in the North and South Terminals respectively. The report did note that there may be scope to improve efficiency through better alignment of staff supply between the terminals.

Absence management

6.69 GAL's personnel have relatively high rates of absence, with an average annual absence rate of ten days per person. This is

[75] For example easyJet allow one item of hand baggage. In contrast BA allows one item of hand baggage plus a laptop.

significantly higher than the economy wide average in the public and private sector of 6-8 days. GAL has stated that it is planning to reduce rates of absenteeism, by reducing the physicality of the security function (for example the need for lower body searches) however no allowance for this improvement has been included in the RBP.

6.70 If GAL are able to reduce levels of absenteeism in line with economy wide benchmarks there would be scope for further efficiency savings in the RBP.

Outsourcing

6.71 Security outsourcing has been introduced at several European airports, including Birmingham, and Oslo and has been proposed as an option for GAL by the airlines. Outsourced security staff are also used by the AOC to operate baggage security at Heathrow. This is considered to be an activity analogous to passenger security in terms of scale, complexity and staff skill.

6.72 Security outsourcing could potentially reduce costs and improve efficiency through enabling a competitive bidding process for at least part of the airport security function. The CAA recognises that Gatwick, given its size and complexity may not have a straightforward proposition for outsourcing, especially given the potential for transition risks.

6.73 The transition to an outsourced workforce could be difficult and would clearly have implications for the management of security risks. GAL has stated that it does seek to outsource activities such as PRM and concierge services, however it regards security as a core business function and an important factor in overall airport quality, which it wishes to retain in-house.

6.74 It is not for the CAA to dictate to GAL how it organises its operation to service its security functions. Rather the CAA is interested in whether further reasonable efficiencies are possible. Based on the analysis above, the CAA does consider that GAL may be able to make some further efficiencies in security over Q6 to reflect planned reductions in rates of absenteeism.

Treatment of pension costs

6.75 GAL has stated that they wish to include the pension deficit and commutation payments made at the time of purchase within the Q6 settlement. The IDS study found that a report by the GAL scheme actuary in November 2011 estimated that there was a pension deficit of £8 million. Given GAL's deficit reduction plan does not begin until 2015, the CAA may need to give further consideration to the efficiency of the planned deficit payments and whether the scheme has been underfunded in Q5, in particular as the IDS analysis of GAL's pension costs described above indicated that GAL's pension costs are high in comparison with benchmarks although within the 25% cap set in the Q5 decision. Without further evidence the CAA is not minded to include the costs of the pension deficit in the final proposals.

6.76 The CAA considers that the pension commutation payment made to BAA was paid as part of the sale of the airport and should have been reflected in a lower sale price than had the payment not been made. It would not therefore be appropriate to include the commutation payment within the Q6 settlement.

Summary of Efficiency Analysis

6.77 The RBP implies real cost growth of 1.0% per year from 2013/14 over Q6. In combination, the evidence from the efficiency analysis described above indicates that GAL should be able to reduce opex relative to these projections.

6.78 Based on the upper and lower quantified efficiency estimates identified above and before any consideration of profile or risk, such efficiencies are likely to be equivalent to a reduction of between £26 million and £42 million per year by the end of Q6 relative to the RBP (or between £11 million and £27 million lower than opex in 2013/14.

6.79 This is roughly equivalent to a reduction of 0.8% to 2.0% per year over Q6 from 2013/14.

CAA initial projections

6.80 In developing an initial opex projection, the CAA has considered a range of evidence including the business plans, consultation with stakeholders, consultancy studies and benchmarking evidence described throughout this section.

6.81 The CAA recognises that there is no method for benchmarking GAL's opex efficiency that does not have some imperfections. For this reason, it has sought to challenge the RBP forecasts using a wide range of benchmarks and commissioning six independent studies.

6.82 Overall, the CAA considers that there is evidence that GAL could improve efficiency over Q6 relative to the RBP, particularly with regard to staff wage and pension costs.

6.83 In drawing together this evidence into an initial projection the CAA has had to consider several factors. First the overall extent of the efficiency saving that GAL could be expected to achieve over Q6; and second the profile of such savings given the practical constraints faced by the airport operator and the time needed to implement the savings in an efficient manner.

6.84 Some factors point to a fairly assertive stance on the scale of potential efficiencies. These include the relatively high growth in costs compared with other airport operators and airlines and ensuring that shareholders and not passengers fund any inefficiency. The information asymmetries involved in assessing GAL's opex, could mean that the efficiency analysis may have missed some opportunities and hence the ranges may be an underestimate.

6.85 On the other hand there are several factors which suggest that a lower point in the range may be more appropriate, including:

- the fact that many of the benchmarks are derived from comparators that cannot completely take into account all aspects of GAL's operating environment meaning that the upper range of efficiencies may be overstated;
- even an organisation at the 'frontier' of cost performance is unlikely to be efficient in every dimension, hence the cumulative total of high estimates from the efficiency analysis could overstate the potential for savings when aggregated;
- many of the efficiency savings could require significant changes to the management and operations of the airport, which may require some time to be efficiently implemented;
- the need to ensure that any efficiency target is achievable to provide GAL with a realistic opportunity for outperformance as a regulatory incentive;

- GAL has outperformed the Q5 regulatory opex settlement. Whilst this is partially related to lower than expected passenger numbers, this may suggest that further efficiency savings may be more challenging to achieve over Q6 than in Q5; and
- the CAA has assumed higher traffic growth than the RBP - overall the CAA's passenger forecasts are 3% higher in total over Q6. This means that the RBP may slightly underestimate costs.

6.86 The CAA considers that the balance of argument points towards the selection of a target within the lower middle part of the range identified by the efficiency analysis. It has therefore set an overall opex efficiency target of 1.1% per year from the RBP opex projections for 2013/14.

CAA Projections

6.87 Based on the preceding analysis, the CAA has developed initial opex projections for Q6. In these projections, costs will fall from £286 million in 2013/14 to £271 million in 2018/19, with total cumulative opex over the period equal to £1,385 million. This is 7% lower than the RBP.

6.88 This projection is equivalent to an annual real reduction in cost of 1.1% per year from 2013/14 to 2018/19. In comparison, the RBP assumes a real increase of 1.0%. The projections are summarised in figure 6.8 below.

Figure 6.8: CAA initial projections for Q6 – summary

CAA April 2013 GAL Projections - Summary Q6				
£m 2011/12 prices	**Total Q6**	**of RBP**	**CAGR (Q6)**	**Opex Per Pax (£)**
Passengers (m)	176		1.1%	
Total RBP	1,481	100%	1.0%	8.44
CAA Efficiency Estimates	-96	-7%	na	-0.59
CAA Opex Forecast	1,385	93%	-1.1%	7.89

Source: CAA

Figure 6.9: CAA initial projections for Q6

CAA April 2013 GAL Projections	**Q5**					**Q5+1**	**Q6**				
£m 2011/12 prices	**2008/09**	**2009/10**	**2010/11**	**2011/12**	**2012/13**	**2013/14**	**2014/15**	**2015/16**	**2016/17**	**2017/18**	**2018/19**
Passengers (m)	33.1	32.4	31.6	33.8	34.1	34.0	34.5	34.7	35.0	35.4	35.9
Total RBP	323.9	316.1	277.5	281.7	282.2	286.2	287.8	294.4	297.3	300.4	301.2
CAA Opex Forecast							283.1	280.0	276.9	273.8	270.8
Opex per pax RBP (£)	9.79	9.76	8.78	8.33	8.27	8.42	8.34	8.48	8.49	8.49	8.39
Opex per pax CAA Forecast (£)							8.21	8.07	7.91	7.74	7.54

Source: CAA

CAA Projections for Q7

6.89 The RBP included opex projections for 'the further 5 year period beyond Q6' otherwise known as Q7. These projections are based on the same drivers used to estimate the Q6 forecasts, with an 'overlay' to reflect the impact of capital projects.

6.90 The CAA has developed comparative projections for Q7, largely based on an extrapolation of projections for Q6. The CAA has taken its opex forecast for 2018/19 and increased the costs to reflect forecast passenger growth using an elasticity of 0.5.[76]

6.91 Offsetting this growth, the CAA has applied a net frontier shift target of 1% based on the conclusions of the CEPA study described above. The CAA has also applied an overlay to capture the impacts of GAL's capex projects. Based on this method, the CAA's opex projections are shown in figure 6.10.

6.92 Overall the CAA estimates that opex would grow from £271 million per year in 2018/19 to £278 million per year in 2023/24 - a rate of 0.5% per year. The CAA Q7 projections are 13% below those contained in the RBP. This is primarily caused by the lower forecasts over Q6, from which the Q7 forecasts are rolled forward.

Figure 6.10: CAA Q7 GAL initial projections

	Q7				
£m 2011/12 prices	**2019/20**	**2020/21**	**2021/22**	**2022/23**	**2023/24**
Passengers (m)	36.6	37.2	38.1	39.0	40.1
RBP Opex Forecast	307.5	311.5	316.1	322.1	326.8
CAA Opex Forecast	271.4	271.9	273.6	275.7	278.3
Opex per pax RBP (£)	8.40	8.37	8.30	8.26	8.15
Opex per pax CAA Forecast (Mid) (£)	7.41	7.31	7.18	7.07	6.94

Source: CAA and GAL RBP

[76] This elasticity figure is based on the Steer Davies Gleave mid-Q analysis of STAL's opex, which estimated the elasticity to be around 0.5.

CHAPTER 7

Commercial revenues

7.1 The forecasts of GAL's commercial revenues, that is revenues from retail, car parking and property, are important as they are netted off the revenue required from airport charges under the single till approach. This chapter discusses the outcome of CE, the subsequent review of GAL's RBP by the airlines and associated areas of disagreement between GAL and the airlines. This chapter concludes with the CAA's initial projections for commercial revenues to be taken into account in calculating the fair price based on a RAB-based calculation.

Constructive Engagement

7.2 There was limited discussion during CE between GAL and the airlines on the commercial revenues projections.

7.3 During CE, the ACC commissioned consultants, Javelin and ACTM, to review GAL's IBP (which had a higher commercial revenues forecast than GAL's RBP). The airlines' consultants argued for more ambition in the revenue projections for retail, advertising and car parking (they did not review all of the commercial product categories, including property).

GAL's January 2013 Revised Business Plan

7.4 In total GAL projects commercial revenue of £904.8 million in Q6 (at 2011/12 prices), shown in figure 7.1. Most of the income is assumed to be 'base' growth in revenues from the existing commercial estate at Gatwick, with a small overlay of income from new projects for implementation in Q6.

Figure 7.1: Summary of GAL's projections for commercial revenue

Category	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	Q6 Total
Base growth	182.6	180.0	182.1	174.7	172.1	172.2	171.2	872.3
Q6 projects income	0.0	0.0	1.3	-1.3	6.9	8.9	16.8	32.6
TOTAL	182.6	180.0	183.4	173.4	179.0	181.1	188.0	904.8
Annual % change		-1.4%	1.8%	-5.5%	3.3%	1.2%	3.8%	

Source: GAL

Independent review of GAL's projections

7.5 To help inform its initial projections the CAA commissioned an independent study by consultants SDG to validate and challenge GAL's projections. [77]

7.6 SDG focused on:

- a review of the reasons for the difference between the Q5 settlement and outturn;
- a review of the overall Gatwick commercial revenue forecast in Q6 and robustness of the underlying assumptions. This review examined both the airport operator's justification for its Q6 commercial revenue forecasts and a review of the airport operator's proposals undertaken by the airlines' consultants, Javelin/ACTM;
- a review of the Gatwick property revenue forecasts;
- a review of the costs and benefits of any new commercial projects that are being proposed by the airport operator; and
- developing independent projections for the Q6 period split into retail, car parking and property.

7.7 SDG's findings were based on a mix of data provided by GAL along

[77] Steer Davies Gleave, April 2013, *Assessment of commercial revenues at Gatwick Airport*, http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=14279

with that derived from publicly available sources (e.g. benchmarks from airport operator annual reports), insights from discussions with the airport operator, the airlines and their consultants, expert judgement and views on wider market trends provided by a cross-section of retail and parking concessionaires currently operating at the airport and representing most of the key commercial product categories.

7.8 SDG has also consulted Birmingham Airport Limited (BAL) about the results of trials undertaken there to examine the potential impact of the Tobacco Display Act, and analysed data from Dublin Airport annual reports to understand the results from similar trials at Dublin.

Q5 performance

7.9 SDG noted that retail revenues (excluding car parking) fell throughout Q5, declining in real terms at a 3 year CAGR of -2.6% (or -3.3% on a per passenger basis). All retail product categories experienced a fall in real income with the exception of bureau de change.

7.10 Retail revenue performance in Q5 has been adversely impacted by a mix of factors including traffic effects (notably a reduction in traffic and a change in mix away from North Atlantic long haul and high spending charter traffic to EU short-haul low cost traffic), development projects (which have led to a temporary reduction in airside retail space as well as a more permanent reduction in landside retailing), and ongoing wider society/high street changes such as the move away from books and newspapers to e-books and digital news. Retail revenues per passenger initially outperformed the Q5 settlement but in 2011/12 were in line with Q5 forecasts.

7.11 Similarly total car parking revenues have fallen during Q5 (CAGR -4.2% in the first 3 years of Q5). The performance in Q5 to date reflects weakness in passenger traffic (including mix changes), and the effects of competition from other modes, including an increasing proportion of 'kiss and fly' rather than 'park and fly' traffic and off-airport parking operators.

7.12 Total property revenues have also fallen during Q5 (CAGR -4.4% in the first 3 years of Q5). Key factors influencing the performance of property have been airline mix changes which have reduced the aggregate demand for airport property, a lack of growth in real rents (reviews take into account a comparison to local off-airport rents which have been subdued reflecting the wider macroeconomic climate), and planning-related constraints on the ability of GAL to sell void space. Property revenues per passenger initially outperformed the Q5 settlement but are now in line with Q5 forecasts.

7.13 Compared to the Q5 settlement, combined retail and car parking revenues have underperformed the CAA's Q5 projection by -6.6% to the end of 2011/12. Property revenues have underperformed the settlement projection by -1.1%. During the first three years of the Q5 period, total commercial revenues per passenger outperformed the Q5 settlement, despite the poor macroeconomic environment, although by 2011/12 revenues per passenger were broadly in line with the settlement.

Areas of disagreement between GAL and the airlines

7.14 GAL believes that the macroeconomic environment is likely to be challenging for airport retail in Q6, but the airlines' consultants suggested that expenditure growth in key categories should be strong as the retail sector appears to have been outperforming the wider UK economy. SDG considered that growth should be stronger than in Q5 subject to no further unforeseen circumstances such as a triple dip recession.

7.15 The airlines' consultants believed that there is latent retail potential at Gatwick as demonstrated by its lower income densities relative to Heathrow. SDG expected GAL to achieve lower income densities than HAL and agreed with the view that there is some latent potential in the existing commercial space. However SDG did not think this would be the only driver of future commercial revenues and considered that the further development and improvement of retail space would also be a key factor in improving commercial revenues performance in Q6.

7.16 SDG agreed with GAL that a decline in tobacco duty free sales is likely to arise as a result of the Tobacco Display Act. The airlines' consultants suggested there would be no decline, but in the event that there was, this could be offset by increased sales of other products. SDG's discussions with BAL suggested that the impact is likely to be lower than advocated by GAL and this view was reinforced by analysis of published results from the Dublin trial, which also indicated a lower loss than that suggested by GAL.

7.17 The airlines and GAL were in broad agreement with respect to some particular retail themes while not in agreement on the detail. Examples include optimisation of the concession mix and changes to layout and reconfiguration of the retail offer.

7.18 The airlines' consultants identified opportunities to deliver an additional £1.5 million of advertising income through activities such as attracting one of the 'top two' agencies into the airport along with extending the number and quality of advertising space within the terminals. SDG considered that there is relatively less opportunity for outperformance in advertising than advocated by the airlines.

7.19 The airlines also believed that it is plausible to assume outperformance against GAL's car parking revenue projections and also that there is a lower requirement for capital investment. SDG suggested that it would be reasonable to assume stretch against GAL's projections but they did not agree with all of the recommendations made by the airlines' consultants.

Review of GAL Q6 projections

7.20 SDG used GAL's traffic forecasts as an input to its projections. Differences against the GAL RBP therefore reflect alternative assumptions about potential growth in revenues per passenger at the individual product category level.

7.21 Following a review of the RBP, SDG considered that there were opportunities to outperform GAL's projections in most retail product categories.

7.22 SDG identified an opportunity to increase concession margins by +1% through Q6 in duty free and specialist shops (phased in from the start of Q6), along with a margin increase in catering (North Terminal airside) of £2 million versus the RBP assumption in 2018/19.

7.23 Specifically for the duty free category SDG recommended an alternative, lower, assumption of a 12% to 20% decline in revenues from 2015/16 arising from the impacts of the Tobacco Display Act.

7.24 For bookshops SDG forecast that revenue growth in line with increases in passenger volumes from 2013/14 should be achievable.

7.25 For advertising SDG recommended an increase in sponsorship income relative to the RBP of £0.3 million per annum, commencing

2015/16.

7.26 In addition SDG identified the opportunity to deliver further retail income through the provision of new airside retail space along with reconfiguration and reassignment of existing airside catering space to duty free. However these projects would require capital investment in addition to that in the RBP and SDG therefore excluded them from their ‘core’ projections.

7.27 For car parking SDG recommended a £12.6 million stretch to the RBP projections through Q6 based on the enforcement of forecourt pick-up activity (which would increase short-term car park revenue) and increases in long stay parking prices and revenue from licensing and e-commerce.

7.28 SDG also identified that additional income could be generated from introduction of a forecourt drop-off charge (additional revenue of about £6 million per annum), as currently implemented at Stansted and other airports. However SDG acknowledged that this could be difficult to implement in practice and therefore did not include this in their 'core' forecasts.

7.29 For property SDG identified an additional £5.6 million through Q6 based on a combination of further income from re-letting of office and ramp voids, and ad-hoc contractors' accommodation, plus additional turnover-related income from hotels.

7.30 GAL does not agree with SDG's forecasts and maintains that the RBP projections are reasonable.

Q6 projections

7.31 Based on the analysis described above SDG developed the following projections of commercial revenues for Q6 (£ million, in 2011/12 prices) (shown in figure 7.2 and figure 7.3. This results in total commercial revenues of £951.2 million for Q6 some 5.1% higher than forecast by GAL. In addition SDG has identified a ‘super stretch’ case of £999.2 million, based on the delivery of additional airside retail space (as an increment to that assumed in the RBP) and through the introduction of a forecourt vehicle drop-off charge.

Figure 7.2: SDG forecasts for commercial revenues in Q6

£m 2011/12 prices	2014/15	2015/16	2016/17	2017/18	2018/19	Q6 Total
Retail	127.1	122.0	129.0	130.2	137.2	645.5
Car Parking	37.7	36.6	35.8	35.4	36	181.2
Property	23.4	23.2	24.2	26.7	27	124.5
Total	188.2	181.8	189.0	192.3	200.2	951.2
GAL RBP	183.4	173.4	179	181.1	188	904.9
Difference	4.8	8.4	10.0	11.2	12.2	46.3

Source: SDG

Figure 7.3: SDG forecasts for commercial revenues per passenger in Q6

£ per pax 2011/12 prices	2014/15	2015/16	2016/17	2017/18	2018/19
Retail	3.68	3.52	3.69	3.68	3.82
Car Parking	1.09	1.06	1.02	1.00	1.00
Property	0.68	0.67	0.69	0.76	0.75
Total	5.45	5.24	5.41	5.43	5.57

Source: SDG

CAA initial projections

7.32 At this stage the CAA intends to rely on the SDG forecasts for the basis of the initial projections. The CAA has used SDG per passenger forecasts and uplifted them in line with its own overall traffic projections. This gives a total commercial revenue forecast over Q6 of £981 million, as shown in figure 7.4. The CAA acknowledges that higher traffic projections could create upward pressure on the per passenger commercial revenue forecasts, for example from a tightening of capacity constraints on car parking. The CAA also considers that there would be downward pressure on the per passenger forecasts, from the reduced proportion of long-haul traffic in the CAA's traffic forecasts. Given these countervailing pressures, the CAA considers that the use of the SDG per passenger forecasts is a reasonable basis for the initial projections

7.33 For the two years following Q6 where SDG did not provide projections, the CAA has assumed that the difference between the SDG and GAL per passenger commercial revenue forecasts remains constant.

Figure 7.4: CAA's commercial revenue forecasts

2011/12 prices	2014/15	2015/16	2016/17	2017/18	2018/19	2020/21	2021/22
£ per pax							
Retail	3.68	3.52	3.69	3.68	3.82	n/a	n/a
Car Parking	1.09	1.06	1.02	1.00	1.00	n/a	n/a
Property	0.68	0.67	0.69	0.76	0.75	n/a	n/a
Total	5.45	5.24	5.41	5.43	5.57	5.54	5.46
CAA passenger forecast	35.0	35.5	36.1	36.8	37.6	38.5	39.3
£m							
Retail	128.7	124.8	133.2	135.5	143.7	n/a	n/a
Car Parking	38.1	37.6	36.8	36.8	37.6	n/a	n/a
Property	23.8	23.8	24.9	28.0	28.2	n/a	n/a
Total	190.5	185.8	195.2	199.9	209.5	213.2	214.1

Note: numbers may not add up due to rounding.

Source: SDG and CAA

CHAPTER 8

Other charges and revenues

8.1 This chapter sets out the CAA's initial projections for other charges at Gatwick. This is relevant to the calculation of the fair price as the forecast contribution made from other charges is a component of the single till approach to price regulation. The revenue is from charges on airlines and other companies operating at the airport for facilities and services that are essential for their operations. In previous control periods these have been termed non-regulated charges, however these charges were in effect subject to some form of regulation through a transparency condition. Given this, the CAA considers that the term "other charges" is more appropriate.

Constructive Engagement

8.2 CE did not address revenues from other charges. It is the CAA's understanding that GAL and airlines will discuss forecasts for Q6 within the Charges Group during 2013.

GAL January 2013 Revised Business Plan

8.3 GAL's RBP includes forecasts of other charges for Q6 that show a 7% increase in revenue in the first year of Q6. Revenue is then forecast to increase each year but at a lower rate. In 2018/19 annual revenue from these charges is forecast to be about 19% higher than revenue in 2013/14 (and about 22% higher in 2020/21). On specific items, GAL mentions that it has been under recovering in Q5 from check-in and baggage charges, the highest individual element of other charges, and is proposing a 19% increase in revenue from these charges in 2014/15, with revenue 39% higher in 2018/19 (and in 2020/21) than in 2013/14. GAL also says it may consider moving charges for staff car parking towards the market price for car parking at the airport. The latter was not factored into its Q6 forecasts. GAL said that as much of the revenue is a recharge of costs incurred by the airport operator, the level of revenue is directly related to its cost forecasts. Figure 8.1 shows GAL's forecast revenue from other charges.

Figure 8.1: Forecast revenue from other charges in Q6 (£m in 2011/12 prices)

	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
Check-in/baggage	19.4	21.8	22.0	22.8	22.6	22.6	22.6
Staff car park	6.1	6.2	6.3	6.3	6.4	6.5	6.6
Fixed electrical ground power (FEGP)	3.0	2.9	2.9	2.9	2.8	2.8	2.7
Identity cards	1.6	1.6	1.6	1.6	1.6	1.6	1.6
Bus & coach	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Airside licences	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Aviation fuel	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Electricity	6.8	7.0	7.5	7.6	7.6	7.8	7.9
Water & sewerage	0.8	0.8	0.8	0.8	0.8	0.8	0.8
Heating	0.2	0.2	0.3	0.3	0.3	0.3	0.3
Gas	0.2	0.2	0.2	0.2	0.2	0.2	0.3
PRM	6.5	6.3	6.7	7.0	7.5	7.8	8.3
Vehicle fuel and oil	2.8	2.8	2.8	2.8	2.8	2.8	2.8
Intercompany	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other non-specified revenue	3.3	3.7	3.7	3.9	3.9	3.9	3.9
Total	51.6	54.3	55.5	56.9	57.3	57.9	58.5

Source: GAL Revised Business Plan[78] Note: numbers may not add up due to rounding.

Discussions of key issues

8.4 The CAA notes that GAL and airlines have not discussed other charges revenue yet. Given this the CAA has not taken a view on GAL's forecasts at the moment. However, as it needs a forecast to calculate a fair price for GAL, the CAA will use GAL's RBP forecasts for this purpose at the moment. However, as most of the forecasts are cost based they will be lower if the CAA adopts the lower

[78] GAL's forecasts include revenue under the following categories: check-in baggage, staff car park, FEGP, identity cards, bus and coach, airside licences, aviation fuel, electricity, fuel, water and sewerage, heating, gas, PRM, vehicle fuel and oil, intercompany, and other non-specified revenue. The CAA is not proposing that all of these categories should be covered by the transparency condition.

operating costs that it is proposing.

8.5 In its Q5 decision, the CAA said it did not preclude adjusting airport charges in Q6 to take into account increases in other charges in Q5 that had not been adequately justified with reference to stated principles of cost recovery and the published forecasts of charges in Q5. In the first four years of Q5 GAL received about £188.0 million in revenue from charges covered by the transparency condition. As the forecast for these four years was very similar at £188.4 million, the CAA is not proposing adjusting the price cap in Q6.

CAA initial projections

8.6 The CAA proposes using the forecasts for other charges from GAL's Business Plan for its calculation of a fair price at present. The forecasts are shown in figure 8.2. Before confirming the forecasts, the CAA will want GAL to provide disaggregated cost forecasts, so that the CAA can ensure that the forecasts are appropriately cost based.

Figure 8.2: CAA initial projections for revenue from other charges in Q6 (£m in 2011/12 prices)

2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
51.6	54.3	55.5	56.9	57.3	57.9	58.5

Source: GAL RBP

CHAPTER 9

Regulatory asset base

9.1 This chapter provides the CAA's assessment of the issues relating to the RAB and depreciation and concludes with the CAA's initial projections for the value of the opening RAB in Q6, the movements in the RAB in each year of Q6 to be used in the price determination and the depreciation charge. Capex, which is added to the RAB, is discussed in chapter 5.

9.2 The CAA's Q5 decision set out how the CAA intended to calculate the closing RAB for the five year of Q5. It starts with the previous period's closing RAB value, plus or minus movements within the period to give a closing RAB value. No formulae were set out as to how the RAB would be rolled forward for Q5+1, although the Q5 decision provides useful guidance on the principles. The closing value for Q5+1 is taken as the opening value for Q6.

Constructive Engagement

9.3 The RAB roll forward was not a topic of discussion for CE.

GAL's January 2013 Revised Business Plan

9.4 Figure 9.1 sets out GAL's calculation of the reconciliation between the opening Q5 RAB and the opening Q6 RAB.

Figure 9.1: GAL's calculation of its RAB roll forward

£ million	**4 years to 31-Mar-12 Audited Actual prices**	**year to 31-Mar-13 Forecast Actual prices**	**year to 31-Mar-14 Forecast Actual prices**
Opening RAB	1,560	2,201	2,400
Additions	736	235	200
Car parks	21	-	-
Proceeds from disposals	(2)	-	-
Depreciation	(346)	(115)	(153)
Indexation	237	73	63
Profiling	(5)	5	-
Closing RAB	2,201	2,400	2,510

Source: GAL's regulatory accounts and GAL forecasts

Discussion of key issues

Deriving the opening RAB

9.5 The CAA has validated GAL's projections for the value of capex spent in Q5. The regulatory accounts, audited by GAL's statutory auditors, set out the value spent on Q5 capex (and proceeds from disposals) for the first four years of Q5. For the final two years this has been estimated by GAL to be £435 million.

9.6 The CAA has verified the inflation indexing calculation.

9.7 The depreciation charge deducted from the RAB during Q5 is the same as that included in the Q5 decision, plus £153 million for Q5+1. Due to the legal framework governing the one year extension of Q5 (Q5+1), there is not a set of building blocks which add to the price cap of RPI+0.5% in Q5+1. Furthermore, the CAA's Q5+1 decision did not include a view on the appropriate depreciation to be included in the RAB for that year. GAL's BP assumption appears reasonable given the Q5 assumptions and the Q6 forecasts.

Figure 9.2 Opening Q6 RAB

£ million	
Forecast closing RAB per GAL's BP (31/3/2014 prices)	2,510
Adjustment required to reflect RAB in 2011/12 prices	(140)
Forecast opening RAB in 2011/12 prices	2,370

Source: CAA analysis

Calculating the RAB for Q6 and the depreciation charge

9.8 Net capex in Q6 is calculated from the forecast capex expenditure used in chapter 5 and GAL's forecast for disposals included within its business plan.

9.9 Under RAB-based price regulation, the choice of depreciation policy does not affect the value of the business because it only affects the timing of the return. The depreciation policy is, in effect, NPV neutral when considered alongside the return on the RAB. However, the choice of depreciation lives affects the profile of revenues and prices, and matching the depreciation life to the useful economic life of the assets is likely to:

- facilitate the financing of the assets; and
- produce smoother price profiles.

9.10 The depreciation allowance is determined by the overall value of the RAB, and the asset lives and age of the existing assets contained within it. The RAB is reduced annually by an amount equal to the projected annual depreciation allowance. Total regulatory depreciation consists of:

- depreciation of the existing assets, which includes assets which are already part of the Q5 programme; and
- depreciation of the forecast capex in Q6.

9.11 GAL's depreciation of existing assets is in line with GAL's regulatory accounts, and GAL's asset lives and depreciation policy are consistent with those in the Q5 determination. GAL has profiled depreciation between Q6 and Q7, in effect reducing the depreciation charge and therefore price in Q6 and increasing them in Q7. The CAA's current view is that it does not see merit in this case of moving value from one period to another and therefore, its initial proposals do not include this profiling.

9.12 In addition, the CAA's review of the estimated depreciation charge on Q6 capex:

- corrects the timing of some of the depreciation (reducing it by around £13 million);
- corrects the treatment of depreciation on capex in year 6 (increase of £8 million); and
- reduces depreciation in line with the reduction in capex in the CAA's initial projects compared to GAL's FBP.

9.13 Figure 9.3 sets out projected depreciation charge on this basis.

Figure 9.3 Depreciation charge

£m (2011/12 prices)	2014 /15	2015 /16	2016 /17	2017 /18	2018 /19	5 yr total	2019 /20	2020 /21	7 yr total
GAL depn	**127**	**129**	**140**	**143**	**143**	*682*	**173**	**174**	*1,029*
Remove profiling	17	23	14	1	11	*65*	(13)	(13)	*39*
Correct timing of depn	(1)	(1)	(4)	(4)	(2)	*(13)*	-	-	*(13)*
Inclusion of Q7 capex	-	-	-	-	-	-	-	8	*8*
Impact of lower CAA capex	-	(1)	(2)	(4)	(6)	*(13)*	(8)	(9)	*(29)*
CAA depn	**142**	**149**	**147**	**136**	**146**	**721**	**152**	**161**	**1,034**
Comprising									
Existing assets	141	134	124	107	104	*610*	98	90	*798*
New assets	1	16	23	29	42	*111*	54	72	*236*
Total CAA depn	**142**	**149**	**147**	**136**	**146**	**721**	**152**	**161**	**1,034**

Source: CAA analysis

9.14 As a result of these assumptions, the forecast for RAB is set out in figure 9.4.

Figure 9.4: CAA forecast RAB for Q6

£m (2011/12 prices)	2014 /15	2015 /16	2016 /17	2017 /18	2018 /19	5 yr total	2019 /20	2020 /21	7 yr total
Opening RAB	2,370	2,394	2,438	2,467	2,479	2,370	2,443	2,466	2,370
Net capex	167	193	176	149	110	794	176	228	1,198
Depn	(142)	(149)	(147)	(136)	(146)	(721)	(152)	(161)	(1,034)
Closing RAB	2,394	2,438	2,467	2,479	2,443	2,443	2,466	2,534	2,534
Average RAB	2,382	2,416	2,452	2,473	2,461	n/a	2,455	2,500	n/a

Source: CAA calculations

CAA initial projections

9.15 The CAA's initial projections for the calculation of the opening Q6 RAB, the average RAB within the year, and the depreciation charges to be included within the Q6 price caps are set in figure 9.4.

9.16 The CAA will update the opening RAB calculation before making a final decision to ensure that it captures up to date information.

CHAPTER 10

Cost of capital

10.1 The WACC is an important component to the calculation of the price caps owing to the need to remunerate past investment represented by the accumulated RAB. It is also important in encouraging continued investment to support the capital programme discussed in chapter 5.

10.2 This chapter discusses some of the key methodological issues raised by stakeholders, followed by a summary of the GAL business plan and submission received from BA and the ACC. Following this, it sets out the results of an independent analysis commissioned by the CAA and concludes with the CAA's initial projections.

WACC and the Capital Asset Pricing Model

WACC and the Capital Asset Pricing Model

10.3 Two key concepts in the estimation of allowed returns are the WACC and the capital asset pricing model (CAPM).

10.4 In previous regulatory reviews, the allowed returns to be included in price caps for GAL were based on forward-looking estimates of the cost of capital. The cost of capital is a weighted average of two components: the cost of equity (K_e); and the cost of debt (K_d), where the weightings (gearing or g) reflect the relative importance of each type of financing in a notional firm's capital structure.

Equation 1: WACC

$$WACC = g.K_d + (1 - g).K_e$$

10.5 The cost of debt is directly measurable for many firms in the UK economy. The cost of equity, by contrast, cannot be directly observed and instead estimation is based on the returns that are expected to be demanded by a shareholder in exchange for their holding shares in GAL. The primary tool that the CAA, other sector regulators and the CC have used when estimating the cost of equity is the CAPM, which relates the cost of equity to the risk-free rate (R_f), the market-wide equity risk premium (ERP) (R_m – R_f) where R_m is the expected return on the market, and a firm-specific measure of investors' exposure to systematic risk (β or beta):

Equation 2: Cost of equity (Ke) under CAPM

$$K_e = R_f + \beta.(R_m - R_f)$$

10.6 Please note: the CAA uses a pre-tax real WACC in this chapter unless otherwise stated. This approach means that the cost of capital allowance includes an allowance for corporation tax but excludes an allowance for inflation (instead inflation is included in the RAB).

10.7 A pre-tax real WACC is not used by all regulators, so to facilitate discussion a real vanilla WACC has been used in some places. Where this is used it is clearly indicated. The real vanilla WACC excludes the allowance for tax and therefore also facilitates comparisons in light of changing tax rates.

Constructive Engagement

10.8 Although the cost of capital was not a formal part of CE, the CAA received submissions on methodological issues from stakeholders.

10.9 No stakeholders advocated a departure from using the CAPM as a basis for calculating the WACC.

10.10 Some methodological issues with the application of the WACC/CAPM approach were raised. These were:

- split cost of capital; and
- indexation of the cost of debt.

10.11 In addition, HAL raised the issue of skewness of its returns and GAL, in its response to the CAA's Policy update paper of May 2012, argued that its returns were also skewed.

Skewness of GAL's returns

10.12 In respect of the Heathrow price review, HAL submitted a paper by Ian Cooper which suggested that due to the capacity constraints at its airport its returns are 'negatively skewed'. That is to say, the airport operator's returns are capped during upswings in the market (due to capacity constraints); and not for downturns. HAL argued that finance theory supports the idea that investors in companies with negative skewed returns require a premium.

10.13 In GAL's response to the Policy Update it said that it thought its returns were negatively skewed[79], although the sources of skewed returns at Gatwick were different. It argued that, in combination, these sources create a greater degree of negative skew in GAL's range of expected returns compared to HAL. Specifically, Gatwick's traffic numbers have been significantly lower than forecast at the start of either Q4 or Q5. Additionally, it noted that negative shocks to traffic were demonstrably larger than positive shocks and, moreover, skewness in returns was not solely created by skewness in volumes. GAL thought that the increasingly competitive environment meant greater uncertainty over whether it would be able consistently to price at the level of a RAB-based cap. It argued that this uncertainty was much less of a consideration at Heathrow and, therefore, the profile of expected returns at Gatwick was therefore more skewed towards the downside compared to Heathrow.

10.14 Oxera presented an analysis of co-skewness for Gatwick, which it thought was consistent with the finding of negative co-skewness[80] at Heathrow that had been already been presented to the CAA. Oxera noted that its analysis of the co-skewness for the three London airports suggested that returns at Gatwick were more negatively

[79] The CAPM assumes that share returns have normal distributions. This distribution is symmetric, with equal chances of the same upside gain and downside loss. Because of this symmetry, risk can be fully described by the standard deviation (or equivalently by the variance). Ian Cooper, on behalf of HAL, argued that when returns are not normally distributed, the CAPM is an incomplete model. Skewness means that the upside potential of a company's shares is different to their downside risk. Positive skewness means that upside potential is greater than downside risk, and negative skewness means that downside risk is greater than upside potential. In particular, Cooper argued when there is significant skewness of returns the standard deviation (and consequently the CAPM beta) is no longer an adequate description of risk. Furthermore Cooper argued that skewness matters because it affects the desirability of an investment to investors and, hence, its cost of equity.

[80] Estimation of the cost of equity requires an approach that can be applied at the level of the individual share. For this, one needs a measure of co-skewness that allows for the diversification of risk in portfolios. The measure that does this is the co-skewness of a share with the market. This plays the same role in adjusting the cost of equity for skewness as the beta does in the CAPM.

skewed than at Heathrow and Stansted and implied an uplift to the CAPM-based cost of capital for Gatwick.

10.15 BA did not support GAL's arguments. BA disputed the presence of asymmetric risk on the basis that there are upside opportunities that GAL had not taken into account and that the downside risks are capped because Gatwick is a regulated airport operator with substantial market power. BA argued further that GAL's management should be able to mitigate some downside risks through improvements in cost control and moving to a more flexible cost structure. BA also said that if there were asymmetric risks, GAL would feel these risks to a lesser extent than the airlines. The airlines would feel the first impact of these risks, with lower ticket sales, following which any reduction in revenue which the airport operator experienced could be significantly reduced to the extent that the airlines took this effect in a reduction in profitability. BA argued that the key issue in estimation of the cost of equity was the lack of market data, which would not be addressed by incorporating co-skewness into the model.

Split cost of capital

10.16 BA suggested that the CAA consider a split cost of capital. This approach, if applied to GAL, assumes that GAL's RAB is a long-term relatively risk free asset. In contrast to the development of new capital investment and the operation of the airport are inherently riskier. The model proposes that the RAB can be fully debt funded and should, therefore, attract a relatively low cost. The capital base required to support capex and opex is riskier and should attract the cost of equity.

10.17 In keeping with common regulatory practice, the CAA has in past reviews adopted a single WACC applied to the RAB (including within period capex) and no additional capital base is required to support opex. Those that support the split cost of capital argue that this may over reward GAL on its RAB and under reward GAL on its capex and opex.

10.18 Neither GAL nor HAL supported the split cost of capital. GAL stated that it do not consider that the concept of a split cost of capital had any relevance at Gatwick. HAL submitted a paper it commissioned from Ian Cooper that rejected BA's suggestion. This separated the split cost of capital into two issues:

- the split cost of capital approach should not change the cost of capital if there is no change in the regulatory contract. If the regulatory contract does not change the overall amount of risk borne by the airport operator, the asset beta should not change since splitting a given amount of risk does not change the overall amount of risk; and
- for the split cost of capital approach to change the overall cost of capital, it would have to be accompanied by changes to the regulatory contract. To reduce the cost of capital these would have to materially reduce (or eliminate) risk to the RAB without affecting other risks. Indeed, funding the RAB entirely with debt would require all risk to be eliminated. In that case, the change in the cost of capital would come not from the split cost of capital approach itself, but from the change in the regulatory contract.

Indexation of the cost of debt

10.19 BA, through its consultants CEPA, supported the use of a cost of debt index to set the allowed cost of debt. This approach, it argued, had been applied by Ofgem, which used an all-in cost of debt allowance based on a ten-year trailing average of a forward-looking cost of debt index. It noted that this approach also allowed the historically low rates that currently exist to be incorporated while allowing flexibility for the rate to change as market conditions change.

Discussion of the key issues (I): methodology

10.20 The CAA commissioned two independent reports from PricewaterhouseCoopers (PwC), one on the methodological issues of the split cost of capital and skewness of returns and another report on the calculation of the cost of capital.[81]

Skewness of returns

10.21 PwC's advice to the CAA was that it would be inappropriate to adjust GAL's regulatory cost of equity to reflect skewed risks. PwC's recommendation was based on a number of factors.

[81] These are both available from the CAA's website: http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=14279

- PwC found that there was no long-term conclusive evidence on the negative skewness of BAA/GAL's financial returns. PwC's statistical analysis of BAA's returns suggested no skewness over the period 1987 to 2006. The co-skewness coefficient for the period 1987 to 2006 was positive, although some sub-periods, including the August 2001 to July 2006, were negative.
- Since 2006[82], when BAA was delisted, only operational data, such as passenger numbers, were available. Although such data suggested a negative co-skewness coefficient, PwC concluded that the robustness of the skewness analysis based on passenger volumes and ATMs was not proven. For example, passenger volumes (and underlying growth rates) did not represent a solid proxy for equity returns. PwC considered real economic variables did not reflect present values in the same way as share prices, so there was a lack of consistency between the operational variables and the financial variables used. In addition, in respect of the Heathrow review, HAL argued there are theoretical grounds for a strong correlation between passenger numbers and HAL's equity returns, however PwC argued that empirical evidence suggests that the explanatory power of such a regression was low.
- Estimates of the co-skewness coefficients before 2006 were particularly volatile (and more volatile than other components of the CAPM formula such as the beta). For example, based on the financial data from 1987 to 2006, the coefficient was +0.16 although if the period is divided into four periods of five years it varies from -0.46 to +0.56. This would affect the WACC by between -50 and +40 bps. PwC was concerned that it would not be appropriate for the cost of capital to move around from price control to price control on the basis of a highly volatile estimate of the co-skewness coefficient.

[82] BAA/HAL have suggested that capacity constraints at UK designated airports, particularly Heathrow are a more recent phenomenon and therefore more weight should be attached to the most recent estimate of BAA's co-skewness coefficient. However, this is unsatisfactory given the volatility of co-skewness coefficient estimates and inconsistent with evidence that BAA has operated with capacity constraints for many years.

- There were a number of practical complications that reduce the robustness of any adjustment for skewed risk. These included the need (i) to modify the CAPM (by reducing the equity market risk premium if including a separate co-skewness risk premium); (ii) to reassess the co-skewness risk premium using UK financial market data[83]; (iii) to assess the statistical significance of the co-skewness coefficients and (iv) the effect on other components of the CAPM on incorporating skew (if skew is caused by capacity constraints then those constraints are also likely to reduce beta).
- Each of these practical implications would require further calculation, estimation and judgement to the basic CAPM. This could undermine the robustness because of the lack of evidence against which to sense check the results. Furthermore, it would move the airports sector away from the well established application of the CAPM in regulatory settings.

10.22 Having considered the representations made by GAL and BA, along with the advice from PwC from its own independent study, the CAA is not persuaded that it should make a specific adjustment to uplift GAL's cost of equity to reflect negatively skewed returns. Among other things, it has placed weight on PwC finding no conclusive proof of asymmetric risk and the argument that downside risks can partially be mitigated by GAL. GAL could make its cost base more efficient and flexible. The CAA has also considered that, even if GAL has negatively skewed returns, it is not clear it would materially change the estimated WACC.

Split cost of capital

10.23 PwC recommended the CAA did not adopt the split cost of capital approach. PwC argued that:

- regulated businesses such as GAL are integrated with revenues and risks that cannot be meaningfully split along the lines suggested in the split cost of capital approach. The value of the RAB is closely linked to on-going capex and opex, and in combination makes up the regulated business. Any split to the regulated business would be arbitrary and not reflect meaningful commercial entities;

[83] Currently, the only estimate of the co-skewness risk premium is based on US data.

- the existing regulatory framework does not 'guarantee' GAL's RAB, and therefore it is unlikely to be risk-free, or even of sufficiently low risk to be 100% debt financed;
- given the relative shares of the RAB and non-RAB components for GAL, the implied cost of equity for the non-RAB business could be very substantial. PwC considered that this did not necessarily invalidate the approach, but did make it harder to estimate and benchmark the cost of capital for the non-RAB component; and
- if such a split of the cost of capital was carried out, under the current regulatory framework, it would not change the overall cost of capital, nor the level of regulated prices. This limits the benefit of such an approach.

10.24 On balance, the CAA considers that although the split cost of capital may have some academic attractions, it is not persuaded to employ it for GAL for Q6. There is a risk that implementing it without changing the regulatory framework would not reduce risk but merely apportion it between two theoretical parts of the business. While arguments for a split cost of capital on the basis of market inefficiencies could also be made, we have not received evidence on this matter. We therefore tend to see potential reduction in the cost of capital from changing the regulatory contract (for example by eliminating all risk from the RAB) as not a benefit to passengers, and potentially (given the open-ended risk future passengers would adopt here) as contrary to the passenger interest. The CAA also notes that one of the assumptions of the split cost of capital – that the RAB is risk-free – may not always be the case for GAL, especially if in the future it faces stronger competitive constraint.

10.25 The CAA notes that the split cost of capital has been considered but not subsequently adopted by any of the other UK sector economic regulators such as Ofgem, Ofwat and the CC.

Indexation of the cost of debt (and automatic in period adjustment)

Introduction

10.26 Indexing the cost of debt automatically adjusts the cost of debt within a control period to equal a benchmark of market rates. Those in favour of indexation have argued that regulators 'aim up' on the cost of debt in the WACC to allow for the possibility that the cost of debt might be higher over the period than expected. The longer the price control period the greater the uncertainty over future yields and therefore the greater the incentive on the regulator to 'aim up'. Indexing the cost of debt would eliminate the need for aiming up.

10.27 Those that argue against indexing the cost of debt consider that financing is a matter for the company and that the company is best placed to make financing decisions. By introducing a set formula for calculating the cost of debt, the CAA might be incentivising the airport operator to favour debt over equity and/or match the indexing assumptions.

10.28 Those that argue against indexation consider that there would be difficulties in constructing the appropriate index and, if the CAA was to index the cost of debt, that it would need to commit (as far as it could possibly do so) to taking a similar approach at each subsequent regulatory review. In effect it would be setting the mechanics for calculating the cost of debt for the foreseeable future. While consistency is important, the cost of capital also requires judgements to be made and discretion to be exercised, which could be restricted if the CAA commits to a mechanical approach to the cost of debt.

10.29 On the other hand, BA was supportive of indexation as it removed the incentive on the regulator to aim up, and BA did not think indexation would remove GAL's incentive to minimise debt costs.

Ofgem's approach to indexation

10.30 Ofgem has chosen to adopt indexation for all its recent regulatory determinations. Ofgem's indexation is a simple trailing 10-year average of yields on A and BBB rated debt. Ofgem noted that there were several reasons for it to use indexation:

- it may benefit users because regulatory decisions have generally lagged the decline in market rates;
- financeability tests may benefit as new debt, financed at efficient rates, would be fully funded in the future regardless of movements in market rates;
- it can reduce uncertainty in light of market conditions, that are difficult to interpret; and

- Ofgem's research concluded that there was no convincing evidence that risks would be any greater than under the current approach.

10.31 The CAA's Q5 approach to the calculation of the fixed ex ante cost of debt had similar properties to Ofgem's indexation in that it blended a mixture of historical yields with current yields to reflect a notional debt portfolio (albeit the Q5 approach did not adjust the cost of debt within the quinquennium). The historical yields reflect fixed rate debt taken out over a period of time while the current yields reflect floating rate debt and new debt to be taken out over the forthcoming price control period.

Incentive effects on GAL

10.32 The CAA notes the selection of the benchmark is an important consideration. The less closely matched the benchmark to the actual composition of GAL's debt portfolio[84], the greater the potential for variance and thus, the greater the 'optionality' implied by the chosen benchmark and the scope for arbitrage.

10.33 The longer the regulatory period with a fixed cost of debt (however derived), the greater the potential arbitrage. This could have potentially perverse incentive effects. For example, if a fixed ex ante estimate (the CAA's Q5 approach) is used and the market level subsequently dips below the level of the estimate, the regulated entity will have an incentive to 'lock in' the arbitrage profit for the remainder of the period. If large enough, this 'profit' would potentially ensure outperformance of the regulatory settlement, blunting incentives to strive for outperformance of the other cost assumptions. Conversely, if the market moves persistently above the level of the estimate, incentives to outperform other cost assumptions will be sharpened. Ex ante, there is a broadly equal probability of both outcomes, but as the future path of market rates is non-controllable and largely unpredictable (at least beyond the short term), the incentive effects implied by the cost of debt determination are random and may be 'good' or 'bad'.

10.34 All other things being equal, reducing the arbitrage opportunity by

[84] The CAA notes that debt used to finance GAL is also held by other group companies, but for ease of drafting, the term 'GAL' is used.

adjusting the regulatory cost of debt determination more frequently may, therefore, improve the incentive properties of the regulatory settlement overall. The longer the period for which the determination is made, the greater would be the benefit. In current circumstances, where it might be argued that interest rates are unsustainably low, the risk that future market rates will be different from present rates is likely to be greater than in more stable market conditions.

10.35 In the extreme case, a fixed ex ante estimate based on current market rates may cause financeability problems. Including an uplift in the cost of debt estimate to address the heightened risk will inevitably be arbitrary with unpredictable and potentially perverse incentive effects. Providing for intra-period adjustment may therefore be a better solution.

10.36 Annual adjustments based on ex post estimates derived from a market benchmark on the lines of Ofgem's approach are one way of doing this, and have the advantage of being automatic, requiring no further regulatory action and thus implying little regulatory risk. An alternative would be the approach used by the Irish regulator in respect of Bord Gais, which provided for an interim adjustment if and when a market benchmark moved outside a pre-determined limit.

10.37 The CAA considers that the arguments for and against indexation are finely balanced. The greater the uncertainty over future yields during the price control period (be that due to a longer price control period[85] or increased market uncertainty) would suggest that the benefits of the mechanism might outweigh the costs, with the opposite being likely if uncertainty was low. It is the CAA's intention to further explore the issue before its final proposals and the CAA would especially welcome feedback from stakeholders on this issue as part of the consultation.

10.38 If the CAA were to introduce indexation of the cost of debt it would expect that the starting value would be within the range for the cost of debt indentified by PwC. Furthermore, the CAA notes that Ofgem's current cost of debt of 2.92% based on its indexation method is within and towards the top end of PwC's range.

[85] The CAA notes that Ofgem's indexation of debt has coincided with its move to an eight-year control period.

Other methodological issues

Real or nominal cost of capital

10.39 The CAA has previously sought views on whether inflation should continue to be included in the RAB (and not in the cost of capital) or whether there should be a change to including inflation in the cost of capital (and not in the RAB).[86] The CAA has received no submissions in support of a change in its approach. Furthermore, the CAA is aware that, broadly to match the CAA regulatory approach, GAL has issued some index-linked derivatives on which it pays down the principal accretion every five years.

Accounting rate of return

10.40 In Q5, the financial model (shared by GAL, the CC and the CAA) converted the cost of capital (6.5%) into an accounting rate of return (ARR) (6.3%)[87] to the RAB to take account of the fact that returns could themselves be reinvested during the course of each year, thereby generating the allowed return by the end of the year.

10.41 The CAA notes that the adjustment is adopted by some, but not all, of the other regulators such as ORR, Northern Ireland Utility Regulator, and the CC (in respect of airports and Bristol Water). The CAA understands that Ofgem makes a similar adjustment.

10.42 Since, the WACC is ultimately a judgement within a plausible range of outcomes, the accounting adjustment may risk importing spurious accuracy. However, the CAA continues to consider that there is an argument for the concept of the accounting rate because returns that are earned throughout the year can be reinvested. It is, therefore, something the CAA expects to take into account when judging where in the range to adopt its initial proposals for Q6.

Traffic forecast risk

10.43 The cost of capital captures expected returns. Expected returns are the mean average returns and therefore the traffic forecasts need to be the expected (or mean) traffic forecast for the period. Traffic forecasts are discussed in chapter 4, where the CAA provides a

[86] CAA, May 2012, *Q6 Policy Update*.

[87] In Q5 the ARR, derived from the WACC, is applied to the average of the opening and closing RAB to calculate the allowed pre-tax returns.

central or expected forecast of traffic.

GAL's estimate of WACC

10.44 GAL submitted its business plan which included papers by Oxera. Oxera estimate GAL's WACC to be 7.1%. This compares to a 6.5% WACC used by the CAA and the CC for the Q5 determination.

Gearing

10.45 Oxera proposed a notional gearing assumption of 55% for GAL. Its assessment of the increase in risk faced by GAL in Q6 suggested that an appropriate notional financial structure for GAL would be expected to move away from HAL (60% was assumed in Q5) and closer to STAL (50% was assumed in Q5). Accordingly, Oxera thought it is reasonable to reduce the notional gearing assumption for GAL from 60% to 55%.

Cost of debt

10.46 Oxera thought that the allowed cost of debt for GAL in Q6 should be based on the cost of efficiently issued embedded debt as well as any new debt to be issued during the period. It calculated that the nominal weighted average cost of GAL's embedded debt is 6.0%. It estimated that if GAL were to issue new debt during Q6 to finance some of its investment programme, the weighted average cost of debt would decline to around 5.8%, based on the current yields on corporate debt. Overall, this suggested a range of 5.8 to 6.0% for the nominal cost of debt for GAL. Oxera proposed a point estimate of 6.0% at the upper end of this range for the nominal cost of debt is appropriate because it noted that:

- GAL did not foresee the need to raise extensive amounts of new debt over the Q6 period;
- even if GAL were to issue new debt over Q6, it is likely that it would not be able to obtain financing at terms that are indicated by current corporate bond yields, which are very low.

10.47 Oxera noted that this indicated a real cost of debt of around 3.2% (based on an inflation assumption of 2.9% and a 15 bp allowance for issuance costs).

Risk and beta

10.48 Oxera thought that, since Q5, GAL's risk profile had increased considerably, resulting from both market-wide and Gatwick-specific factors:

- changes in ownership resulting from the CC's requirement for the break-up of BAA airports, leading to increased competition among the airports that, it thought would be expected to intensify when the sale of Stansted was completed; and
- airline business models which have evolved towards a more flexible model whereby airlines re-base aircraft and change routes rapidly from low-profitability routes towards more profitable ones, a shift that can be observed by looking at low-cost carriers.

10.49 Taken together, Oxera thought that these factors contributed to an increase in passenger volatility for UK airports, which can, in turn, be expected to increase the risk profile of the sector as a whole. Furthermore, it thought that given the nature of Gatwick, these factors affected GAL to a greater extent than either STAL or HAL and, therefore, passenger volatility at Gatwick had increased more than that at other London airports.

10.50 Oxera took a fundamentals-based modelling approach to estimate beta because none of the London airports was publicly listed (the asset risk for GAL cannot be directly approximated from observed equity betas) and changes in GAL's risk profile since Q5 cannot be adequately reflected in the observed equity betas for other airports Oxera's fundamentals-based modelling exercise indicated that GAL's profitability risk increased by 15 – 25% from the level assumed at Q5, which implied an estimated asset beta range of 0.60 – 0.65, and a debt beta of around 0.12 – 0.13.[88]

10.51 Oxera cross checked this to comparator airports (Auckland: five year asset beta of 0.77, Aeroports de Paris: 0.63, Gemini (which owns Roma airport amongst other businesses): 0.37 and Sydney: 0.55) although it excluded 6 airports (including Fraport) from the sample because the shares were thinly traded (less than 100% share turnover per annum). Oxera also compared the asset beta to the market

[88] Implicit in Oxera's assumption was that increase in total risk did not change the proportion of systematic and non-systemic risk.

(which it estimated to be 0.84), and with energy transmission and distribution (0.3 to 0.4) and telecoms (Openreach 0.41 to 0.55 and BT 0.46 to 0.59).

Risk-free rate

10.52 Oxera proposed a point estimate for the risk-free rate of 1.75%, noting that since the start of Q5, market yields on UK government bonds have declined considerably. This was tempered by, in its view, market evidence on forward rates suggesting that the market was expecting a rise in the risk-free rate and also that regulators have adopted a cautious approach in recent determinations by allowing considerable headroom over market rates for the uncertainty in the estimation of the risk-free rate based on current yields of index-linked gilts (ILGs).

Equity risk premium

10.53 Oxera proposed a point estimate of 5.5% based on:

- a number of sources of evidence, including historical evidence on stock market returns, survey-based evidence, forward-looking evidence on dividend growth, and evidence from regulatory precedents. It thought that these sources indicate a range for the ERP of approximately 5 – 7%.
- evidence that equity investors were exposed to considerable uncertainty regarding future stock market returns; and
- regulatory decisions on the ERP have steadily increased since Q5, particularly since the start of the financial crisis in 2007–08.

10.54 The proposed 5.5% point estimate, in combination with the 1.75% risk-free rate, results in a total equity market return of 7.25%, which Oxera noted was broadly in line with recent regulatory precedents — for example, the most recent determinations by Ofgem (7.25%), the CAA (7.0%) and Ofwat (7.4%).

Overall estimate of the cost of capital

10.55 Combined with a tax rate of 21%, Oxera estimated that the appropriate cost of capital was in the range 6.8 to 7.1%. Oxera selected a point estimate at the top end of the range (7.1%) because, in its view:

- there were some drivers of uncertainty to which GAL will be exposed over Q6 that have been identified in this assessment but their impact on the WACC has not been quantified, for example, asymmetric returns.
- delisting of BAA has exacerbated the potential for errors in estimation of risk.

BA's estimate of WACC

10.56 BA submitted a report it had commissioned from CEPA, which estimated a range for GAL's WACC in the region of 4.5% to 5.5%, the same range that it had estimated for HAL.

10.57 CEPA thought that the gap between the riskiness of HAL and GAL had narrowed since the Q5 decision and that both airports now lay in the same range for calculating the risk. CEPA thought that GAL was no less risky than HAL and that there may be factors, such as Heathrow's hub status that might mean that GAL was slightly more risky.

10.58 Comparing CEPA's estimate of the individual components of the WACC with Oxera's estimates, other than on tax (for which they agree) all of CEPA's estimates led to a lower WACC than Oxera. The larger differences related to the cost of equity components, while the cost of debt estimates were closer.

Risk-free rate

10.59 CEPA used historical evidence on five-, ten- and twenty-year index-linked UK government bonds (index-linked gilts – ILGs) as a proxy for the risk-free rate. As a check, it also considered rates on nominal bonds. It noted, however, that the financial crisis and the Bank of England's market interventions meant that recent evidence may not be representative of the true, underlying risk-free rate.

10.60 CEPA considered that the evidence suggests that a rate as low as 1.0% may be justifiable. However, given the considerable uncertainty regarding the underlying risk-free rate, CEPA acknowledged that a rate of 2.0% was also a possibility – and this would be consistent with regulatory precedent. CEPA's preferred narrow range of 1.5 to 1.75% was in its view a reasonable interpretation of the evidence as a whole.

Equity risk premium

10.61 CEPA estimated the ERP based on the latest figures calculated by Dimson, Marsh and Staunton, although consideration was also given to a Barclays Capital Equity Gilt Study and recent regulatory determinations.

10.62 CEPA's overall view was that a value for the ERP of 5.0% was appropriate, especially given the fall in the risk-free rate, although it acknowledged there is long-term evidence suggesting a rate either above or below this figure.

10.63 Combining CEPA's estimates for the risk-free rate and ERP produces a total market return of 6.5% to 6.75%. This compares to Oxera's estimate of 7.25%.

Beta

10.64 In the absence of a direct estimation of GAL's beta, CEPA selected a broad range of comparators as it thought evidence from international airport operators alone was not sufficiently robust, and that it was more appropriate to include a broader comparator set including UK-based regulated networks. It noted that this was consistent with the CC's approach to Q5.

10.65 CEPA noted that the pool of listed international airports was small, and although the comparators might in theory be different for GAL to HAL, its choice was limited to those available (primarily Frankfurt and Charles de Gaulle). CEPA noted that other international airport comparators generally appeared to produce lower beta estimates, although it acknowledged that these are arguably likely to be lower risk than Gatwick.

10.66 CEPA considered demand risk to analyse the relative risk of GAL and HAL. Examining year on year changes in passenger numbers at Gatwick and Heathrow, CEPA concluded that while Gatwick showed greater variation, it could be explained by idiosyncratic (one-off) events. CEPA noted that passenger numbers volatility should be considered alongside analysis of revenue, capital and operational expenditure which might show that due to mitigation management action the volatility of GAL's returns may be lower than the raw passenger numbers would suggest.

10.67 However, CEPA also noted that due to Heathrow's hub status and capacity constraints at the airport leading to excess demand, it was likely that the demand risk at Heathrow was lower than Gatwick. To support this view CEPA noted that Heathrow was operating at 98% capacity while Gatwick was operating at 80% in summer and between 70 and 80% in winter.

10.68 CEPA thought some argument could be made for the airport being subject to less demand risk going forward as, following the change of ownership, management will be focused solely on the airport. CEPA noted a GAL investment presentation[89] which explained the risk of Gatwick through the prism of 'credit highlights', which included resilient financial performance amongst other things.

10.69 Taking into account the CC's previous analysis, CEPA considered that the equity beta was likely to be around one. It noted that this was also in line with an examination of the asset betas for the comparator airports which were broadly similar to what they were in the lead up to Q5 when the asset beta for Heathrow was estimated as being 0.47 and the consequent equity beta was in the range of 0.9 to 1.15.

10.70 CEPA considered that an estimate as low as 0.9 would be supportable based on recent evidence for a close comparator (Frankfurt), but in its view anything below this would represent a selective interpretation of the available evidence. Equally, it thought an equity beta estimate above 1.2 would not be consistent with evidence from the two closest available comparators. CEPA concluded that the appropriate range for the equity beta was 0.9 to 1.1.

Cost of equity (and tax)

10.71 Combining these estimates for the risk-free rate, ERP and equity beta, CEPA estimated a range for GAL's post tax cost of equity of 6% to 7.25%. With a tax rate of 21%, this equates to a pre-tax cost of equity in the range 7.59% to 9.18%.

Cost of debt

10.72 CEPA took two approaches to estimating the cost of debt. It

[89] Gatwick Airport, February 2011, *Gatwick Airport Bond Investor Presentation*. http://www.gatwickairport.com/Documents/business_and_community/Investor%20relations/Investor%20Presentation%20FINAL%2015-2-2011.pdf

examined the risk-free rate and the debt premium (spread) separately; in addition it estimated the total cost of debt.

10.73 CEPA reviewed a wide range of evidence including spreads over gilts for a range of benchmark indices based on credit ratings, yields on issue and as at January 2013 for bonds issued by GAL. CEPA noted that there is a market perception that risks attached to a single bond are greater when the company is smaller. However, it also noted that while GAL is smaller than HAL, it is still a significant company with large capital investments (£0.8 billion over five years Q6, 2011/12 prices) and CEPA's analysis concluded there was no strong evidence for a debt premium for GAL that was higher than that used in the HAL WACC. Using the first approach CEPA estimated that the debt premium over the risk free rate was likely to be around 1.5%.

10.74 CEPA's second approach looked at similar benchmarks but for total yield from which it deducted inflation. CEPA noted that, based on iBoxx non-financials, data suggested that real spot yields for 10 year+ average A and BBB rated debt were below 2%, while the 10 year average was 3%. Using Bloomberg data for all companies, real spot yields were currently below 1% and the 10 year average was 2.7%.

10.75 CEPA considered two possible debt portfolios (one in which 10% is raised in each of the last 10 years and one based on the proportion of BAA (now Heathrow) debt taken out over each of the last 10 years). Using this method, CEPA estimated the cost of BBB debt to be in the range 2.88% to 3.02%.

10.76 CEPA combined this information to estimate the cost of debt to be in the region of 2.5% to 3.0%. This compares to Oxera estimate of 3.2%.

BA’s suggested cross-checks on the WACC

10.77 BA set out five tests that it thought the CAA should consider when assessing the appropriate WACC and in particular the cost of equity element for HAL.[90] The CAA considers that these may also have resonance for GAL. The tests covered profit performance, actual gearing, ability to raise finance, the use of cash and wider systematic risks.

[90] BA’s assessment of these tests led it conclude that HAL did not require further price increases and it was less risk than the market (i.e. a beta less than 1).

ACC's estimate of the WACC

10.78 easyJet on behalf of the ACC estimated the cost of capital for GAL to be 4.2%. Compared to the CAA's Q5 decision[91], easyJet's estimate was lower because of:

- a reduction in the risk-free rate (from 2.5% to 1.3%), reflecting a decrease in real yields on UK gilts since 2007. easyJet noted that for many maturities such yields have been negative;
- a decrease in the cost of debt, including fees (from 3.55% to 1.33%), reflecting a decrease in bond yields since 2007;
- a reduction in the tax statutory rate (from 28% to 22%).

10.79 All other assumptions were unchanged from the Q5 decision, although ACC noted that this did not mean the ACC believed that they were unchanged.

An independent estimate of WACC commissioned by the CAA

10.80 The CAA commissioned PwC to provide an independent assessment on the calculation of GAL's WACC. PwC recommended that the WACC is in the range 4.48% to 6.05% using current market rates for the market returns. PwC checked this by calculating a single point estimate (akin to the midpoint) of the WACC of 5.3% based on using long-term returns for the risk-free rate and ERP.

Market returns

10.81 In estimating market returns and its component parts, PwC reviewed two approaches. The first approach used the current market assessment of returns with some degree of smoothing to reflect underlying returns assessment. The second approach represented its long-term view on the appropriate return expectations.

10.82 PwC noted that the approaches based on both current returns and long-term returns produce implied total market returns estimates of 6.25% to 6.75% that were broadly comparable and not significantly different to the estimates used by the CAA and CC for Q5 (6.6% to

[91] The CAA's Q5 decision on cost of capital was the same as the CC's recommendations.

7%), CEPA's Q6 estimate (6.5% to 6.75%), but slightly below Oxera's Q6 estimate (7.25%).

Risk-free rate

10.83 PwC estimated the real risk-free rate both with reference to index-linked and nominal gilts (adjusted for inflation), focusing on 10 and 15 year maturities, given regulatory focus on yields on similar maturity debt. Account was taken of current market factors (such as flight to quality and Quantitative Easing) by looking at evidence on trends in the forward rates and also by reviewing recent regulatory decisions.

10.84 PwC noted that yields on ILGs have continued to decline and, at the time of its analysis, were below zero for 5 to 15 year maturities. 10 year averages on these gilts are positive and slightly higher (10 and 15 year maturities averaged 1.1%). Forward rates showed some upward trend.

10.85 Evidence on nominal gilts also showed a general decline in yields since the onset of the financial crisis. After deducting inflation (2.8%), PwC estimated that current real yields were in the region of 0.1 to 0.9% and long term yields in the region of 1.2 to 1.4%. PwC also noted recent regulatory decisions, which included Ofgem (2011 and 2013: 2%), and Ofcom (2011 and 2012: 1.4%).

10.86 Combining all this information, PwC concluded that the appropriate risk-free rate was in the range 0.25 to 0.75% based on current rates and 1.6% for the long-term returns.

10.87 PwC's preferred approach was to use returns that were based on current market assessment as they represent the financing costs that are likely to be applicable for the next 5-year period.

10.88 PwC considered that long-term returns are unlikely to accurately depict the appropriate WACC for a particular time period – allowing firms to benefit from cheaper sources of financing without sharing the benefits with consumers. It used long-term averages as a cross check.

Equity risk premium

10.89 PwC looked at both forward looking and historical evidence. Its choice was shaped by the decision on the risk-free rate under the two different approaches. When looking at current market rates PwC focused on ex-ante (forward looking) estimates for the ERP, whereas when the risk-free rate is based on historical averages PwC preferred historical estimates for ERP.

10.90 PwC preferred market based evidence, because the risk-free rate assumption was not clear in survey based evidence. For its ex-ante ERP, PwC used evidence from Credit Suisse and the Dividend Growth Model. This resulted in a range 5.3% to 6.1%. PwC indicated that 6.0% was the appropriate point estimate. Using current returns, this produces total market returns of 6.25% to 6.75%.

10.91 Using long-term returns, PwC estimated total market returns of 6.6%. PwC based this on evidence from Dimson, Marsh and Stanton, which has a range for the ERP of 3.6% to 5%. PwC used the top of this range together with a risk-free rate of 1.6%.

Beta

10.92 PwC's asset and equity beta estimates were based on review of evidence on trends in evolution of betas across a broad set of airport comparators since the Q5 determination. PwC considered that this evidence suggested there has not been a fundamental change in the risk profile of GAL since CAA's last determination.

10.93 Moreover, PwC considered that there was evidence to suggest that the impact of financial crisis concentrated on the financial sector where the average equity betas markedly increased over time. At the same time, 'non-financials' (including airports), saw their risk-profile decline as they are considered to be safer investments vis-a-vis 'financials'.

10.94 Overall, PwC concluded that the asset beta estimate assumed by CAA at the time of Q5 decision continued to be appropriate and relevant in the context of estimating the cost of capital for Q6. As noted above, PwC recommended that the CAA does not adjust the cost of capital for skewness for GAL in Q6.

Cost of equity (and tax)

10.95 Combining these estimates for the risk-free rate, ERP and equity beta, PwC estimated a post-tax cost of equity based on current implied market rates of between 5.65 to 7.75%. When long-term returns were considered this produced a real post-tax cost of equity of 6.77% (midpoint).

10.96 PwC used a tax rate of 20.2% to translate the post-tax cost of equity into a pre-tax cost of equity. PwC's estimates of the appropriate tax rate reflected the Chancellor's statements in the 2012 and 2013 Budgets that the tax rate would be 21% in 2014/15 and 20% thereafter.

Cost of debt

10.97 PwC estimated the real cost of debt as an equally weighted average of new and existing (fixed rate) debt. The cost of new debt was estimated with reference to yields on benchmark indices with ratings comparable to target investment grade rating considered appropriate by the CAA in Q5 (BBB+/A-) and evidence on yields on traded debt for the designated airports as well as broader evidence on regulated utilities. For existing embedded debt, PwC reviewed evidence on yield to maturity at issuance for debt issued by BAA, GAL and HAL. Nominal yields were converted into real yields using appropriate assumptions on expected inflation.

10.98 PwC noted nominal yields on 10 and 15 year maturity A and BBB rated benchmark indices increased significantly during the financial crisis, but have since declined to 3.8% and 4.4% respectively. PwC translated this nominal[92] spot rate into a real spot rate of 1.0% to 1.6%. PwC incorporated a forward looking adjustment based on the forward yields on government bonds and suggested a range of 1.6% to 2.2%.

10.99 Examining traded yields on HAL and GAL bonds, PwC estimated a blended average spot rate and incorporated a forward looking adjustment to suggest a cost of debt in the range 1.4% to 2.2%.

10.100 Based on estimated yield to maturity at the time of issuance for HAL and GAL bonds and by other utilities (which were lower than for airport operators), PwC estimated a real cost of debt to be in the range 2.5% to 3.5%.

10.101 PwC combined these estimates for new (or floating rate) debt and historical fixed rate debt in equal proportions, with a 20 bps[93] assumption for fees to give a cost of debt of 2.35% to 3.05%. As a

[92] Using an inflation assumption of 2.8%.

[93] This is 5 bps more than HAL to reflect the concept that GAL is not able to issue debt in the larger sized issuance blocks which HAL is able.

sensitivity, PwC also used the actual ratio of outstanding debt and a forecast for new debt and concluded that it did not materially affect its cost of debt estimate.

10.102 PwC noted that this was lower than previous regulatory precedents, reflecting the downward movement in bond yields since the Q5 determination. PwC’s range overlapped that of CEPA (2.6% to 3.0%) and is slightly below Oxera's estimate (3.2%).

10.103 PwC noted Oxera's argument that GAL has carried out most of its financing needs for Q6. Oxera's estimate of GAL's cost of debt was within PwC's estimate of GAL's embedded debt costs. PwC noted that it was setting the cost of capital for a notionally financed airport operator and in this framework, no adjustment is made for actual debt costs.[94] However, PwC noted that the timing of GAL's financing may in part be due to the CC's market investigation, and therefore the timing may not have been within the control of management.

Gearing

10.104 PwC used notional gearing, as opposed to actual gearing, for the airport operators, based on the regulatory concept that companies should be able to choose their own capital structure without any regulatory prescription. PwC noted that this was consistent with evidence based on regulatory precedents as well as gearing estimates across BBB+ and A- rated utilities. Reflecting the systematic and non-systematic risks faced by GAL compared to HAL, PwC concluded that the appropriate gearing level to be used in the GAL WACC was 55% (HAL: 60%).

[94] Although the information is part of the data set used to estimate the cost of debt for the notional airport operator.

Summary of GAL's, BA's, ACC's and PwC's estimates

Figure 10.1 Summary of quantification of cost of capital

	CC/CAA Q5	GAL	BA	ACC	PwC	
		Oxera	CEPA		Current market rates	Long-term returns
Gearing	60%	55%	60%	60%	55%	55%
Pre-tax cost of debt	3.55%	3.2%	2.5 -3.0%	1.33%	2.35 - 3.05%	2.7%
Risk-free rate	2.5%	1.75%	1.5 - 1.75%	1.3	0.25 - 0.75%	1.6%
Equity risk premium	2.5-4.5%	5.5%	5.0%	2.5-4.5%	6.0%	5.0%
Asset beta (number)	0.46 – 0.58	0.60-0.65	-	0.46 – 0.58	0.46 – 0.58	0.52
Equity beta (number)	1 - 1.3	1.19 - 1.29	0.9-1.1	1-1.3%	0.9 – 1.17	1.03
Post tax cost of equity	5.00 – 8.35%	8.3 – 8.9%	6.0-7.25%	3.8 - 7.15%	5.65 – 7.75%	6.77%
Tax rate	28%	21%	21%	22%	20.2%	20.2%
Pre-tax cost of equity	6.94 – 11.6%	11.2 – 11.9%	7.59 - 9.18%	4.87 - 9.17%	7.08 – 9.71%	8.48%
Pre-tax WACC - range	4.91 – 6.77%	6.8 – 7.1%	4.5 - 5.5%	2.75 – 4.46%	4.48 – 6.05%	-
Pre-tax WACC – point estimate	6.5% (6.3%)	7.1%	-	4.2%	-	5.30%
Vanilla WACC - range	4.13 - 5.47%	5.5 - 5.77%	3.9 - 4.7%	2.32 - 3.45%	3.84 - 5.17%	-

	CC/CAA Q5	GAL	BA	ACC	PwC	
Vanilla WACC - point estimate	5.3% (5.14%)	5.77%	-	3.45%	-	4.3%

* The headline WACC for Q5 was 6.5%. However, it was the ARR of 6.3% that was the rate applied to the RAB in calculating the price caps. The 'vanilla' equivalents were a Q5 vanilla WACC of 5.3% and a Q5 vanilla ARR of 5.14%.

Source: Submissions and CAA analysis

Summary of recent regulatory decisions

10.105 Figure 10.2 sets out recent regulatory decisions.

Figure 10.2: Summary of recent regulatory decisions

	CAA	Ofcom[95]	Ofcom	Ofcom	Ofgem	Ofgem	Ofgem	Ofgem	Ofwat	ORR
	NATS	Open reach[96]	Rest of BT[97]	MCT	Elec Dist	Elec trans	Gas trans	Gas dist	Water	Network rail
Control period	2011-14	Feb 2013 view		Feb 2011	2010-15	2013-21	2013-21	2013-21	2010-15	2009-14
Gearing	60%	32%	32%	30%	65%	55%/60%	62.5%	65%	57.5%	
Pre-tax cost of debt	3.6%	3.0%	3.0%	3.0%	3.4%	2.92%	2.92%	2.92%	3.6%	
Risk-free rate	1.75%	1.4%	1.4%	1.5%	2%	2%	2%	2%	2%	
Equity risk premium	5.25%	5%	5%	5%	5.25%	5.25%	5.25%	5.25%	5.4%	
Equity beta (number)	1.35	0.90	1.13	0.76	0.9	0.9-0.95	0.9-0.95	0.9-0.95	0.9	
Post-tax cost of equity	8.8%	5.8%	7.0%	5.3%	6.7%	7%	6.8%	6.7%	7.1%	
Real vanilla WACC	5.7%	4.9%	5.7%	4.6%	4.7%	4.55 - 4.8%	4.4%	4.2%	5.1%	4.75%

Source: CAA analysis

[95] Ofcom sets a nominal cost of capital.

[96] This is Ofcom's current view (February 2013) on the appropriate WACC for Local Loop Unbundling and WLA. It might differ from its most recent decision.

[97] This is Ofcom's current view (February 2013) on the appropriate WACC for Wholesale Broadband access and Lease Lines Charge Control.

10.106 The CAA has reviewed recent decisions of UK economic regulators (figure 10.2)

10.107 Estimates for the point estimate pre-tax cost of debt range from 2.92% to 3.6%, noting that the more recent determinations are towards the low end of this range. This compares to 3.2% for Oxera, 2.5% to 3% for CEPA and 2.35% to 3.05% for PwC.

10.108 Estimates for market returns range from 6.4% to 7.25%. This compares to 7.25% for Oxera, 6.5% - 6.75% for CEPA and 6.2% - 6.75% for PwC.

10.109 Due to differences in the treatment of tax in the price cap design across regulators a vanilla WACC has been presented. A vanilla WACC is the pre-tax cost of debt and the post tax cost of equity.

10.110 A vanilla WACC for Oxera, CEPA, ACC and PwC would result in a WACC of 5.77%, 3.9% to 4.7%, 3.45% and 3.8% to 5.2%, respectively. This compares to the Q5 decision of 5.3%.

Discussion of the key issues (II): estimating WACC

Total market returns

10.111 Although there are differences between PwC, Oxera and CEPA's estimates for the risk-free rate and ERP, these are reduced when the total market return is considered (risk-free rate plus the ERP) on the whole are offsetting. PwC's estimate, at the top of its range is 6.75% (= 0.75% + 6%) while Oxera's estimate is 7.25% (= 1.75% + 5.5%) and CEPA's estimate at the top of its range is 6.75% (= 1.75% + 5%). The difference in the market return is slightly eroded when an equity beta greater than one is used to produce the cost of equity. Consistent with the CC's Q5 recommendations and the CAA's Q5 decision and NATS (En Route) plc (NERL) CP3 (RP1) decision, market return in the region of 6% to 7% appears appropriate.

Risk

10.112 Oxera set out several risk factors to which it thought Gatwick was exposed. These were increased competitive pressures (following splitting up BAA and from European airports), increased volatility of passenger numbers and an underperformance of passenger numbers compared to the Q5 determination.

10.113 The CAA concurs that volume risk is one of the main systematic risks facing GAL, although this is, in part, dampened by airlines cutting yields in the short run and by the CAA re-setting the price cap every five years or so. Furthermore, management can take action which means that the volatility of returns is less than the raw volatility of passenger numbers.

10.114 Oxera presented data that suggested Gatwick's volatility had increased in Q5 compared to Q4.[98] The CAA notes that in the sample of airports for which Oxera calculated the data, Stansted showed a decrease volatility, Birmingham was the same volatility and the other airports (Edinburgh, Glasgow, Heathrow, Luton and Manchester) all showed increased volatility but by very different amounts. This suggests to the CAA that the increase in volatility that Oxera has observed may be due to non-systematic factors. In addition, the CAA notes that CEPA's analysis of Gatwick's passenger volatility may be due to non-systematic factors such as ash, snow, new 'open skies' agreement. While Oxera assume that the increased volatility is in part systematic and non-systematic (in the same proportions as assumed in the Q5 decision), the CAA is concerned that Oxera's assumption might overstate GAL's risk for Q6.

10.115 The CAA notes that it is important to differentiate between systematic risk and non-systematic risk.[99] Only systematic risk should be considered in a CAPM framework and non-systematic risk can be taken into account in the gearing and cost of debt assumptions. The risks that Oxera raised (competition and forecasting accuracy) would appear to be non-systematic in nature. While such risks might exist and might have increased, it is not appropriate to incorporate them in the CAPM framework, but rather through the gearing assumption in the WACC.

10.116 The CAA notes that there have been other events in Q5 which are

[98] In the form of the standard deviation of the percentage change in year-on-year passenger numbers.

[99] Systematic risk is the risk inherent to the entire market. It is also known as un-diversifiable risk or market risk and is unavoidable. A well diversified investor can avoid non-systematic (or idiosyncratic) risk and, therefore, when considering the risk of an investment is only concerned with the investments exposure to systematic risk.

non-systematic in nature: air passenger duty (APD) which was increased in November 2010 (£12 for short-haul and £170 for long-haul passengers), volcanic ash in April 2010 and BA cabin crew strikes. The CAA suggests that these stressful economic conditions in Q5 reveal the resilience of the airport and its low business risk.

10.117 Credit rating agencies note the strength of GAL's business, although also note its exposure to the leisure market. For example Standard and Poor’s (S&P) noted 'Our view of [GAL's] business profile remains "strong"--reflecting the U.K.'s supportive regulatory regime, the quality of Gatwick's catchment area, and diversified revenue streams in terms of destinations and airlines. These factors are partially offset, firstly by Gatwick's exposure to the potentially volatile U.K. leisure market, as its passengers are mainly point-to-point passengers--meaning that the airlines operating out of Gatwick cannot offset declining local demand through transfer passengers. Secondly, in our view, there is a potential increase in competition if Stansted is sold by BAA.'[100]

10.118 The CAA draws two conclusions from this analysis. First that GAL’s exposure to systematic risk does not appear to have materially changed during Q5. Second that GAL appears to be resilient to the systematic and non-systemic risks that its business has faced over Q5, despite the financial risks created by its actual gearing. As noted below since the disposal by BAA, GAL and its owners have been able to raise significant debt and sell two minority equity stakes.

Beta[101]

10.119 PwC estimated that GAL’s asset beta is unchanged from the Q5 determination (0.46 to 0.58). Oxera estimated the range to be 0.60 to 0.65 from a review of the underlying risk of the airport operator.

10.120 The CAA notes the lack of available direct recent market evidence as to GAL’s beta. There are various indirect methods including proxies such as the performance of other airport operators and GAL’s actual experience in the market (sale of equity stakes and its ability to raise debt). The latter analysis is best suited to assessing the cost of capital rather than a point estimate of the beta, and is discussed

[100] S&P, 20 January 2012, *Ratings Assigned In Gatwick Funding Corporate Securitization Series 2012/1 and 2012/2*.

[101] The equity beta represents how risky the equity of GAL is in relation to the market generally. The asset beta adjusts the equity beta to the effects of financial gearing.

below.

10.121 Whilst the airport comparators show a mixed performance since the Q5 decision, the top end of the range of PwC's estimate of GAL's asset beta (0.58) is well within the range of comparators and, given the strong demand and capacity constraints at the airport, is consistent with the relative risk.

10.122 As noted above, Oxera estimated GAL's Q6 beta by estimating the increase in risk since the last regulatory decision. Using this method it estimated that GAL's asset beta was in the range 0.6 to 0.65, some 30% higher than Q5. The CAA notes that Oxera's estimate for Sydney[102] was 0.55 and the average beta of its comparator airports is 0.58, which is the same as the top of PwC's range.

10.123 The CAA also notes that other regulated company equity betas have shown a general pattern of decline over the past few years. For example CEPA's analysis showed that recent estimates of equity betas for National Grid, SSE, United Utilities Severn Trent and Pennon all show lower 1 year equity betas than 5 year equity betas. CEPA estimates that the betas for these companies range from 0.5 to 1.0 at 60% gearing.

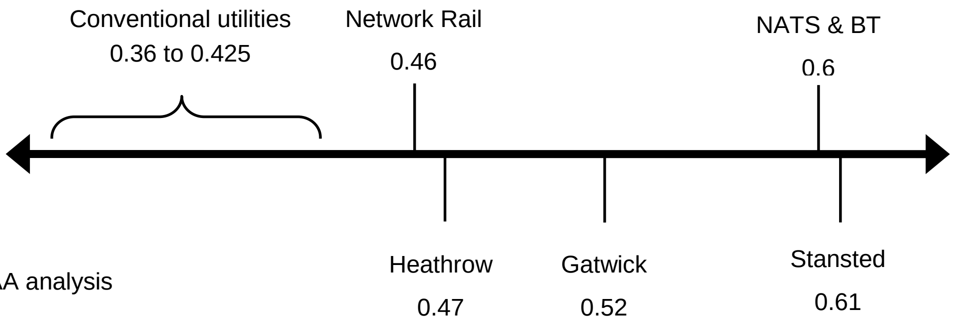
10.124 Finally, the CAA notes that the market equity beta (i.e. the average of all assets) is 1 at the market level of gearing of approximately 30% this equates to an asset beta of 0.7.

10.125 The CAA concludes that the available evidence supports PwC's view that there has been no material change in GAL's beta since the Q5 determination, and the estimate of 0.46 to 0.58 is appropriate for its asset beta in Q6.

10.126 Figure 10.3 compares this judgement to the assessments made of asset betas in other periodic reviews carried out since 2007.

[102] Like Gatwick Sydney has one runway, but slightly fewer passengers and is Australia's hub airport.

Figure 10.3 Diagrammatic presentation of recent regulatory decisions and CAA's Q6 proposals



Source CAA analysis

10.127 This picture, which is very similar to an equivalent chart that can be found within the CC's Q5 recommendations, looks to contain a logical hierarchy of risk. The CAA takes this to be a useful corroboration of its assessment.

Cost of equity

10.128 To convert the post-tax cost of equity into a pre-tax cost of equity PwC used an average tax rate (20.2%) reflecting the 2013 Budget while GAL and CEPA used the expected tax rate announced by the Chancellor in the 2012 Budget (21%).

10.129 The CAA notes that, while there will always be uncertainty with respect to future tax rates, the Chancellor has reduced the corporation tax rate in line with, or by more, than he has previously signalled. The CAA will review the appropriate tax rate in line with any further information released by the government in the run up to setting final proposals. The CAA will consider the appropriateness of an adjustment mechanism if warranted by short-term uncertainty at the time of its decision.

Cost of debt

10.130 PwC recommended the cost of debt was in the range of 2.35 to 3.05% while Gatwick suggested 3.2%. The Q5 decision was 3.55%.

10.131 The CAA notes from PwC's report the clear, but gradual reduction in yields on benchmark bonds since the financial crisis of 2009 and the spot rate and 6 month average is now in the region of 4 to 5% for A and BBB (nominal rates, i.e. including the allowance for inflation).

Yields on debt issued to fund HAL and GAL has been slightly higher and generally in the range 4% to 6%, while utility issued debt is slightly cheaper and in the range 3.4% to 5%. Focusing on the top of the range and blending the estimates to reflect the average cost of debt for a notional portfolio built up over a period of time, PwC's estimate of a real cost of debt of 2.35% to 3.05% (after deducting inflation of 2.8% and including fees of 0.20%) appears appropriate for the CAA's initial projections. This is similar to Oxera's estimate of 3.2%.

10.132 PwC noted that GAL has already secured most of its financing needs for Q6. The CAA considers that it would not be appropriate to include GAL's actual cost of debt (3.2%) in the WACC because, consistent with Q5 and other regulatory sectors, the CAA is setting the WACC for a notionally financed company. To include actual cost of debt would substantially remove the incentive for the airport operator to finance itself efficiently and would pass financing risk to users. The CAA notes that the change of ownership occurred during the CC's market investigation (and before the CC required the divestment). The finance used to acquire Gatwick has since been replaced by bonds. The CAA considers that the timing and nature of GAL's current financing was within the control of management and that there is no justification for the CAA to depart from regulatory best practice by including actual cost of debt within the WACC. In some periods the cost of debt for the notional company may be higher than the airport operator's actual cost and in other periods it may be lower. The CAA concludes that it is appropriate to take a consistent approach and apply the cost of debt for the notional company.

10.133 PwC considered that fees of 20 bps were appropriate to include in the cost of debt, Oxera used an estimate of 15 bps. PwC's estimate for GAL (20 bps) was 5 bps higher than its estimate for HAL (15 bps) to reflect the smaller issuance size blocks for GAL. Other regulatory decisions where fees have been explicitly stated include Bristol Water (CC, 10 bps), STAL Q5 (CAA/CC 10 bps) HAL and GAL Q5 (CAA/CC 15 bps) and Northern Ireland Utility Regulator (15 bps).

10.134 The CAA considers that it is being consistent in its approach - it is not allowing for GAL's actual cost of debt, but it is including an allowance for fees for raising debt finance in Q6.

10.135 The CAA is concerned that if it sets a cost of debt above PwC's range of 2.35% to 3.05%, the airport operator will have the opportunity of a significant gain if it took the opportunity to re-finance.

10.136 Figure 10.4 compares the CAA's overall cost of debt calculation to estimates made in other recent periodic reviews.

Figure 10.4: Regulator determinations since 2008

Regulator, sector	Date	Allowed cost of debt (%)
CAA, GAL	2008	3.55
Ofwat, water and sewerage	2009	3.6
Ofgem, electricity distribution networks	2009	3.6
CAA, NATS	2010	3.6
Ofcom, Openreach	2011	3.4
Ofgem, energy networks	2012	2.9
Ofcom, Openreach	2013	3.0
CAA, GAL	2013	2.35 - 3.05

Source: CAA analysis

10.137 The table shows that the CAA's judgement in the initial projections is consistent with the overall trend in regulatory decisions during recent years.

Gearing

10.138 Assumptions about gearing affect the weightings of the cost of debt and cost of equity components of the WACC. They are also important inputs to the calculation of the cost of debt and cost of equity themselves—all other things being equal, a higher level of gearing will increase the risk to both debt and equity holders, causing them to demand a higher return in exchange for making capital available.

10.139 Consistent with other sectoral regulators, the CC recommended and the CAA set the airport operators' Q5 cost of capital in line with notional levels of gearing consistent with maintaining a solid investment-grade credit rating.

10.140 The CAA, and other regulators, considers that a notional, rather than actual, capital structure is an appropriate assumption. The company is best placed to take decisions about what is the appropriate financing structure because it takes the benefits and bears the costs of those decisions.

10.141 Whilst less complex than HAL, GAL's actual capital structure incorporates many of the same features including charges (security) over the assets and financial ratio covenants.

10.142 Both PwC and Oxera thought gearing of 55% was the appropriate assumption for Q6. At 30 September 2012 GAL had gearing of 60% and a BBB+ credit rating, although a credit rating report[103] noted GAL's long-term financial objective of increasing the ratio of net debt to the value of its RAB to around 65% from its current level of 60%. Furthermore Fitch noted "that the current rating [BBB+] should be sustainable if the regulatory asset ratio is increased to the 70% trigger covenant level".[104] This suggests that gearing for a solid investment grade rating in a covenanted, secured debt structure is in the region of 65 -70%,[105] although 70% appears somewhat high as it is the same the trigger covenant level.

10.143 The CAA has considered whether the 60% gearing assumption for the Q5 WACC remained appropriate for Q6 and whether the CAA should consider credit enhancements such as security or a structure with different tranches of debt in its notional capital structure.

10.144 In considering these issues, the CAA has had to consider both the consequences of setting a figure too low and too high. On the one hand, using an unrealistically low gearing figure would result in higher price caps than are necessary and benefit shareholders at the expense of users. This suggests that the gearing assumption for GAL should be no lower than 50% if the benefits of financial efficiency and innovation pass through to users.

10.145 On the other hand, an overly aggressive assumed gearing figure might leave GAL with returns and cash flows that are too low to support the notional level of gearing. This makes it imperative that the price control package as a whole is financeable. In performing the CAA's duties the CAA must have regard to the need to secure that the licence holder is able to finance its provision of airport operation services in the area for which the licence is granted.

10.146 The work that the CAA has carried out in this regard, described in

[103] 22 January 2013.

[104] Fitch, 7 February 2012.

[105] This compares to approximately 70 to 75% for HAL.

chapter 11, suggests that the CAA ought to be quite cautious about assuming that the airport operators could sustain gearing higher than 60% while maintaining a solid investment-grade credit rating. Overall, the CAA's judgement is that the WACC calculations should be based on a gearing figure of 55%. While this is lower, and may well turn out to be lower over Q6, than the debt-to-RAB ratio that GAL is able to achieve the CAA nevertheless considers the choice of a relatively conservative figure to be prudent given the uncertainties that surround the rating process and is a step towards ensuring that if the airport operator maintains the assumed gearing it will find the package of price control recommendations to be financeable.[106]

10.147 Furthermore, unlike the CAPM, the gearing assumption does take into account non-systematic risks. And although some of the risks presented by GAL in respect of the cost of equity are non-systematic, (such as increased competition) the CAA considers that a prudent gearing assumption will enable the airport operator to continue to be resilient to the shocks of the nature that GAL and Oxera have suggested that GAL faces.

10.148 The CAA's view that gearing of 55% is appropriate for GAL and compares to its current views on HAL (60%) and STAL (50%), Ofgem's recent decisions (55% to 65%) and Ofwat 2009: (57.5%). It is, however higher than telecoms (wholesale broadband access: 50% and mobile call termination: 30%), but the CAA considers that this is consistent with the risk differential between the sectors.

Setting the WACC for the CAA's initial projections

10.149 PwC estimated that the cost of capital was in the range of 4.48 to 6.05%. The ACC in its Q6 position paper used 4.2%, both of which are below the Q5 cost of capital of 6.5%. GAL estimated the cost of capital to be 7.1%.

10.150 Had PwC's average Q6 tax rate (20.2%) been used in the calculation of the Q5 WACC it would have been approximately 0.4% lower at 6.1%, therefore all other things being equal, one would expect a

[106] The CAA has considered the financeability of the notionally financed airport operator and not GAL's and/or related financing companies' actual current or planned financing.

reduction in the WACC.

10.151 The CAA has examined the sale of equity stakes in GAL's parent company. While it is not possible to precisely estimate the value of GAL from this (and therefore the cost of capital) PwC's estimates suggest that the value in excess of the RAB at the time is in the region of -7% to +4%. CEPA estimated Global Infrastructure Partners paid a modest premium to the RAB once the pension commutation had been taken into account, and that this may have been 'unexpected' given the environment in which GAL was sold.

10.152 The CAA would expect a small premium to the RAB to reflect GAL's incentive to outperform the price control assumptions. This information suggests that the Q5 cost of capital allowance[107] (once adjusted for the reduction in corporate tax) is broadly correct. This evidence is informative, but given the difficulty with estimating, the CAA is cautious of an overly formulaic approach to its interpretation.

10.153 The CAA notes that the new licensing framework enables the CAA to revisit the settlement within the period if traffic assumptions prove significantly out of line with the forecast. The CAA also notes its proposals in relation to capital efficiency (see chapter 15) may have the net effect of reducing some risks borne by GAL's shareholders.

10.154 Given the uncertainties in WACC estimates, the CAA considered the cost of setting an allowed WACC that was too high or too low. If the WACC is set too high then GAL's shareholders may be over-rewarded (but not significantly so if it remains in the plausible range) and users may pay more than they should. If the WACC is set too low, there may be underinvestment from GAL or potentially costly financial distress.

10.155 Given the significance to customers of timely investment at Gatwick, the CAA has given particular weight to the cost of setting the allowed WACC too low. The CAA considers that it is in the interests of future passengers that GAL carries through its Q6 investment programme, a large share of which is essential asset renewals and maintenance.

10.156 Moreover, it is difficult for a regulator to reduce the risks of underinvestment within a regulatory period; it is equally difficult to

[107] Approximately 5.8%, being the Q5 ARR (i.e. the rate actually applied to the RAB in the price cap) (6.3%) minus the effect of tax (0.47%).

redress within the period a price cap which is higher than it should otherwise be. The CAA notes that, compared to the AA86, the Act makes it relatively easier to re-open price cap decisions, although the CAA would not do so lightly.

10.157 As noted earlier, returns can be reinvested during the course of each year, thereby themselves generating an additional return by the end of the year. This suggests that, to earn the WACC, the actual rate to be applied to the RAB is approximately 10 bps to 16 bps lower. In Q5 the CAA applied the ARR to the RAB. In Q6 the CAA is proposing to apply the WACC to the RAB, but to take into account the concept of the ARR in selecting a point in the WACC range.

10.158 Taking all these factors into account, the CAA's initial projections for the GAL WACC are that it should be towards, but not at, the top of PwC's recommended range. The CAA's proposed WACC is 5.65% pre-tax real and this represents the 75th percentile of PwC's range and 40 bps from the upper end of its range. This position in the range is very similar to the CC's Q5 recommendations and the CAA's decision on the rate which is applied to the RAB which equated to the 75th percentile in the range and was 47 bps from the top of the range. The CAA has reviewed recent regulatory decisions and notes that point estimates were between the 50th and 100th percentile of the range from which they were chosen.

10.159 Although the CAA does not accept Oxera's arguments about a higher cost of equity and cost of debt, it notes that this cautious approach to adopting a point estimate in the range should cover a reasonable range of uncertainty on these two issues.

10.160 The CAA has compared its initial projections for WACC with the Q5 decision, by comparing the tops of the ranges, see figure 10.5. This shows that compared to Q5, if the effect of reduced tax rates is set aside, the CAA has basically lowered the WACC by 27 bps to reflect a lower cost of debt. Although it has not quantified the impact on WACC, the CAA notes that its ability to revisit the price control within period of traffic is a significant variance to be forecast would, other things being equal, lower risk and hence the WACC.

Figure 10.5 Comparison of Q5 decision and Q6 initial projections

	%
Q5 WACC decision	**6.50**
Reduction in Corporation Tax	(0.47)
Reduction in gearing	0.03
Reduction in the cost of debt	(0.27)
Net change in the market return and its mix	-
Other adjustments[108]	(0.13)
Q6 initial projections	**5.65**

Source CAA analysis

10.161 The CAA will continue to monitor all aspects of the cost of capital before developing its proposals in October 2013.

10.162 The vanilla WACC is a useful way of comparing across sectors (if the tax treatment differs) and across time (when the tax rate differs). The CAA's initial proposals equate to a vanilla WACC of slightly less than 4.85% for GAL. Compared to recent regulatory decisions this is:

- generally higher (c10 bps to 60 bps) than ORR (for Network Rail), Ofgem (for energy transmission and distribution) and Ofcom (its current view on BT Openreach and its MCT decision) ;
- very slightly lower (c25 bps) than Ofwat for the water companies, although it is noted that the last water determination was in 2009; and
- lower (c90 bps) than Ofcom's current view on 'the rest of BT'.

10.163 The CAA will keep under review proposals and decisions of other regulators including the CC before making is final proposals.

CAA's initial projections

10.164 The CAA has applied a rate of 5.65% to a simple average of GAL's opening and closing RAB. The resulting contribution towards the calculation of price caps is in the region of £135 million to £140 million

108 This includes the adjustment for an ARR referred to in paragraph 10.157.

per year (figure 10.6).

Figure 10.6: Cost of capital charge included within the RAB-based price cap

£m (2011/12 prices)	2014 /15	2015 /16	2016 /17	2017 /18	2018 /19	*5 yr total*	2019 /20	2020 /21	*7 yr total*
Average RAB	2,382	2,416	2,452	2,473	2,461	n/a	2,455	2,500	n/a
Cost of capital	135	137	139	140	139	688	139	141	968

Source: CAA analysis

CHAPTER 11

A fair price

11.1 Part B provides the CAA's assessment of a fair price, which is used in the assessment of the form of regulation set out in Part C, and for the CAA's initial proposals, which are set out in Part D.

11.2 This chapter summarises the CAA's initial projections with respect to financial modelling at Gatwick and on the financeability issues. This chapter brings together the RAB-based ‘building block’ components, which have been discussed in the previous chapters, and sets out the CAA’s initial proposal on what would be a fair price in terms of the maximum level of airport charges for GAL for the five year Q6 period, and the seven year period covered by GAL's commitment proposals.

CAA’s view of a fair price

11.3 The CAA’s view of a fair price, in terms of the maximum level of airport charges, is based on a RAB-based 'building block' approach. The main assumptions in its financial modelling for each of the ‘building blocks’ relevant to its recommendation of the appropriate maximum level of airport charges in Q6 were as follows (all figures at 2011/12 prices, unless otherwise stated):

11.4 Figure 11.1 sets out the CAA’s initial projections for the calculation of the RAB and associated depreciation and WACC charge.

Figure 11.1: CAA's initial projections for the RAB

£m (2011/12 prices)	2014 /15	2015 /16	2016 /17	2017 /18	2018 /19	5 yr total	2019 /20	2020 /21	7 yr total
Opening RAB	2,370	2,394	2,438	2,467	2,479	2,370	2,443	2,466	2,370
Net capex	167	193	176	149	110	794	176	228	1,198
Depn	(142)	(149)	(147)	(136)	(146)	(721)	(152)	(161)	(1,034)
Closing RAB	2,394	2,438	2,467	2,479	2,443	2,443	2,466	2,534	2,534
Average RAB	2,382	2,416	2,452	2,473	2,461	n/a	2,455	2,500	n/a
Cost of capital	135	137	139	140	139	688	139	141	968

Source: CAA calculations

11.5 Figure 11.2 includes the depreciation and WACC charges alongside all the other building blocks required to calculate a fair price.

Figure 11.2 Components of the RAB-based calculation

£m (2011/12 prices)	2014 /15	2015 /16	2016 /17	2017 /18	2018 /19	*5 yr total*	2019 /20	2020 /21	*7 yr total*
Opex	283	280	277	274	271	1385	271	272	1,928
Depreciation	142	149	147	136	146	721	152	161	1,034
Cost of capital	135	137	139	140	139	688	139	141	968
Total revenue requirement	560	566	562	550	556	2794	562	574	3930
Other revenues	(242)	(240)	(251)	(257)	(267)	(1,257)	(271)	(273)	(1,800)
Net revenue requirement	318	326	311	293	289	1,537	291	301	2,130
Passengers	35.0	35.5	36.1	36.8	37.6	180.9	38.5	39.3	258.6
Yield per pax (unprofiled) £	9.09	9.19	8.63	7.96	7.69	n/a	7.57	7.67	n/a

Source: CAA calculations

11.6 In previous price control reviews the CAA has smoothed the yield per passenger to avoid unnecessary fluctuations and to simplify the price control. Such smoothing or profiling is done in a NPV-neutral manner, i.e. the NPV of the net revenue requirement is the same under both unprofiled and profiled prices.

11.7 The CAA is aware that a significant difference between the profiled and unprofiled prices can lead to a short-term mismatch between revenues and costs and thus create liquidity issues for GAL. These issues can have implications for the financeability assessment.

11.8 If the resulting yield per passenger is smoothed across a five year Q6 period, it equates to a price change of no more than RPI+1.0%[109] per year, see figure 11.3. This compares to GAL's Business Plan of RPI+6.9%. Under the CAA's initial projections a fair price (in 2011/12 price base) is expected to be £8.68 per passenger in 2018/19 which is £2.89 (or 25%) lower than using GAL's projections.[110]

11.9 If the initial projections are extended to 7 years, the price change is no more than RPI+0.0% per year, see figure 11.3. This is below GAL's commitment proposal of RPI +4% per year.

Figure 11.3: Profiled and unprofiled prices for Q6

£ (2011/12 prices)	**2013 /14**	**2014 /15**	**2015 /16**	**2016 /17**	**2017 /18**	**2018 /19**	**2019 /20**	**2020 /21**
Yield per pax (unprofiled)	8.31	9.09	9.19	8.63	7.96	7.69	7.57	7.67
Year on year change	n/a	9.42%	1.11%	-6.07%	-7.72%	-3.39%	-1.61%	1.38%
5 year smoothed price cap (RPI+1.0%)								
Yield per pax (profiled)	8.31	8.41	8.50	8.55	8.60	8.68	n/a	n/a
Year on year change	n/a	1.24%	1.04%	0.60%	0.59%	0.98%	n/a	n/a
7 year smoothed price cap (RPI+0.0%)								

[109] In the formula RPI±X, RPI is the change in the index and can be negative or positive.

[110] The CAA notes that GAL included a P0 adjustment in its RBP, which would reduce the difference at the end of the period but increase it at the start of the period.

£ (2011/12 prices)	2013 /14	2014 /15	2015 /16	2016 /17	2017 /18	2018 /19	2019 /20	2020 /21
Yield per pax (profiled)	8.31	8.33	8.34	8.31	8.28	8.28	8.28	8.28
Year on year change	n/a	0.29%	0.09%	-0.35%	-0.36%	0.03%	0.03%	0.03%

Source: CAA calculations

Note: The CAA has used the inflation forecast from Oxford Economics and assumed a long-run inflation rate of 3%.

11.10 The X in the formula RPI±X is not the same as the year-on-year change in the real price cap for two reasons.

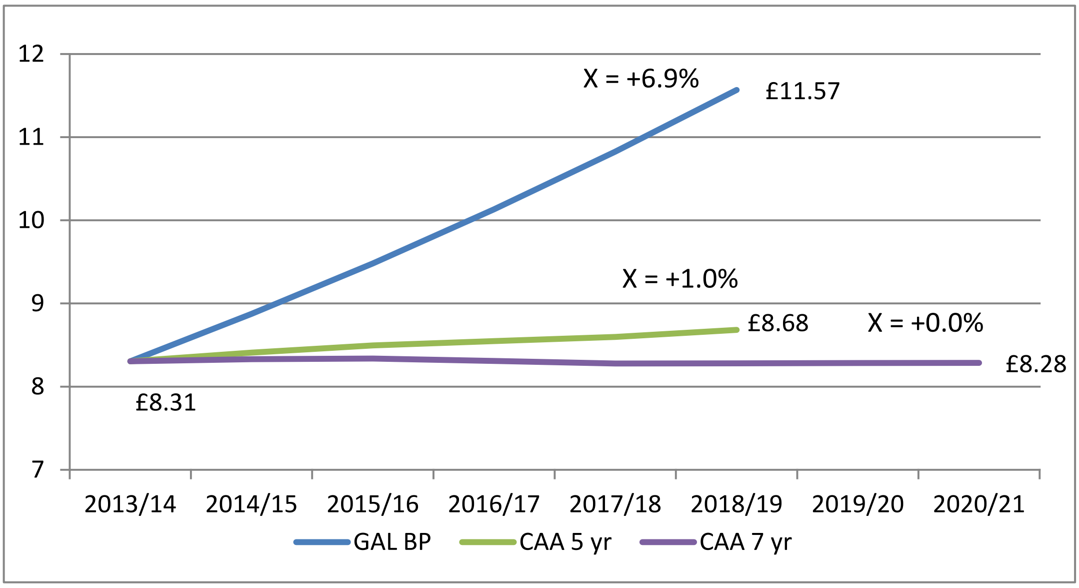
- In simple terms the price cap formulae in previous years has been $P_2 = P_1.(\Delta RPI+X+1)$, where P_1 is the price in year 1, P_2 is the price in year 2, ΔRPI is the change in the value of the retail prices index and X captures the 'change'. However, this formula, where X is a constant, does not give a smooth year-on-year change in real prices. A constant change in real prices is $P_2 = P_1.(1+\Delta RPI).(1+Y)$, where Y is the constant change. It can be seen that, for the same change in prices X and Y are related but not equal.[111] This means that if the formula $P_2 = P_1.(\Delta RPI+X+1)$ is used and X is to be the same in each year of the quinquennium, then the annual year-on-year change in real prices will not necessary equal X and furthermore will be different in each year. However, the average year-on-year change (Y) will approximate to X.
- The RPI used in the price cap formula is the index as at 31 August each year, while our modelling uses average index for the year ending/ended 31 March each year. So, if forecast inflation based on these slightly different time periods is different, then even using $P_2 = P_1.(1+\Delta RPI_{AUG}).(1+Y)$ will give a price change in real prices (year ending/ended 31 March) which is not equal to Y.

11.11 In this document, where an X has been quoted, it is the X to be used in a RPI+X formula, and is a constant value over the quinquennium. The CAA has also presented a price profile in which the year-on-year change in real prices is constant. The profiles give the same expected net present value of the revenue requirement (at the

[111] X=Y where ΔRPI = 0, ΔRPI = ∞, or $P_2 = P_1.(\Delta RPI+1)$

regulatory WACC), and the airport operator is not expected to gain or lose from the CAA's choice of profile.

Figure 11.4: Yield per passenger (smoothed)

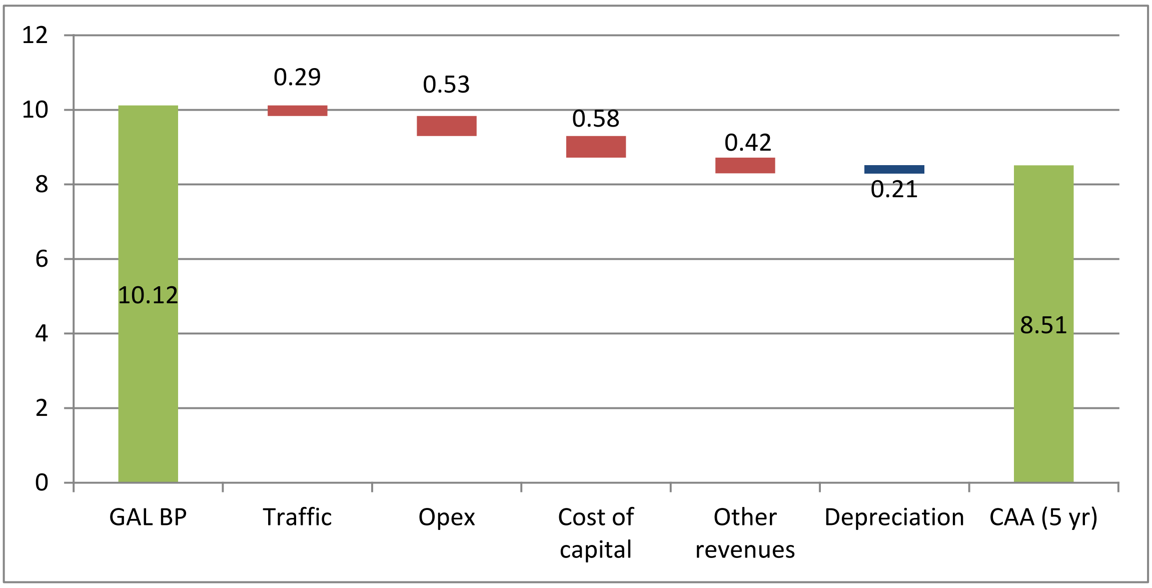


Source: CAA

11.12 Figure 11.5 shows how the CAA's initial projections compare to GAL's view of a RAB-based price cap by comparing a simple average of the yield in each of the five years. This shows that the main differences in the resulting price profiles arise from different assumptions for:

- traffic (the CAA's forecast is 5.4 million (or 3.1%) higher than GAL's over Q6);
- opex (the CAA's forecast is £97 million or 6.5% lower than GAL's);
- other revenues (the CAA's forecast is £76 million (or 6.5% higher than GAL's); and
- the WACC (the CAA has calculated that the WACC should be 5.65%, while GAL in its modelling has used 6.5%); being partially offset by
- depreciation. As noted in GAL's RBP, section 12.2, GAL moved some depreciation due in Q6 into Q7, while the CAA's initial projections include depreciation in the period to which it relates.

Figure 11.5: Average yield GAL compared to CAA



Source: CAA

P_0 adjustments

11.13 The CAA notes that GAL has floated the idea of increasing prices sharply in year 1 of Q6 and then keeping prices relatively flat throughout the period. The CAA's profiled price caps show a modest RPI adjustment. If the CAA were to use a P_0 adjustment, it would result in a large increase in price in the first year and a sharp decrease in price in the following years. The CAA does not consider such price profiling appropriate.

Financeability

Discussion of the key issues (II) - financeability

11.14 In addition to proposing maximum levels of airport charges, the CAA has assessed the financeability of its initial projections for Q6. The CAA has a duty to have regard to the need to ensure that licence holders such as GAL can finance their provision of airport operation services when it comes to the exercise of the CAA's functions such as setting price caps. This cannot override the CAA's primary duty. However, the CAA considers that the setting of a price control condition that is aligned with an efficient operator being able to finance its business is consistent and not in conflict, with present and future passengers' interests.

11.15 The CAA therefore considers it appropriate to establish whether the Q6 initial projections would enable an efficient GAL to finance its operations including the capex programme in Q6 on reasonable terms in the banking and capital markets through some combination of debt and equity.

Maintaining solid investment grade credit

11.16 A key assumption in determining the appropriate level of gearing in the CAA's estimation of the WACC is that GAL should be able to obtain and maintain a solid (sometimes known as 'comfortable') investment grade rating at an assumed gearing level of 55%.

11.17 A solid investment grade rating is interpreted as in the region of BBB/BBB+ (using S&P and Fitch Ratings Limited's terminology) and Baa2/Baa1 (using Moody's Investor Service terminology). This is a couple of 'notches' above the bottom of investment grade of BBB– or Baa3. The aim of the financeability assessment is for GAL to be in a position to absorb reasonable unanticipated downside risk and still retain an investment grade credit rating.

11.18 The CAA has gathered evidence directly from three credit rating agencies; Fitch Ratings Limited, Moody's Investor Service and S&P. In determining a credit rating, an agency typically considers both qualitative evidence (e.g. business risk and corporate governance) and quantitative evidence (e.g. financial risk and credit ratios).

11.19 In forming a view on the business risk of an airport operator, an agency will consider, among other things:

a) the competitive position of the airport compared with airports owned by competitors, which in turn may include:

   i) location (catchment area, local transport links); and

   ii) customer airlines and the passenger mix, (hub airlines, alliances, destinations of those airlines);

b) the regulatory regime, and in particular the rigour and predictability of the regime;

c) the diversity of the airports owned or operated by the company[112]; and

d) charges (for example landing, passenger and security charges).

11.20 GAL would appear to have a stable position from a credit perspective. Gatwick is the world's busiest single runway airport and the second busiest airport in the UK. It has an attractive catchment area, convenient transport links and diversified revenue streams in terms of destinations and airlines. On the other hand, GAL is exposed to the prospect of continued sluggishness in the UK economy and the potentially volatile UK leisure market.

11.21 The Act, and indeed the CAA's initial projections for Q6, do not propose fundamental changes to the form of regulation for GAL. Hence neither can be expected to weaken the credit strength of GAL. If anything, the ability of a licensing regime to revisit the price control if key assumptions such as traffic are significantly at odds with the forecast, is a possible credit strength.

11.22 One of the key assumptions of the CAA's financeability assessment is that the CAA's price review will not affect GAL's business risk; therefore, the CAA assumes that the regulatory risk of GAL is unchanged from credit rating agencies' current views. However, the CAA recognises that the proposed building blocks of the price cap could affect the financial risk of GAL.

11.23 In forming a view on the financial risk of a business it is rating, an agency may consider matters such as:

a) historical and forecast financial performance, including:

i) cash flow and profitability;

ii) revenue diversity and stability;

iii) liquidity and financial flexibility;

iv) capital structure of the company (including gearing);

[112] The CAA considers the airports on a standalone basis, so while this factor might be important for the credit rating agencies, the CAA's analysis ignores other airports in the same corporate group of companies.

v) covenants and security including securitisation; and

b) financial policy and strategy of management (including merger & acquisition activity, dividend policy, etc).

11.24 The rating agencies place different emphasis on the various ratios. Some of the agencies also differ in their benchmarks (e.g. the value the ratio needs to be for a certain credit rating).

CAA analysis of credit ratios

11.25 The CAA has considered whether the forecast performance of GAL under the CAA's Q6 initial projections is consistent with a solid investment grade based on assumed gearing of 55% and considered six ratios used by the various agencies.[113]

a) interest cover[114];

b) funds from operations (FFO[115]) interest cover[116];

c) post-maintenance interest cover ratio (PMICR)[117];

d) adjusted interest cover (adjusted ICR[118]);

e) FFO to debt[119]; and

f) regulatory asset ratio (RAR[120] or gearing) (debt divided by RAB).

11.26 The CAA has used a separate section in GAL's financial model, which was created to provide illustrative calculations of the above financial

---

[113] These ratios and some of the terms used in them do not have agreed definitions.

[114] ICR = (EBITDA – tax paid – 2% of total RAB)/interest paid. Nb: the rating agencies using this metric assume that 2% of total RAB is required to maintain the regulatory assets.

[115] FFO= Net income from continuing operations adding back depreciation, amortisation, deferred income taxes and other non-cash items, less any changes to operating components of working capital.

[116] FFO/interest expense = FFO (as above) + gross interest paid on debt/gross interest expense on debt.

[117] PMICR = (EBITDA – corporation tax paid – regulatory depreciation)/interest paid

[118] Adjusted ICR is FFO + interest expense – regulatory depreciation + profiling adjustment divided by interest expense.

[119] FFO/net debt, where FFO is as defined above and net debt = closing RAB x gearing ratio.

[120] RAR = debt less cash and authorised Investments/total RAB.

ratios. These are set out in nominal terms[121] as this tends to be the basis used by rating agencies.

11.27 The CAA has undertaken the analysis on the basis of the notional capital structure consistent with the CAA's cost of capital proposals in chapter 10. This assumes:

a) a constant gearing level of 55%, with the level of dividends being the balancing item used to keep gearing at this level;[122]

b) a nominal cost of debt of 5.7%;

c) index-linked debt making up 35%[123] of the total debt balance; and

d) a cost of index-linked debt of 2.9%.[124]

11.28 The CAA has had to make some additional assumptions and adjustments in order to derive the financial ratios in figure 11.6.

11.29 Based on these results, the CAA considers that a notionally financed and efficient GAL would be likely to achieve and maintain a solid investment grade credit rating.

---

[121] In contrast, the rest of the GAL model used for the price control was specified in real terms.

[122] The CAA relaxed this assumption and after allowing for a modest dividend yield, gearing was in the range of 55% to 56%.

[123] Ofgem assumes 25 per cent of each network company's debt is index-linked. In the Q5 price control review, the CAA assumes that the proportion of index-linked debt is 25 per cent. The CAA has also calculated the actual proportion of GAL's index-linked debt, based on GAL's financial statements. The calculated proportion is approximately 55 per cent. Taking into account all the available evidence, the CAA takes the conservative point of 35 per cent in the range of 25 per cent to 55 per cent.

Ofgem, 17 December 2012, '*RIIO-GD1: Final Proposals - Finance and uncertainty supporting document*', p. 25.

GAL, ' Report and unaudited interim financial statements for the six months ended 30 September 2012', p. 15.

[124] The cost of index-linked debt of 2.9% is consistent with the top of the range of PwC's recommendation (excluding fees). The nominal cost of debt includes inflation of 2.8%.

Figure 11.6: CAA financial ratios for GAL in Q6

Key financial ratios: benchmarks and calculations					
	Benchmark		Calculation by CAA		
Key financial ratios	**Moody's (Baa2[125])**	**Fitch (BBB+)**	**GAL (5 yr Q6)**		
PMICR		1.5 - 1.6	1.8	1.8	1.9
ICR	1.4 -1.6	n/a	3.4	3.2	3.4
RAR - Net debt/RAB	68% - 75%	n/a	55%	55%	55%
Other financial ratios					
FFO interest coverage	2.25-3.0	n/a	3.4	3.3	3.5
FFO to net debt	6-10%	n/a	19%	19%	20%

Source: CAA analysis

11.30 The CAA notes that its ratio analysis suggests that the notionally financed airport operator would meet a solid investment grade credit rating. In addition, the CAA has assessed the ratios for a 7 year period, and conducted analysis by incorporating a variable dividend payout ratio. The CAA considers that its conclusions are not sensitive to changes in the underlying assumptions noted above.

11.31 The CAA has used GAL's financial model to calculate the Q6 price cap proposals and analyse price cap profiling and financeability. GAL's model, including assumptions, logic, internal consistency and formulae has been externally audited.

11.32 The CAA's Q6 price cap calculations have been internally audited. The CAA will undertake an external audit prior to the development of its final proposals.

Model audit

11.33 The CAA has used GAL's financial model to calculate the price cap proposals and analyse price cap profiling and financeability. GAL has

[125] Moody's does not produce ratings for GAL. These ratios are those that the CAA has estimated for HAL. The rating agencies consider GAL's business risk to be slightly higher than HAL, so in order to achieve the same credit rating as HAL, GAL has to perform slightly better on the credit metrics to be slightly riskier than HAL.

stated that the financial model, including assumptions, logic, internal consistency and formulae has been audited. The CAA's price control proposals have been internally audited.

Part C:
Form of regulation

Part C: Form of regulation

The calculation of a fair price is an important benchmark to assist in the evaluation of the form of regulation. The CAA needs to consider a full range of options on the form of regulation before making its initial proposals.

CHAPTER 12

Form of regulation

12.1 The overall model or form of economic regulation for GAL should reflect its market power and the potential for abuse and be designed in a manner that furthers the CAA's duties.

12.2 The current GAL price control is based on RAB-based framework. As an alternative to licence regulation, GAL has put forward proposals for airport commitments. These commitments, which GAL is proposing to include in its Conditions of Use, set out caps on airport charges, a service quality regime and commitments on consultation, investment, and operational and financial resilience.

12.3 This chapter discusses the merits of GAL's proposed commitments and alternative forms of licence regulation that could apply from April 2014 for GAL.

Q6 Policy Update

12.4 The CAA narrowed down the potential options for the regulation of GAL in the Q6 Policy Update.

12.5 The CAA stated that an enhanced RAB-based framework is one option available to the CAA. The CAA noted that this option was supported by the airlines but not GAL. The CAA said it would undertake a RAB-based calculation, not least as this provides a reference comparator and might be required as a fall back position if it proves difficult to establish a suitable default settlement.

12.6 While continuing to calculate a RAB-based comparator, the CAA stated that it was keen to explore credible alternatives. In particular, the CAA noted that there may be benefits from moving away from a 'one size fits all' approach and allowing greater commercially led service differentiation, while providing sufficient protection against SMP. In this regard, the CAA stated that it wished to explore a regulatory default settlement where the price could be set for a minimum level of service, providing GAL an incentive to earn additional income from agreeing contracts with airlines for higher levels of service quality. The CAA noted that the price cap within a regulatory default settlement could be based on a RAB approach or an alternative approach.

12.7 While noting the difficulties it had identified with alternative approaches, the CAA stated that it intended to do more work looking at other options which might inform the setting of any price cap, including using airport comparator index approach. While not explicitly mentioned, the CAA did not rule out setting a price cap based on a LRIC (also sometimes referred to as LRAIC, or long-run average incremental costs) approach, although the CAA highlighted a number of weaknesses with this approach. The CAA also did not rule out price monitoring, although it noted that, taken in isolation, this may be most relevant where there may be increasing competitive pressure which could be broadly relied on to restrain prices.

Stakeholder views

Responses to the Q6 Policy Update

12.8 In response to the Q6 Policy Update, GAL considered it no longer needed formal regulation and put forward a proposal for airport commitments that would provide airlines with an agreed level of service at a capped average price for an initial duration of three years. If regulated, GAL stated that it would support a LRIC approach as this has been used in other regulated sectors or price monitoring as this was similar to its airport commitment proposals, although this would require clear criteria on when to intervene. GAL also welcomed the work on airport charge comparators although it noted that much depended on the validity of the comparator group. GAL stated that the CAA should not calculate a RAB-based price cap as this could distort airlines' behaviour and lead them to support the form of regulation that offered them the lowest price.

12.9 Airlines had some differences in their views. BA supported a continuation of a RAB approach, and Virgin, while open to discussing bilateral contracts, was sceptical that anything other than a RAB approach would be appropriate. easyJet supported a default contract, but considered that other non RAB-based forms of regulation would either be unworkable in an airport context or provide inadequate protection to users. GATCOM stated that the existing price cap was inflexible and costly and lighter touch regulation would be more appropriate involving the agreement of service levels and publication of performance.

Responses to the RBP

12.10 The CAA also sought views from airlines and passenger groups on GAL's RBP and commitment proposals. Views were mixed.

12.11 easyJet stated that it was concerned that GAL's commitment proposals were intended to complicate and confuse the work to regulate GAL. However, it was open to further discussion on the commitments, although it raised concerns around the lack of clarity on the proposals and the unreasonable pricing and other conditions. BA raised concerns that a commitments and bilateral contracts regime would be more costly than licence regulation, and that any additional flexibility could be available under alternative forms of licence regulation.

12.12 BA, Virgin and Thomson Airways highlighted a number of concerns with the enforceability of the commitments, the marginalisation of the CAA and whether the terms in the commitments reflected those that would be attainable in a competitive commercial settlement, for example in terms of the level of the price and coverage of the price cap and the ability to pass through certain elements of costs.

12.13 Monarch welcomed the initiative from GAL to bring forward a alternative to RAB-based regulation, although it raised concerns over the relationship between the commitments and bilateral contracts, how capital investment would relate to individual airline needs and the need for the CAA to play an arbitration role.

12.14 Emirates stated that while they did not consider that Gatwick met the requirements for regulation, deregulation may need to be done in stages and commitments may be a good way of doing this. Emirates highlighted some areas of concern in the commitments in terms of their ability to ensure continuing service quality resilience, the need for the CAA to have a continuing arbitration role and the need for detail on a building block alternative at the end of the commitments period.

12.15 GATCOM stated that the commitments could provide a workable framework, although it considered that the commitments should be amended to: allow service quality standards to be increased during the period; encourage better environmental performance; provide a firm commitment on the outputs to be delivered by the capital plan and require the involvement of GATCOM and Passenger Advisory Group (PAG) in the development and modification of the commitments.

Further documents submitted by GAL

12.16 In March 2013, subsequent to the RBP and commitment proposals, GAL submitted two documents to the CAA:

- regulatory regimes at airports: an international comparison, Oxera, January 2013; and
- sectoral examples of market power, regulation and deregulation and implications for Gatwick airport, London Economics, November 2012.

12.17 Oxera discussed the regulatory regimes at seven international airports, which it considered to be comparable to Gatwick. The regimes varied from price monitoring type arrangements in Auckland and Sydney and price cap regulation, generally based on some form of building block approach, with varying levels of airport-airline negotiation and single/dual till cross subsidy at Brussels, Copenhagen, Dusseldorf, Paris-Orly, Rome-Fiumicino. Oxera suggested that Gatwick was subject to the greatest regulatory constraints while having the greatest potential for passenger and airline substitution. Oxera noted that the assessment was based on a qualitative judgement and did not reflect the outcome of a MPT. The CAA's views on market power at Gatwick are set out in the market power assessment and differ from those of GAL and its consultants. Oxera highlighted the importance of commercial negotiations. The CAA notes that it tried to increase the scope of CE for Q6, although GAL was reticent about providing the level of detail on opex and commercial revenues requested by the airlines. Oxera also noted the move away from single till at some airports. As set out in the beginning of Part B, the CAA is not persuaded about moving to a dual till as it continues to consider that a single till approach is the best approximation to a competitive airport market.

12.18 London Economics highlighted a number of examples of how regulation has taken into account the potential for competition. Test B of the market power assessment has considered the examples cited by London Economics, where reliance has been placed on competition law rather than licence regulation. In addition to these examples London Economics cites the example of the UK telecoms market where Ofcom allowed a relatively lose or precautionary price cap to allow competition to develop over time. The sale of Stansted to Manchester Airports Group (MAG) will mean that all the main London airports are in separate ownership and so one might expect competition between airports to increase. However, unlike telecoms, due to the influence that government has on new airport capacity in the South East of England, the CAA considers that entry by new airports and significant expansion by existing ones is unlikely. Capacity constraints are therefore likely to tighten rather than weaken over the next control period. The CAA also notes that the CC rejected precautionary price caps for STAL when considered as part of the Q5 review due to a lack of potential competitive constraints. Consequently, the CAA considers that, if anything, competition is likely to decrease rather than increase over the next control period. Consequently, the CAA does not consider that precautionary price caps would be appropriate for GAL.

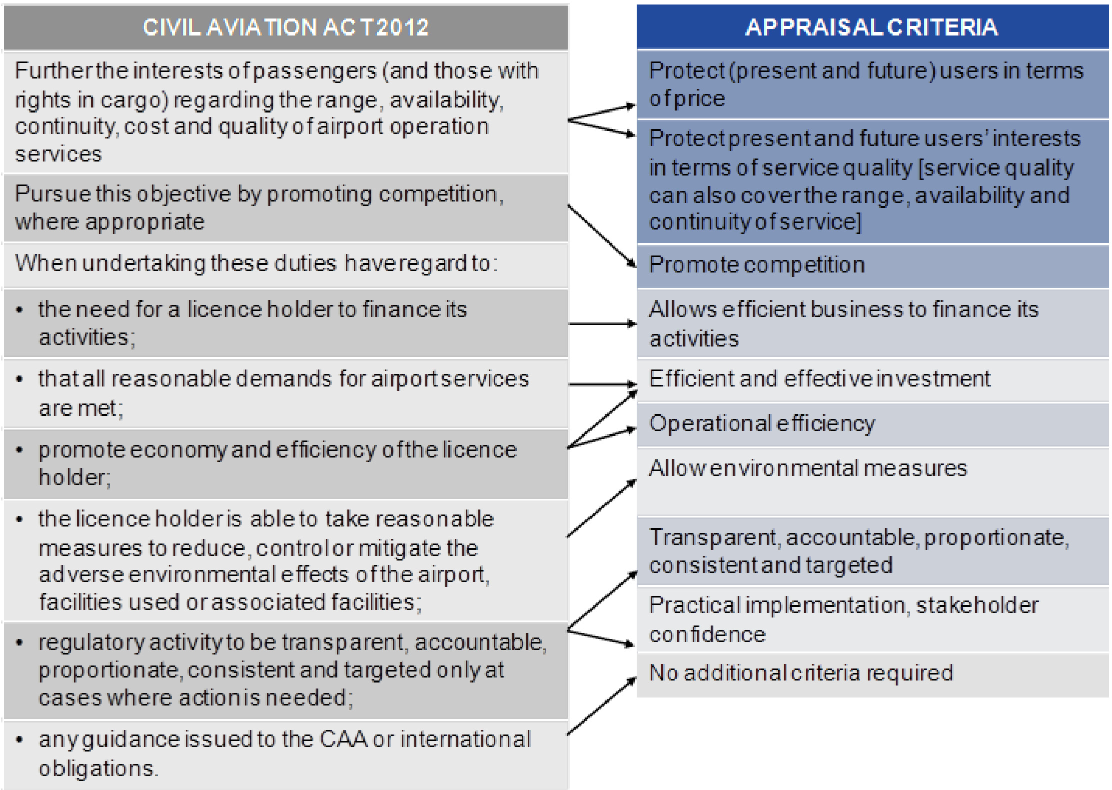
Evaluation criteria

12.19 The CAA has developed a set of appraisal criteria based on its duties under the Act (figure 12.1).[126] The primary criterion is protection of the interests of users (passengers and those with rights in cargo) regarding the provision of airport operation services, and to do this by promoting competition, where appropriate.

12.20 Other criteria include allowing efficient businesses to finance their licensed activities, operational efficiency, and the Better Regulation Principles (within which the CAA has considered the need not to impose unnecessary regulatory burdens).

[126] The CAA had similar evaluation criteria for its May 2012 Policy Update document, however these were based on the latest draft of the government's Bill before it full parliamentary scrutiny and its subsequent Royal Assent.

Figure 12.1: Appraisal criteria for assessing regulatory design



Source: CAA

Assessment of alternative forms of regulation

12.21 The CAA has assessed each of the alternative forms of regulation against its evaluation criteria, focusing on the protection against the potential harm from the abuse of market power. The evaluation has taken into account the CAA's assessment of GAL's market power and the risks of abuse. The assessment draws on discussions that the CAA has had with stakeholders and a number of CAA commissioned consultancy studies. The assessment of GAL's proposed commitments has also been summarised against the same criteria.

12.22 A separate appraisal has not been carried out for a default price cap. The price cap within a default settlement would need to be based on a RAB, LRIC or alternative approach and so would be subject to many of the same considerations as these measures.

GAL's commitment proposals

12.23 GAL set out its airport commitment proposals in detail in Appendix 1 of its RBP, and has subsequently provided further detail on the service quality regime and the incorporation of the commitments into the Conditions of Use. GAL's commitment proposals are a form of voluntary undertaking provided by the airport operator to the airlines.

12.24 The CAA considers that GAL's airport commitments are a positive step. The commitments could potentially provide a number of protections for airlines and passengers against the potential abuse of SMP that are normally found in licence regulation. They key features of GAL's proposed commitments are set out in figure 12.2.

Figure 12.2: GAL's commitment proposals

Issue	Commitment proposal
Contractual basis	GAL commits to include the commitments in the conditions of use
Duration	7 years, with GAL providing 2 years' notice if it wishes to extend commitments
Change mechanism	Following consultation and if agreed by GAL and at least 51% of airlines paying published charges
Price	Price cap on airport charges based on published charges with discounts only available in bilateral contracts not included. No regulation of other charges. Variations to price cap for changes in security costs, second runway development and allow under and over recovery of airport charge revenues to be balanced over the seven years
Consultation	Consult on charges in accordance with the ACR and publish pricing principles (initial version included in commitments)
Service quality regime	Same rebate and bonus scheme as Q5, with bonus scheme extended to cover all elements and to be equal in scale to rebates at 7% of revenue at risk. Airfield availability measure to replace aerodrome congestion charge and airline service quality targets on check-in and arrivals bag performance, which would funded by netting off airport rebates
Investment	Consult (in accordance with ACR) and publish rolling five-year investment plan
Operational resilience	Develop and maintain an operational resilience plan and use best endeavours to minimise detriment to users

Issue	Commitment proposal
Financial resilience	Not to take action to lose investment grade rating and provide an annual confirmation of adequate financial resources
Accounts	Publish annual statutory accounts

Source: GAL RBP and CAA analysis

12.25 GAL has proposed that these commitments might be combined with bilateral contracts for some individual airlines. GAL considers that the conclusion of bilateral contracts may be more likely with airports commitments in place than under a traditional price cap as the commitment is longer term (7 years compared to a traditional 5 year price cap). They would also reduce the risk for GAL and the airlines concerned that the terms offered in a typical 10 year bilateral might not be consistent with regulation over more than one control period.

12.26 Airlines and passengers at Gatwick are more diverse than at other airports subject to economic regulation. It is therefore unlikely that one size would fit all and the commitments may provide benefits over a licence in the form of additional flexibility. A combination of airport commitments and bilateral contracts could therefore better further the interests of passengers as it could better be tailored to the business needs of individual airlines and their passengers, providing greater flexibility while still providing protection to all passengers. There could also be advantages from a reduction in complexity and a refocus of relationships towards airlines and away from the CAA.

12.27 Under Test C of the MPT, the CAA has to consider whether, for passengers and cargo owners, the (incremental) benefits of licence regulation are likely to outweigh the adverse effects. GAL's commitments could, in principle, be relied on within this legal framework as evidence that to support a conclusion that it was not appropriate to introduce licence regulation. For this to be the case the regime created by the commitments would need to be reasonable and effective for passengers in that the overall deal would have to be reasonable compared to a regulatory settlement. Given the lack of an express statutory power to accept voluntary commitments, the CAA would need to be satisfied that accepting commitments was a suitable exercise of its discretion under the Act. In particular, given the risks of abuse of SMP identified under Test A, the CAA would need to be satisfied that the commitments proposed would better protect passengers' interests than licence regulation.

12.28 The CAA's review of the adequacy of the protection in the commitments is set out in detail in Test C of the market power assessment. The key conclusions of this analysis are as follows.

12.29 The current proposal to include commitments in the Conditions of Use raises a number of concerns about the inadequate substance and **enforceability** of the provisions for airlines which would not provide sufficient protection against the risk of abuse of SMP. The commitments are enforced by airlines and so may not offer the same protection to passengers and cargo owners as compared to a licence enforceable by the CAA, which has a statutory duty to protect their interests. The commitments also offered no explicit protection from repeated failure against service quality standards and the dispute resolution mechanism could unduly delay airlines from taking enforcement action.

12.30 The **price** offered in the commitments of RPI +4% per year over seven years is significantly in excess of a reasonable price as judged by a RAB-based comparator, described in Part B, which gives a price of RPI +0% per year, over the same period.

12.31 The impact on **efficiency** of the commitments is likely to be mixed, with potential benefits from retaining the benefits from efficiency improvements for longer (at least seven years), offset to some extent by the looser price cap providing less of an incentive to be efficient, and by the full pass through of security costs and the development costs of a second runway.

12.32 The commitments include a similar **service quality scheme** as used for Q5. However, the extension and the increased money at risk for bonuses could provide windfall gains to GAL, and my not provide sufficient protection against repeated service quality failure.

12.33 The commitments do not include **capex** commitments or triggers. Instead, investment would be driven by the service quality regime and GAL's vision for the airport in the future. Given GAL's SMP position there is a risk that beneficial enhancements for passengers would not be taken forward. The consultation arrangements under the commitments would be based on those under the ACR. While this may save costs and speed processes, for an airport operator with SMP this means that users' interests may not be fully taken into account.

12.34 The commitments would have benefits over a licence, in that they would avoid the **direct costs** of staff and consultancy associated with a regulatory review. GAL estimates that the costs associated with RAB-based regulation are currently around £10 million per year. Costs may be reduced under other forms of licence regulation. Potential cost savings from commitments would be significantly reduced if there is not effective partnership working between the airport operator and airlines, and consequently there are numerous complaints to the CAA under competition law or ACR. Airline feedback on the commitments has been mixed.

12.35 The commitments would also have benefits in terms of: **avoiding management distraction**, as the enforcement of the commitments would be linked to commercial negotiations; and removing **some perverse incentives** that may occur under a regulatory regime, for example potential distortions to capex incentives under a RAB-based framework, or the potential for regulatory gaming.

12.36 Overall, the CAA welcomes GAL's commitment proposals. However, the CAA is not sufficiently convinced that the enforceability and the terms of the commitments would provide better protection to passengers and cargo owners than the security offered under a licence. Consequently, the CAA considers that the benefits of licence regulation are likely to outweigh the adverse effects. Figure 12.3 summarises the appraisal of GAL's proposed commitments.

Figure 12.3: Appraisal of GAL's proposed commitments

Criteria	Assessment
Price protection	The commitments could in theory provide adequate protection, however the price in the commitments is significantly higher than that which the CAA considers to be a fair price, and the way the commitments have been included in the Conditions of Use raises concerns over the enforceability of the proposed price path.
Service quality protection	The commitments include much the same SQR scheme as used for Q5. However, the extension and the increased money at risk for bonuses could provide windfall gains to GAL. The commitments do not contain explicit protection against repeated service quality failure.
Promote competition	The commitments could avoid distortions to competition, for example if a price cap is set too low then this could distort charges and investment at other airports and bilateral contracts could be more likely under

Criteria	Assessment
	commitments, although they are not ruled out under licence regulation.
Allows efficient business to finance its activities	GAL is unlikely to propose commitments that would not allow it to finance its activities.
Efficient and effective investment	Investment would be driven by the service quality scheme and GAL's vision for the airport. Commitments would avoid some of the perverse incentives from RAB-based regulation particularly around investment incentives. Consultation arrangements would be based on those under the ACD. While this may save costs and speed processes, for an airport operator with SMP, this could mean that users' interests may not be fully taken into account. There is also no guarantee that investments that do not directly impact on outputs covered in the SQR scheme would be taken forwards.
Operational efficiency	Potential benefits to efficiency incentives from the retention of benefits for longer (at least seven years compared to a typical five year RAB-based control), offset by the looser price cap providing less incentive to be efficient.
Allows environmental measures	The commitments do not prevent the introduction of environmental measures.
Transparent, accountable, proportionate, consistent and targeted	The commitments would only be enforceable by airlines and so may not offer the adequate protection to passengers and cargo owners. The terms could allow GAL to make unilateral variations or contract out, and so may make accountability and consistency difficult. There is no direct enforcement or intervention mechanism by the CAA. Commitments could provide substantial cost savings compared to licence regulation, although cost savings would be significantly reduced if there is not effective partnership working between the airport operator and airlines. Given the concerns over enforceability, the process for reintroducing a licence could take two to three years, allowing significant user detriment to occur during this time. The commitments only require the publication of some service quality information and statutory accounts. This is a lower level of transparency than currently provided under the ACD and the provision of additional information may strengthen the ability of airlines to understand the underlying costs assumptions and negotiate charges.
Practical implementation and stakeholder confidence	The concerns over the enforceability of the commitments could make practical implementation difficult. Airline feedback on the commitments has been mixed and while some stakeholders have expressed support

Criteria	Assessment
	for commitments, most have raised concerns over enforceability.

Source: CAA analysis

Commitments backed by a licence framework

12.37 Given the concerns highlighted above, the CAA considers that there is an option for commitments to be backed up by licence regulation. Such a framework could provide clear benefits in terms of enforceability and speed of response.

12.38 Under such a framework the CAA's initial views are that a licence should include:

- A condition enabling the CAA to enforce the commitments. This would provide a direct response to concerns about enforceability and would allow enforcement in the interests of end users, rather than simply airlines.
- A condition preventing GAL from altering the commitments without good reason and from withdrawing the commitments. This would address the concerns that the conditions of use could allow the airport to unilaterally vary or withdraw the commitments.
- A condition allowing the CAA to direct changes to the commitments in response to a dispute where the commitments are operating against the user interest. This power would operate within quite narrowly defined circumstances.
- A condition allowing the CAA to introduce a freeze on charges if it is undertaking an investigation. This would prevent detriment during the time it takes to remedy the failure of the regime, for example while new licence conditions are introduced, or the MPT is being reassessed. The charge freeze would prevent GAL from changing the current structure of charges and average yield. The CAA considers that the charge freeze would operate for 18 months. This would address stakeholder concerns about the potential detriment that could occur if the commitments are considered to be failing.

12.39 While the above conditions would address a number of concerns associated with the enforceability of the commitments, they would not address concerns associated with the terms on offer in the commitments themselves. For a commitments and licence framework to be demonstrably better than alternative forms of regulation, the CAA considers that improvements would be required to the commitments in the following areas:

- Price: The CAA would want the commitments to offer a price that is fair. The CAA's views of a fair price are set out in Part B.
- 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 ACD and address the significant information asymmetry between GAL and the airlines; allow airlines to provide properly informed views on the capital programme, the changes made to the programme and their implications; and provide clarity over how the airport operator has made decisions in contentious areas.
- Transparency: The commitments should provide sufficient information to airlines to allow them to understand whether charges are reasonable. As a minimum, the commitments should include the same public provision of audited data as currently provided in the regulatory accounts, together with transparency over the costs of activities currently covered by the public interest condition (with the exception of activities covered by the Airports (Groundhandling) Regulations 1997 (AGR)).

- 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. As a minimum the commitments should include resilience planning, collaboration with key stakeholders and dissemination of information.
- Financial resilience: The commitments should provide clarity on what GAL will do to ensure the financial resilience and continuity of service. For example, they should include commitments to address the adequacy of resources, parent company undertakings, restriction on activities and a continuity of service plan.

12.40 The commitments should also remove the pricing principles as these are for the airport to provide as part of the ACR requirements and the CAA would not wish to be seen to be standing over principles that could fetter its discretion if concerns arose under the ACR at a later date.

12.41 The CAA considers that these issues are not a prescriptive determination of what needs to be included in the commitments. The CAA would, however, expect rigorous justification for any departures. If these issues are addressed then the CAA confirms that a framework of commitments backed by a licence could provide a suitable form of regulation for GAL and could provide benefits from avoiding some of the perversities that can occur from alternative forms of licence regulation. Figure 12.4 summarises the appraisal of a commitments and licensing framework for GAL.

Figure 12.4: Appraisal of commitments and licensing framework for GAL

Criteria	Assessment
Price protection	If the commitments include a fair price, together with increased transparency and the potential for licence enforcement then this should provide adequate protection to users.
Service quality protection	If the proposed changes are made to the service quality regime then a commitments and licensing framework should provide adequate protection to users.
Promote competition	The CAA does not consider that including a fair price in the commitments should distort competition. The presence of a licence

Criteria	Assessment
	should not prevent bilateral contracts from being more likely under commitments.
Allows efficient business to finance its activities	GAL is unlikely to propose commitments that would not allow it to finance its activities.
Efficient and effective investment	If the investment and consultation requirements are improved as set out above then a commitments and licensing framework should provide adequate protection to users.
Operational efficiency	Potential benefits to efficiency incentives from the retention of benefits for longer (at least seven years compared to a traditional five year RAB-based control), which would be reinforced if the price offered is fair.
Allows environmental measures	The commitments would not prevent the introduction of environmental measures
Transparent, accountable, proportionate, consistent and targeted	By including licence conditions that allow the CAA to enforce the commitments, prevent GAL from amending the commitments without good reason or withdraw them and allow the CAA to amend the commitments in response to a dispute should ensure that GAL is held properly to account for its action. These licence conditions are focused on areas of concern and so are proportionate. The introduction of a price freeze to prevent significant user detriment from occurring when CAA is investigating potential abuses. Even with the changes outlined above a commitments and licence framework should provide cost savings compared to other forms of licence regulation. The publication of the additional information in terms of regulatory accounts, transparency of costs of specified activities and improvements to investment consultation should provide the necessary transparency.
Practical implementation and stakeholder confidence	Allowing licence enforcement of the commitments should overcome the concerns over practical implementation and increase stakeholder confidence.

Source: CAA analysis

RAB-based

12.42 In the Q6 Policy Update the CAA stated that, where it applied a RAB-based approach in the future, it would consider using a flexible RAB-based approach, which would take advantage of the flexibilities under the Act, for example in terms of duration, capital incentives and flexibility to respond to exceptional circumstances.

12.43 Many regulators use a RAB-based framework to set price caps. A RAB-based framework at Gatwick has advantages in that it is well understood by stakeholders, and supported by airlines (but not GAL). There is also less uncertainty on individual building blocks, in particular traffic, than there is at Stansted. Also unlike Stansted, the historic investment, and consequently the value of the RAB, does not appear to be out of line with the needs of the airlines and passengers that use Gatwick. A RAB-based approach can provide good protection to passengers through a price cap, SQR scheme, efficiency incentives and capex triggers and consultation requirements.

12.44 The CAA acknowledges that there are drawbacks with a RAB-based approach. A RAB-based price cap can be costly and time consuming as it requires the regulator to have a lot of information to overcome information asymmetries. It can distort investment incentives, either by encouraging too much investment (which will need to be addressed in the periodic review by the regulator) or by distorting investment decisions at airports that potentially compete with Gatwick (although this does not appear to be the case in practice). A RAB-based approach can also introduce rigidities into the capital planning approach and from the SQR scheme, although the CAA considers that it may be possible to overcome these, to a degree, through a more flexible RAB-based approach. Since the CAA considers that GAL currently has SMP and this will endure for Q6, the CAA considers that a RAB-based approach could be an appropriate form of regulation for GAL.

Figure 12.5: Appraisal of flexible RAB-based approach for GAL

Criteria	**Assessment**
Price protection	A RAB-based price cap can ensure that users only pay for efficiently incurred costs, and provides both users and the airport operator with certainty and stability. At Gatwick there is a reasonable level of certainty over key inputs, increasing the robustness of RAB-based calculations.
Service quality protection	Service quality requirements can be specified as part of decision/licence although care is needed to ensure that they meet the needs of users. This provides a one size fits all approach, which may not be right for individual airlines or their customers. Nevertheless it secures a minimum level of service which can be effectively enforced.

Criteria	Assessment
Promote competition	Depending on how it is set, RAB regulation can distort investment incentives at both regulated and unregulated airports which can have an adverse impact on competition. This does not appear to be the case for Gatwick given the investment plans of airports which potentially compete with Gatwick. A RAB approach could discourage commercial agreements, although it does not prevent such agreements. In cases where the airport operator has SMP, by setting an appropriate price cap, a RAB-based approach can help to ensure that any commercial agreements are fair.
Allows efficient business to finance its activities	The regulated business would receive a preset return on current and future investment although it would be subject to some traffic risk.
Efficient and effective investment	A RAB approach can promote investment as regulated business will earn a return on investment and lead to the promotion of investment over opex based solutions. A more flexible RAB approach may improve incentives for the planning, delivery and efficiency of capex.
Operational efficiency	Some incentive to outperform regulated settlement due to the retention of gains during the regulatory period.
Allows environmental measures	A RAB-based framework would not prevent environmental measures from being introduced.
Transparent, accountable, proportionate, consistent and targeted	Setting of price cap is transparent and consistent. The focus of regulation can be targeted on areas of harm, although RAB approach can be complex, time consuming and introduce rigidities into processes. Nevertheless a RAB-based framework should provide some certainty and stability for stakeholders and is proven in other markets where operators have SMP.
Practical implementation and stakeholder confidence	A RAB-based framework is well understood by stakeholders and is used in relation to airports and across a number of other regulated sectors. A RAB approach has strong support from airlines although it is not supported by GAL.

Source: CAA analysis

Long-run incremental costs

12.45 Price caps based on LRIC have been used by some UK sector regulators. LRIC can be calculated in a number of ways. Typically, these include:

- future incremental costs divided by future incremental demand over the asset life, which can involve a small increment, such as changes to make the maximum use of existing facilities, or a large increment such as a new terminal or runway; and
- using the modern equivalent asset value (MEAV) or replacement cost of the existing assets. Ofcom has used current cost accounting for its review of mobile termination charges. This could also be seen as an amendment to a RAB-based approach.

12.46 A LRIC-based price cap can include many of the aspects that characterise the current RAB-based framework, such as a SQR scheme, although features such as capex triggers would not be included given the focus on future rather than current investment.

12.47 The main potential benefit of a LRIC approach is that, in principle, it could signal the long-term average price that might emerge from a 'competitive' market, in that it reflects the costs that a new entrant would have to incur to provide equivalent capacity.[127] Price protection for users is assured by setting a price cap based on LRIC and fixing it for a number of years.

12.48 The CAA commissioned consultants Europe Economics (EE) to provide advice on the application of LRIC estimates to Gatwick and Stansted.[128] EE suggested that LRIC provides the best indication of the competitive price where it is based on the MEAV.[129] In addition EE suggested a LRIC approach may increase efficiency as the regulated company will only be reimbursed for efficient investment.

12.49 There are a number of drawbacks from a LRIC approach.

- A LRIC approach is data intensive and requires regulatory judgement to define the increment. This can lead to significant uncertainty over future price profiles and it may be possible to

---

[127] LRIC has tended to be used to set the cost standard for multiproduct firms to test potential abuse of SMP.

[128] Europe Economics, December 2012, *Advice on the application of long run incremental cost estimates for Gatwick and Stansted*, http://www.caa.co.uk/docs/1350/Europe%20Economics,%20Advice%20on%20the%20application%20of%20long%20run%20incremental%20cost%20estimates%20for%20Gatwick%20and%20Stansted%20-%20nonconfidential%20version.pdf

[129] Although this to some extent depends on how demand relates to available capacity.

generate large price increases or decreases depending on the assumptions used, limiting the protection to users and introducing variability owing to regulatory judgements.

- As LRIC is a long-term forward-looking measure there is a risk of over and under recovery in a particular period. This means that LRIC may not be well-suited as a benchmark to indicate whether a particular price is proximate to the ‘competitive’ price at any given time. Though it may be possible to smooth volatility in cost recovery over time, while ensuring changes are cost neutral, this may be difficult if this approach is used in the short term to facilitate a transition to a more competitive sector. Charging a flat LRIC price over time also raises similar issues as any other 'smoothing' effect, for example is that existing passengers may be asked to pay for future improvements from which they may not benefit.
- It has also been argued that LRIC is not an effective proxy for competitive airport prices where investments are very ‘lumpy’ for example LRIC may not reflect the capacity cycle which, in a competitive market, could produce significant price volatility. When considering prices it is important to take account of the effects of the capital intensive nature of airports and of the ‘lumpiness’ of capacity increments.

12.50 EE identified a number of drawbacks from using a LRIC approach for GAL which included the following issues:

- Difficulties in determining the appropriate increment to use. As noted above, EE considered that the most credible increment would be the replacement of an airport (rather than, for example, a small amount of incremental capex or a new runway).
- Greater uncertainty (and loss of accuracy) due to the need to make a judgement as to the efficient levels and types of investment required rather than using historical values that were spent.
- The potential for greater uncertainty of remuneration of investment. As charges are not related to historical investment costs, then this increases uncertainty to the regulated company over the remuneration of investment, particularly if the current configuration of the airport is not ideal.

- Greater potential for volatility, for example if input prices or technology changes.

12.51 EE's analysis identified that any model that is used to estimate LRIC would be sensitive to the inputs and the assumptions that underpin it. In particular, EE's sensitivity analysis indicated that changes to the inputs and assumptions could lead to quite significant changes in a LRIC estimate. More fundamentally, EE questioned the relevance of an estimate of the competitive price obtained through LRIC given the level of government involvement in planning of airport capacity, particularly in the south east of England.

12.52 Following the publication of the EE LRIC study, GAL identified a number of concerns – conceptual points to issues of principle and approach – that it considered would have a material effect on EE's LRIC estimates.[130] At the broadest level, GAL was concerned that:

- too much emphasis was placed on how government policy (on setting overall airport capacity in London) reduced the usefulness of using LRIC to determine prices for airports; and
- the LRIC estimates were 'materially understated', particularly for the airport replacement option – the most preferred option – as various inputs (utility and transport connections, planning and pre-construction activity costs, depreciation and land indexation) had either been omitted or had been set inappropriately.

12.53 To help assess the merit of GAL's concerns, the CAA engaged EE to reconsider its approach and LRIC model.[131] EE considered GAL's concerns and:

- determined that the model could be improved, although EE did not agree with the majority of GAL's concerns, EE considered that the model could be improved through a better consideration of depreciation, which would lead to a small increase in the LRIC estimates;

[130] GAL, March 2013, *CAA Stansted Market Power Assessment – Europe Economics advice on the application of long run incremental cost estimates for Gatwick and Stansted, Reference: Q5-050-LGW54*.

[131] Europe Economics, April 2013, *Response to comments from GAL*, http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=14279

- re-iterated its view that the value of LRIC was reduced if entry and expansion is driven more by government planning and less by price signals.

12.54 The CAA has examined EE's updated approach and considers that its revised approach is reasonable, although the concerns with the usefulness and uncertainty associated with LRIC estimates remain.

12.55 In summary, although the CAA recognises the potential benefits of an LRIC approach, it also acknowledges its drawbacks. The CAA is concerned that a combination of the following will mean that the implementation of a LRIC based control at Gatwick could undermine its primary duty: the practical difficulties in its calculation, the specifics of airport capacity in the south east of the UK that may render it inappropriate, the significant sensitivity of the calculation to regulatory judgement, and the data intensive nature of the calculation. On balance, therefore, the CAA considers that this option is not suitable for regulating GAL's airport charges in Q6 given the risk it could undermine, rather than support, protection for users and the promotion of competition.

Figure 12.6 Appraisal of a LRIC approach for GAL

Criteria	Assessment
Price protection	Provides some protection against charges above the competitive level, although calculations are subject to considerable uncertainty.
Service quality protection	Service quality requirements can be specified as part of decision/licence although need to ensure users' interests are considered.
Promote competition	In theory LRIC better reflects competitive outcomes, although the practical issues highlighted above may limit the extent to which this is the case.
Allows efficient business to finance its activities	The move away from a historical cost RAB would create the risk of capital gains and losses, which would increase business risks and financing costs.
Efficient and effective investment	A LRIC approach would reduce the incentives towards capex spending as the company would not be compensated for over spending.
Operational efficiency	If used within fixed-term control periods then there should be an incentive to outperform the regulatory settlement (and as with a RAB approach roll-over provisions could ensure that incentives are

Criteria	Assessment
	maintained towards the end of the control period).
Allow environmental measures	Would allow individual prices that contribute towards the cap to be adjusted to incentivise improved environmental performance. Environmental measures could be included within the future capital programme as long as additional outputs are explicit.
Transparent, accountable, proportionate, consistent and targeted	LRIC estimates require judgements about the most appropriate increment or the modern equivalent values. Some stakeholders are concerned that a LRIC approach can be complex, time consuming and lead to uncertain future price paths with a high level of regulatory discretion. This may reduce transparency and consistency
Practical implementation and stakeholder confidence	Introducing a LRIC price cap would require a long-term commitment from the regulator to move from the current RAB approach and to even out under and over recovery over time. Stakeholders raised concerns whether sufficiently precise results could be obtained and whether the transfer from a RAB to a LRIC control had sufficient benefits to justify it given the long-term horizons.

Source: CAA analysis

Price caps based on pegging tariffs to comparator airports

12.56 Pegging tariffs to comparator airports would set a price cap based on an index of the airport charges of a set of comparator airports. Airports within the index could be weighted in relation to their relevance to the comparator, for example size, type of traffic and level of underlying demand.

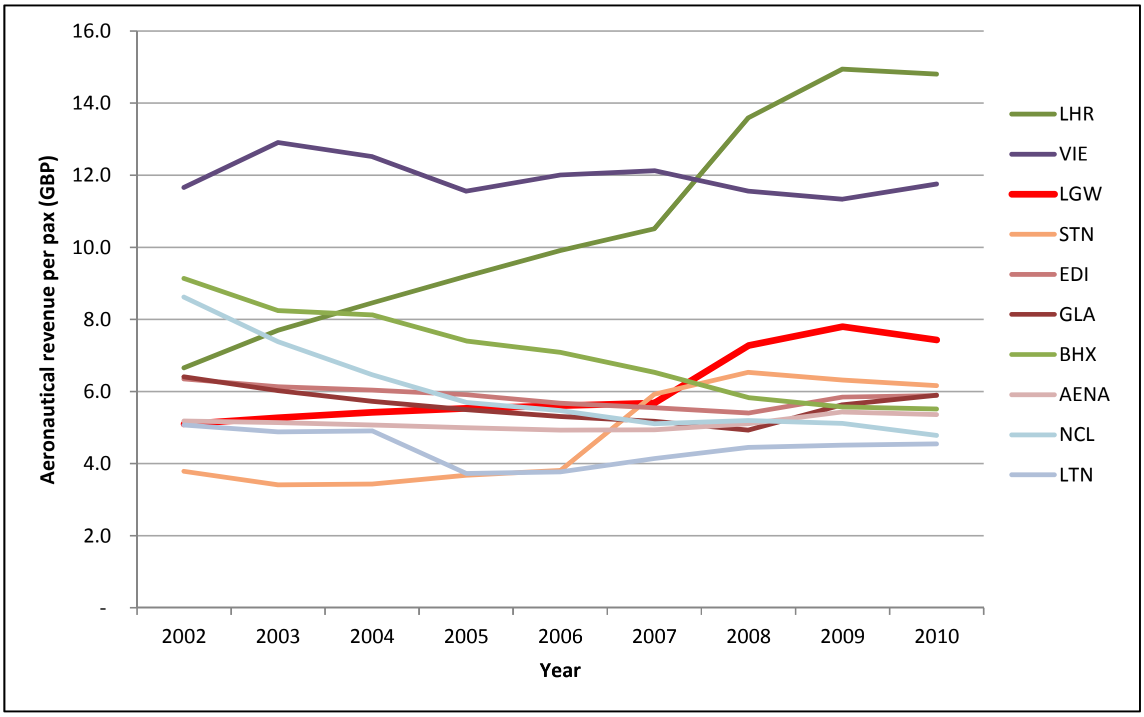
12.57 Pegging tariffs in this way should provide some protection to passengers by setting a direct link between charges and a proxy for the competitive price. It avoids the complexities of scrutinising the bottom up cost and revenue information required by price caps based on RAB and LRIC type methodologies. As well as a price cap, the regime could also include other output requirements such as a SQR scheme and investment requirements.

12.58 In its May 2012 Policy Update document, the CAA considered that a comparator benchmark approach had some merit. In particular, the CAA wanted to explore further whether it could allow the setting of sufficiently precise and appropriate price caps, or whether it would be more helpful as a cross-check on a price control calculated by another approach.

12.59 The CAA commissioned consultants LF to identify whether it was possible to benchmark prices at comparable airports in order to regulate airport charges at Gatwick and/or Stansted. LF identified a potential comparator set of airports separately for Stansted, Gatwick and Heathrow. The comparator set for Gatwick reflects the range of airlines that use Gatwick and includes Heathrow, Edinburgh, Glasgow and Barcelona which are used by BA and Luton and Stansted which are predominately used by LCCs.

12.60 Based on this comparator set, LF benchmarked GAL's aeronautical revenues over the last ten years. This showed that GAL's average aeronautical revenues per passenger increased over the period and were now around average for the group. The results however are sensitive to the inclusion or exclusion of Heathrow from the comparator group. If Heathrow was excluded from the group then GAL's charges would be above the average, although still with the 10 to 15% range of uncertainty identified by LF.

Figure 12.7: Aeronautical revenue per passenger for the Gatwick comparator basket



Source: LF: Note: AENA is Spanish airports and includes both Madrid Barajas and Barcelona which are both comparators to Gatwick

12.61 In developing the comparator basket LF found that trends in aeronautical revenue per passenger were robust against variations in the airports chosen (apart from Heathrow) and changes in the way the index was calculated. However, if used for setting a price cap, due to the additional precision that would be required, LF identified a number of issues that would need to be addressed. In particular:

- whether the comparator basket is held constant or is allowed to change over time, depending on how different airports evolve;
- how the comparator basket is chosen, in particular the cut-off for the inclusion of airports, and whether particular parameters are included;
- how the index is calculated, for example whether airports should be weighted and the treatment of exchange rates;
- inherent uncertainties in the accuracy of the data, especially where estimates have had to be made for example in relation to air traffic control costs and freight revenues; and
- ensuring that the precise portfolio of activities that generate revenue is consistent across airports to ensure a like for like comparison.

12.62 In total, LF considered that the resulting range of uncertainty from the benchmarks was ±10 to 15%. LF stated that this range did not reflect the inclusion or exclusion of additional comparator airports. LF considered that potential issues with comparator based price caps could be reduced by averaging across airports and be resolved through agreement on the comparator set and/or parameters between the airport operator and airlines. Nevertheless LF recommended that it may be better for the comparator benchmark to be considered as a range rather than a point estimate.

12.63 Based on the above analysis the CAA does not consider that it would be appropriate to set precise price caps based on comparator benchmarks. Nevertheless, the CAA considers that comparator benchmarks would provide a useful indicator of the possible range for a competitive price. A summary of the CAA's evaluation against its criteria is given in figure 12.8.

Figure 12.8: Appraisal of pegging tariffs to comparator airports for GAL

Criteria	Assessment
Price protection	In principle the price cap ensures users only pay a proxy for the competitive price, however due to potential measurement and statistical issues the benchmark may not be sufficiently precise to set price caps. There is no guarantee that charges are cost reflective.
Service quality protection	Service quality requirements could be specified as part of a licence although care will be needed to ensure they meet users' requirements. The choice of the comparator group implicitly takes account of the needs of different users by including structural criteria such as the passenger, carrier and destination mix, and airport size in the choice of comparator airports. If higher than typical service quality standards are set then there may be a need for prices to be adjusted. If service quality requirements are not specified then improvements may be avoided if they result in higher prices.
Promote competition	Setting prices in relation to comparator airports could remove distortions from a RAB-based approach as prices would be based on a proxy for the competitive price.
Allows efficient business to finance its activities	Pegging tariffs removes the direct link between charges and costs and so care will needed to allow an efficient business can finance its activities.
Efficient and effective investment	As the price cap is essentially reactive to changes in charges at other airports there may be uncertainty over future prices which might disincentivise investment.
Operational efficiency	As prices are delinked to costs then this should create incentives for efficiency as GAL will effectively be a price taker rather than price maker. GAL will therefore retain any gains made from reducing opex would extend over the long term and would not be limited to a five year regulatory period.
Allow environmental measures	While it should be possible to pursue environmental measures such as the differentiation of charges according to noise impact, funding specific environmental investment may be more difficult if the same requirements are not present across the comparator set.
Transparent, accountable, proportionate, consistent and targeted	As the price cap is based on tariffs at other airports it should be transparent and the costs of regulation may be greatly reduced. Maintaining the same comparator set across the control period may provide consistency.

Criteria	Assessment
Practical implementation and stakeholder confidence	LF has demonstrated it is possible to identify a set of comparator airports for Gatwick, which include a number of airports that operate under light handed regulation. The comparator benchmark is also robust to some changes in the comparator set, although the inclusion or exclusion of Heathrow can have a significant impact. Nevertheless the choice of comparators is likely to be disputed by those parties that do not agree with the resulting benchmark. The benchmark could be vulnerable to unexpected shocks, which might be considered unfair by the airport operator and other stakeholders.

Source: CAA analysis

Price monitoring

12.64 Price monitoring would not involve the CAA setting an explicit price cap to apply from April 2014. Instead, the CAA would expect GAL to self-discipline and self-regulate its actions and take steps to ensure that it does not abuse its market power against a framework of a regulatory backstop to incentivise this behaviour.

12.65 The CAA's role would be to monitor GAL's performance including its prices, service quality, investment and efficiency - with the threat of reintroducing tighter regulation if GAL's performance raised concerns about the exercise or abuse of its SMP.

12.66 In principle, where there is a need for regulation to address a risk of exercise or abuse of SMP but that risk is relatively low, the threat of the regulator intervening may be sufficient to incentivise GAL to act as if it faced effective competition. If monitoring is effective, it would incentivise GAL to act as if it were subject to competitive constraints so as to bring acceptable prices and performance to customers without the need for direct regulatory intervention.

12.67 Monitoring, if effective, has a number of benefits in terms of greater flexibility, reduced regulatory specification and reduction of the regulatory burden. If effective, it would also encourage GAL and the airlines to develop a more cohesive relationship than relying on the regulatory process for setting prices.

12.68 The CAA commissioned consultants First Economics (FE) to develop and assess alternative forms of a monitoring regime. FE identified three generic types of monitoring regime.

- Option A: a regulatory regime where the airport operator's charges are monitored against an external price, benchmarked and automatically capped if beyond a pre-defined level.
- Option B: an annual ex-post review of prices and outcomes, without a prescriptive ex-ante price cap but with transparency on a range of monitoring indicators on charges, financial performance, investment and service quality and a set of high level criteria against which CAA would assess performance.
- Option C: a light touch approach, with the airport operator entering into a voluntary code of conduct before the start of Q6 with less frequent reviews of prices and outcomes. Such a code of conduct would go well beyond the requirements of the ACD/R and would involve meaningful commitments to cost transparency, information provision, dispute resolution and agreement on charges.

12.69 FE considered that of the three options, option A, would be less beneficial than the other options. FE considered that as option A included an automatic movement to ex-ante price control regulation it would effectively be considered by the airport operator as a price cap. The cap could also be subject to unexpected shocks or changes in charges at individual comparator airports. In addition the time lag to comparative data becoming available would mean that assumptions would need to be made on prices in individual years, with adjustments in subsequent years. This would create uncertainty for the regulated airport operator, its investors and customers.

12.70 FE did not express a preference between options B and C, although it suggested that option C, the lightest touch option, would require the airport operator to face meaningful competitive constraints across a significant proportion of its revenue base. The CAA would also need to be convinced that the airport operator is committed to working with its customers in a normal commercial manner and can reach agreement with them without regulatory involvement.

12.71 The CAA's market power assessment for GAL indicates that it is likely that it will not face effective competitive constraints across a significant proportion of its revenue base. Given the diverse mix of airline business models at the airport, GAL is more likely to reach bilateral agreements with individual airlines rather than an agreement on overall charges. Consequently the CAA has focused its assessment on option B, price monitoring based on an annual ex-post review of prices and outcomes.

12.72 FE considered that price monitoring could be an effective form of regulation, if:

- the airport accepts and understands the need for self-regulation (within a price monitoring regime);
- there is a credible and understood threat of price control re-regulation, if the airport operator is found to be abusing its market power;
- the reputational consequences to an airport operator of being found to have abused SMP are unattractive; and
- the financial consequences of ex-ante price control regulation should be unfavourable.

12.73 The CAA has considered two options for price monitoring: price monitoring in the absence of commitments, and price monitoring with commitments. The CAA considers it unlikely that GAL, with its degree of market power, would discipline itself and withstand the temptation to take advantage of the freedoms that the removal of ex ante price controls and a switch to ex post monitoring would give it. The CAA notes GAL's behaviour identified in the market power assessment, in particular that:

- GAL has argued throughout the review that its prices are too low, i.e. below, the competitive level, and need to increase;
- GAL’s view of the price limit that it would choose to set itself in Q6, if given the freedom to self-regulate, involves a cap of RPI + 4% per year, which is significantly in excess of the CAA's view of a fair price.
- Airlines that represent a significant volume of traffic at Gatwick appear to have little countervailing buyer power, with GAL largely setting the terms that an airline will receive in any negotiations so that the scope for negotiation is limited. In particular, it appears that existing airlines (with a few exceptions) have limited scope for negotiation as evidenced by the fact that bilateral contracts have not been agreed.

12.74 Against this backdrop, it is not clear how a switch to a price monitoring regime, in the absence of reasonable and effective commitments at Gatwick, could work. GAL has clearly set out its reading of the market and signalled its pricing intentions. The CAA is equally clear in its views that GAL's proposed price path is unreasonable. If the CAA were now to remove GAL's price cap and give the airport the freedom to set prices at a level of its choosing, subsequent disagreements between GAL and the CAA about the exercise of market power could be inevitable. This would most likely cause the CAA to challenge GAL's price increases and seek some form of remedy or tighter regulation.

12.75 The CAA is of the view that it is better for all parties to resolve the difference of views that GAL and the CAA have about prices now as part of the Q6 review process rather than in 1-2 years, time as part of an ex post investigation into actual pricing behaviour under a monitoring regime. This will ensure that avoidable detriment is not imposed on users. It will also give greater certainty to GAL and users about the appropriate price path for the next five years.

Figure 12.9: Appraisal of price monitoring type ex-post licence conditions for GAL

Criteria	**Assessment**
Price protection	Price monitoring leads to self-regulation of prices. If self discipline is not self evident then there will be a switch to default price caps and more formal price control regulation, although given the issues identified in the market power assessment significant passenger detriment could occur before price controls are reintroduced.
Service quality protection	Service quality could be transparently monitored where poor performance could lead to a switch to default price caps and price control re-regulation. Although given the issues identified in the market power assessment significant passenger detriment could occur before price controls are re-introduced.
Promote competition	The intention of this option is that the airport operator would behave in the same way as airport operators without SMP. From the market power assessment it is not clear that GAL would behave in this manner.
Allows efficient business to finance its activities	There is no reason why an airport operator would set prices at a level that does not permit it to finance its activities.

Criteria	Assessment
Efficient and effective investment	An airport operator would not be constrained from bringing forward efficient new investment plans, which could be taken into account when setting prices.
Operational efficiency	Cost efficiency would be one of the indicators that could trigger a switch to default price caps and, ultimately, ex ante price control regulation. Although again this would depend on the level of prices and the incentive they place on being efficient.
Allow environmental measures	There is no reason why environmental measures could not be introduced under a price monitoring regime.
Transparent, accountable, proportionate, consistent and targeted	There should be no reason why the rules in this option would not be understood clearly by all parties, it therefore is capable of satisfying the better regulation principles. Airlines are likely to argue that the controls in price monitoring are likely to be insufficient to control the market power held by the airport operator.
Practical implementation and stakeholder confidence	This option requires stakeholders to believe that an airport operator will behave responsibly. It cannot be guaranteed that stakeholders will have this belief.

Source: CAA analysis

12.76 Price monitoring might, if combined with GAL's commitment proposals, be a more effective form of regulation than price monitoring alone. The annual report under price monitoring would allow transparency on the main information that airlines might need to negotiate on behalf of users. It would also allow a quicker enforcement route for airlines compared to the commitments alone.

12.77 Given the points raised above on the potential risks of abuse, much of the burden from preventing abuse of SMP would rest on the commitments rather than price monitoring regime itself. Consequently it will be important to ensure that the terms in the commitments are reasonable and effective from the perspective of users. In the absence of such requirements, price monitoring with commitments is likely to suffer from as many of the enforceability issues as commitments alone, albeit that the monitoring will improve transparency and the licence will provide some benefits from being able to enforce in the interests of end users and improving the speed of response. Nevertheless, issues with GAL's ability to change the commitments are likely to remain and the CAA will not able to enforce the terms of the commitments, only the requirements of the price monitoring regime. This option is therefore likely to be less beneficial than a commitments and licensing framework on grounds of enforceability. There would also be additional costs from the price monitoring regime itself. Consequently, the CAA does not consider that price monitoring with commitments should be taken forward.

Figure 12.10: Appraisal of price monitoring with commitments for GAL

Criteria	Assessment
Price protection	Given the issues identified above, much of the burden for preventing the abuse would rest on the commitments and the terms in the commitments would need to be fair to airlines and users. Price monitoring will not be able to enforce the commitments directly and so is likely to be less effective than a commitments and licensing framework.
Service quality protection	Much of the burden for preventing the abuse would rest on the commitments and the terms in the commitments would need to be fair to airlines and users. As above price monitoring would not be able to directly enforce the commitments and so is likely to be less effective than a commitments and licensing framework.
Promote competition	The intention of this option is that the airport operator would behave in the same way as airport operators without SMP. While the commitments would provide some additional protection they would need to be reasonable and effective for airlines and users.
Allows efficient business to finance its activities	There is no reason why an airport operator would set prices in commitments at a level that does not permit it to finance its activities.
Efficient and effective investment	The commitments or the price monitoring regime would not constrain the airport operator from bringing forward efficient new investment, although consultation arrangements would need to be improved to ensure that this would be in users' interests.
Operational efficiency	Operational efficiency incentives are more likely to be dependent on the terms in the commitments rather than the threat of reregulation through price monitoring.
Allow environmental measures	There is no reason why environmental measures could not be introduced.
Transparent, accountable, proportionate, consistent and targeted	There should be no reason why the rules in this option would not be understood clearly by all parties, it therefore is capable of satisfying the better regulation principles. Airlines may have greater confidence in

Criteria	Assessment
	this regime than in price monitoring or commitments alone, however much of the protection would come from the commitments themselves and licence enforcement of these may be more proportionate response.
Practical implementation and stakeholder confidence	This option requires stakeholders to believe that an airport operator will behave responsibly. The commitments provide an indication of what can be expected from GAL, however as a price monitoring regime would not directly enforce the commitments, concerns with enforceability may remain.

Source: CAA analysis

Conclusions

12.78 The Act provides an opportunity for the CAA to introduce regulation that is better tailored to the risks of abuse of SMP and the needs of passengers. The CAA's market power assessment found that GAL holds SMP.

12.79 While not acknowledging that it has SMP, GAL has put forward airport commitment proposals, which, if suitably revised, could offer many of the same protections to airlines than would be available under a regulatory settlement. The CAA considers that these proposals are welcome and could potentially form the basis of the regime for GAL going forward. However, at the present time, the CAA is concerned that the enforceability and the terms of the commitments are such that they do not offer sufficient protection to be in the passenger interest. If the terms of the commitments are improved, then the CAA remains optimistic that GAL's commitments could be a core element in the regime for Q6. However the CAA cannot see how the enforcement framework around the commitments can be strengthened sufficiently that relying on GAL's commitments alone would enable the CAA to provide assurance that passengers' interests will be promoted.

12.80 The CAA has therefore considered what form of regulation should be implemented under a licence. The CAA hopes that a commitments and limited licensing framework could be the preferred form of regulation for GAL. This would be on the basis that the enforcement concerns about the commitments concept was addressed through enforcement under the licence; and that the commitments were amended to address the other concerns identified by the CAA, so that they are reasonable and effective. However, the CAA does not consider that the terms in GAL's current commitment proposals are sufficiently reasonable and effective to take forward this option as its initial proposals and has therefore considered alternative forms of licence regulation. It is open to GAL to revise its commitments following discussions with the airlines. The CAA would reconsider its view should GAL make a satisfactory proposal, particularly if agreed with airlines.

12.81 In reviewing alternative forms of regulation, the CAA does not consider that LRIC or airport comparator benchmarks would be sufficiently robust to be used to set price caps. Furthermore, the CAA does not consider that price monitoring, in particular in the absence of reasonable and effective commitments, would offer sufficient protection given the issues identified in the market power assessment. Price monitoring combined with commitments in a licence may be a more effective form of regulation, however much of the burden from preventing abuse would fall on the commitments themselves. Consequently, simply including commitments in a licence is likely to be a more appropriate form of regulation, particularly in terms of enforceability.

12.82 Given the potential improvements that are available under the Act, and the degree of market power held by GAL, the CAA considers that a RAB-based framework would be an appropriate form of regulation for GAL. A RAB-based framework is well understood and widely used across regulatory sectors. It provides price and service quality protection to passengers, while providing incentives for efficiency and has support from airlines. Unlike Stansted, there is less uncertainty over individual building blocks and the value of the RAB does not appear to be out of line with the investment requirements of passengers. Consequently in the absence of a satisfactory proposal for commitments, and due to the concerns raised around the other potential options, t, the CAA considers that it would be appropriate to base the initial proposals on a RAB-based framework. The remainder of this document sets out the CAA's initial proposals for a RAB-based price control for GAL.

Part D:
CAA's initial proposals for a RAB-based price control

Part D: CAA's initial proposals

Part D sets out CAA's initial proposals for a RAB-based price control for GAL.

Part B set out the CAA's view of a fair price based on a RAB-based framework. The CAA's initial proposal is therefore to set a RAB-based price cap on the basis of these calculations and the initial projections should therefore be regarded as the CAA's initial proposals. While GAL has offered commitments for seven years, the CAA's initial proposal is to continue with a five year control period, given the greater need in a RAB-based framework to define investment needs in advance. Consequently, CAA's initial proposals for a price cap are as follows:

Figure D.1: CAA's initial proposals for a price cap

£ (2011/12 prices)	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
Yield per pax (profiled)	8.31	8.41	8.50	8.55	8.60	8.68
Year on year change	n/a	1.24%	1.04%	0.60%	0.59%	0.98%

Source: CAA analysis

The remainder of Part D sets out the CAA's initial proposals in relation to other aspects of a RAB-based licence, in particular, service quality incentives, operational resilience, capital efficiency incentives, other price control issues and other licensing issues.

CHAPTER 13

Service quality

13.1 This chapter contains the CAA's initial proposals for incentives attached to the delivery of service quality. It sets out where agreements were reached during CE, the proposals of GAL in the RBP (for both commitments and a RAB-based price control), views from the ACC, and other stakeholders. The chapter concludes with a summary of the CAA's initial proposals.

13.2 Chapter 3 of this document set out the CAA's understanding of passengers' interests, which indicate that the priorities for service quality are:

- a need to maintain consistent delivery of current levels of service provision around the critical aspects of the airport experience, for example queue times, and
- that any proposed improvements should be focused on areas where passenger benefits demonstrably outweigh the costs which could impact all passengers.

13.3 The SQR scheme was introduced by the CAA in Q4 to set certain standards which airlines could expect from the airport operator in return for charges paid. Where performance fell below these standards, the airport operator was liable to repay a portion of the charges levied to the airlines. The scheme was expanded for Q5 to include a total of 17 metrics,[132] some of which are for services provided directly to passengers, others for services provided to airlines which in turn promote efficient and reliable operations at the airport, which are the key passenger priority.

13.4 During Q5, the total level of airport charges at risk is approximately 7% per annum spread across the various elements within the scheme. GAL also had the opportunity to earn bonuses where certain elements exceeded their standards. The maximum aggregate bonus GAL could earn per the Q5 decision was 2.24% per annum.

[132] 16 at the South Terminal, 17 at the North Terminal

13.5 For Q5, the service quality standards were set at a level intended to drive up performance which led to substantial rebate payments at the start of the quinquennium. For Q6, the CAA considers that performance has improved at the airport, and rather than driving up average levels of service quality, regulation should be focused on maintaining consistent airport performance across all passengers.

13.6 In recognition of this objective, the CAA proposes to introduce some 'events-based' rebates which focus on reducing the variability of performance levels rather than improving the average level of service (for example, in the area of central search).

13.7 In order to maintain a similar level of overall financial risk to GAL, the CAA proposes that rebates on the existing measures of 'average' performance are correspondingly reduced, and that an annual maximum is set for the events-based rebates.

Stakeholder views

A. Constructive Engagement

13.8 Service quality was initially discussed within the main CE meetings, with a stand-alone subgroup set up towards the end of 2012 to allow GAL and the airlines to fully explore the detailed questions arising, with the intention of completing the summary of agreements and disagreements for the CE report. The CAA attended these meetings.

13.9 The basis of the workstream was to review the existing Q5 SQR and consider whether its structure and content would be appropriate for the period beyond Q5, or whether revisions should be made.

13.10 In line with CAA's primary duty, the service quality workstream focused on the service quality needs of passengers at the airport. To inform their understanding, the workstream made use of a number of sources of information.

- GAL's ongoing passenger research, feedback and complaints data.
- GAL's targeted research looking at the passenger experience and willingness to pay (results contained in Appendices 16 - 18 of the final CE report).

- Airlines' own passenger research and customer insights which informed their views.
- Input from the CAA on their review of available evidence (including their own complaints data).
- Input from GATCOM and the Gatwick APP.
- The structure of the Q5 SQR, which was developed from historical understanding of passenger service quality needs.

13.11 The CE report sets out the joint summary of the output from the service quality discussions. This report indicates that agreement was limited between GAL and the ACC, and in part, this was driven by a lack of consensus across the airlines. However, there are a few areas where the views of the airline community and GAL align.

- For GAL to monitor and publish the performance of UKBF queues at the airport.
- To include monitoring and tracking of GAL performance against the ASQ measures.
- To add a departures (outbound) baggage metric to the service quality scheme (subject to development of metric and standard).

13.12 Whilst not explicitly stated, there also appears to be broad agreement that the Q5 SQR provides a suitable basis for developing the Q6 SQR. The separate submission from the ACC indicates the airlines' agreement that the Q5 SQR has "given the airport a meaningful incentive to maintain and improve service performance in areas that are important to passengers and airlines".

13.13 The CE report notes that there is disagreement between GAL and the ACC on "some of the areas within the SQR scheme". The submission from the ACC provides more clarity over what these areas are, and these are summarised below. There is also clear disagreement between GAL and the airlines over the inclusion of any airline service measures within the SQR scheme.

B. Gatwick Business Plan

13.14 GAL's RBP contains proposals for Service Quality Incentives (SQI) under both a RAB-based price control and commitments. There are some differences between the proposals both in approach and level of detail. The CAA has given consideration to both proposals as it would generally be possible to introduce either proposal under a RAB-based control.

13.15 As part of the SQI, both sets of proposals include a SQR scheme where failure by GAL to deliver service at the targeted standard results in rebates being paid to the airlines. This SQR scheme is the same kind that operates during Q5, and is broadly similar to that in the IBP published previously.

13.16 Alongside the SQR scheme which focuses on airport performance, GAL's service quality proposals include three further areas, and so the overall SQI can be considered in four parts.

1. SQR Scheme.
2. Airport operator bonuses.
3. Airline performance financial incentives.
4. General performance publication incentives.

13.17 There are some changes to the detail of the SQR part of the SQI proposals since the IBP. In summary these are:

- inclusion of an outbound baggage element (metric and standard still to be defined);
- continued inclusion of the flight information element which was removed in the IBP;
- replacement of the ACT and proposed snow SLA with a combined airfield availability element (metric and standard still to be defined).

13.18 The figure below summarises what these are, how they differ from Q5 and how they are incentivised under the IBP, the RBP and GAL's price commitments proposal:

Figure 13.1: Summary of differences in airport service quality proposals

	Initial Business Plan	Revised Business Plan	Price commitments proposal
Airport SQR Scheme			
Outbound baggage	N/A	Included	Included
Flight Information - QSM	Removed	Included	Included
Aerodrome congestion term	Removed, replaced with snow SLA	Removed, replaced with airfield availability (incorporating snow SLA)	Removed, replaced with airfield availability (incorporating snow SLA)
Remainder	As per Q5 except: - overall bonuses increased from 2.24% to 7% - QSM standards and bonus levels increased - no weightings given for rebates/bonuses	As per IBP	As per IBP except: - weightings provided for rebates/bonuses
Airline performance – financial incentives – new for Q6			
Check-in queues	Publication, Performance surcharge/rebate	As IBP except: - details of scheme provided, estimated surcharge of 3p per passenger with quarterly rebate	Publication, Rebate reduction (amount not defined)
Arrival bags	Publication, Performance surcharge/rebate	As IBP	Publication, Rebate reduction (amount not defined)
General performance - publication incentives – new for Q6			
Airline PRM service & pre-notification	N/A	N/A	Publication
On-time performance	Publication, Performance	N/A	Publication

	Initial Business Plan	Revised Business Plan	Price commitments proposal
	surcharge/rebate		
Immigration	Publication	As IBP	As IBP
Airport performance (ASQ)	Publication	As IBP	As IBP

Source: IBP, RBP and CAA analysis

13.19 In its IBP, GAL had proposed inclusion of three further elements outside the direct control of GAL in a performance rebate/surcharge scheme. The RBP reduces this to two elements under a RAB-based approach: check-in queues and arrival bags (with a tightening of the minimum standard for arriving bags from 55 minutes to 45 minutes), and removes on-time performance. The “Rebate Reduction Scheme” is similarly constructed under the price commitments proposal, although the mechanics of the financial incentives are different.

13.20 The IBP and RBP also include proposals to publish performance of immigration and the airport operator’s performance in terms of ASQ scores. The RBP price commitments proposals extend this publication to include airline PRM service and pre-notification; and on-time performance.

13.21 Thus the service quality proposals are broadly the same under the price commitments or the RAB-based approach in the RBP. The main differences are:

- the price commitments proposal sets out a maximum rebate and bonus of ~7% per annum, the RAB-based approach does not give a total at risk, but does specify symmetry between rebates and bonuses;
- there are no proposals around the relative weighting of the elements under either approach in the RBP. However, GAL has subsequently informed the CAA of their proposed weightings under the price commitments proposal;

- the airline performance leads to offsetting of airport charge rebates under the price commitments, as opposed to an ongoing distribution of a passenger surcharge under a RAB-based approach. The RBP also provides further detail on this proposal, indicating a passenger surcharge of approximately 3 pence per passenger to fund a quarterly rebate to those airlines meeting the minimum standards. The price commitments proposal does not set out what the proposed level of rebate offset would be.

C. ACC submission

13.22 The ACC submission contains a chapter on service quality, which outlines the lessons learnt from the design and performance of the Q5 SQR; the airlines' objections to GAL's proposals; and sets out the ACC's objectives for service quality in Q6.

13.23 As noted above, a stumbling block within the CE process which prevented agreement between GAL and airlines was the lack of consensus between the airlines themselves in the area of service quality. There are however a number of areas where the airlines hold a consistent view, which they have presented as their four key objectives for service quality in the ACC submission.

- A greater focus on key measures.
- The removal of bonuses.
- An increase in the potential total rebate – however views diverge on the size of this increase.
- A rebate for airport operator failure on key events - replacing the ACT with an event-based rebate for non-availability of runways and taxiways.

13.24 As to how these objectives should be achieved, the airline views of how the SQR should be structured lie on a spectrum ranging from incremental change building upon Q5, to a move to a focused SLA. These views are summarised below (from the ACC presentation):

Incremental change	Move to a focused SLA
• Use current SQR as basis • No bonuses • Increased money at risk • Rebate for key event failure (e.g. security)	• Focus on a few key measures (security; baggage; airfield; customer satisfaction) • Maximum rebate of 100% • Measures focused on maximum not average • Event-focused rebates

13.25 The main areas of disagreement between the airlines are:

- measurement of performance - whether standards should focus on maximum measures, or percentiles;
- the relative weightings and/or removal of some elements; and
- total rebate at risk.

13.26 The ACC consider that there is a reduced risk of GAL failing to meet the standards set in Q5, due in part to investments made over Q5, and also due to greater management focus that the SQR has brought. The ACC further believe that the CAA should consider how to capture the improved performance of GAL – either through standards which are harder to achieve, or which generate a greater rebate if they fail.

Background

Performance of Q5 SQR scheme

13.27 Figure 13.2 shows the total rebates paid out under the Q5 SQR scheme, and bonuses received by GAL as at December 2012:

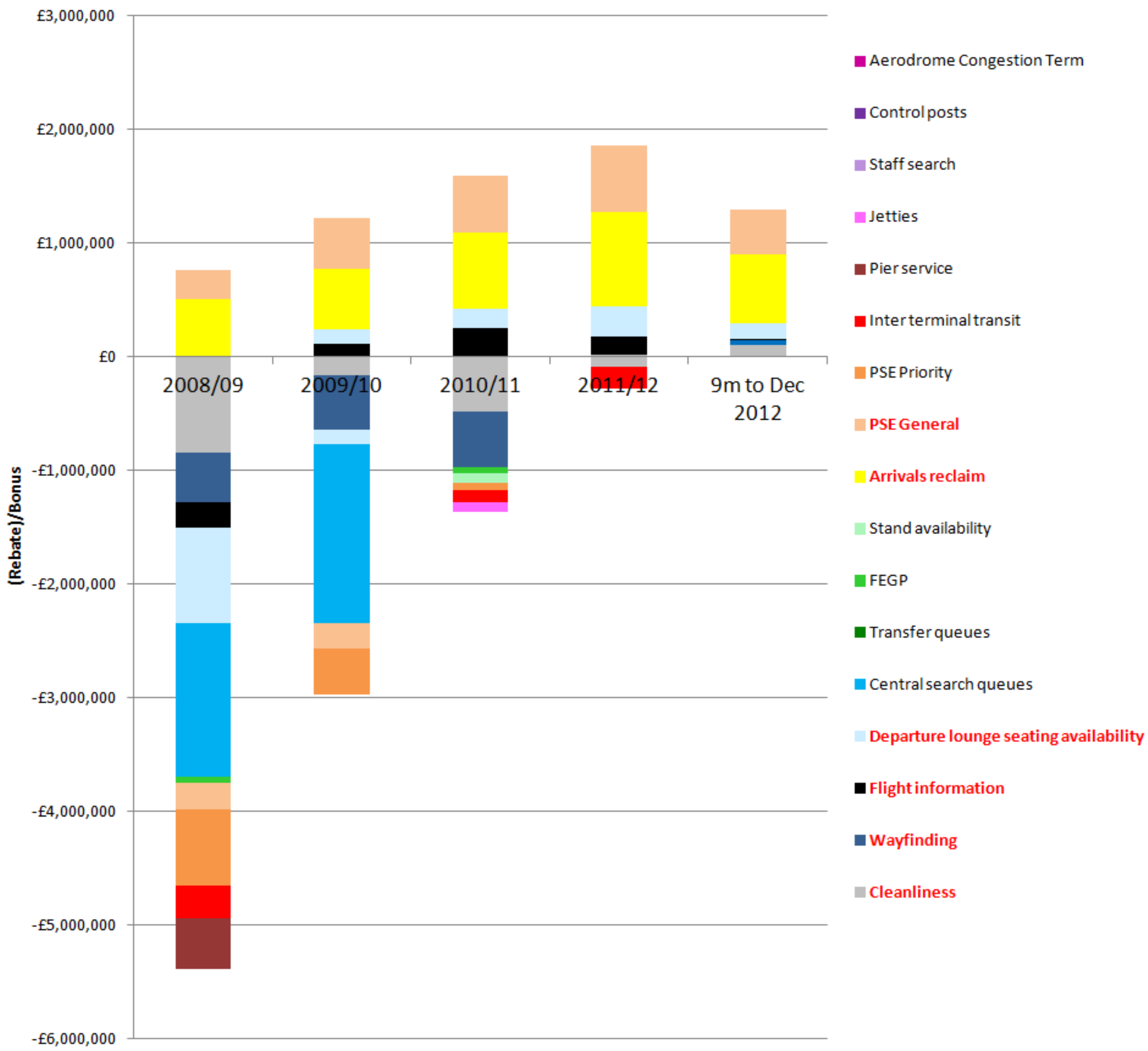
Figure 13.2: Summary of Q5 rebates and bonuses to December 2012

	Total airport charges	Rebates	Rebates as % of airport charges	Bonuses	Bonuses as % of airport charges
2008/09	£234.5m	£5.4m	2.30%	£0.8m	0.32%
2009/10	£241.6m	£3.0m	1.23%	£1.2m	0.41%
2010/11	£241.9m	£1.4m	0.56%	£1.6m	0.66%
2011/12	£271.3m	£0.3m	0.10%	£1.9m	0.68%
Apr 12 – Dec 12		£0		£1.3m	

Source: GAL Regulatory Accounts, GAL RBP

13.28 As figure 13.3 shows, since 2010/11, GAL has earned bonuses in excess of the rebates paid. The bulk of these have been on passenger sensitive equipment (PSE) and arrivals reclaim. The improved service quality performance of GAL has led to a reduction in the rebates it has paid over Q5 from over £5 million in 2008/09 to £281,000 in 2011/12. The most significant driver in this has been the improvement in the performance of central search security.

Figure 13.3: Q5 service quality - rebates and bonuses



Source: CAA, based on GAL RBP, Appendix 13

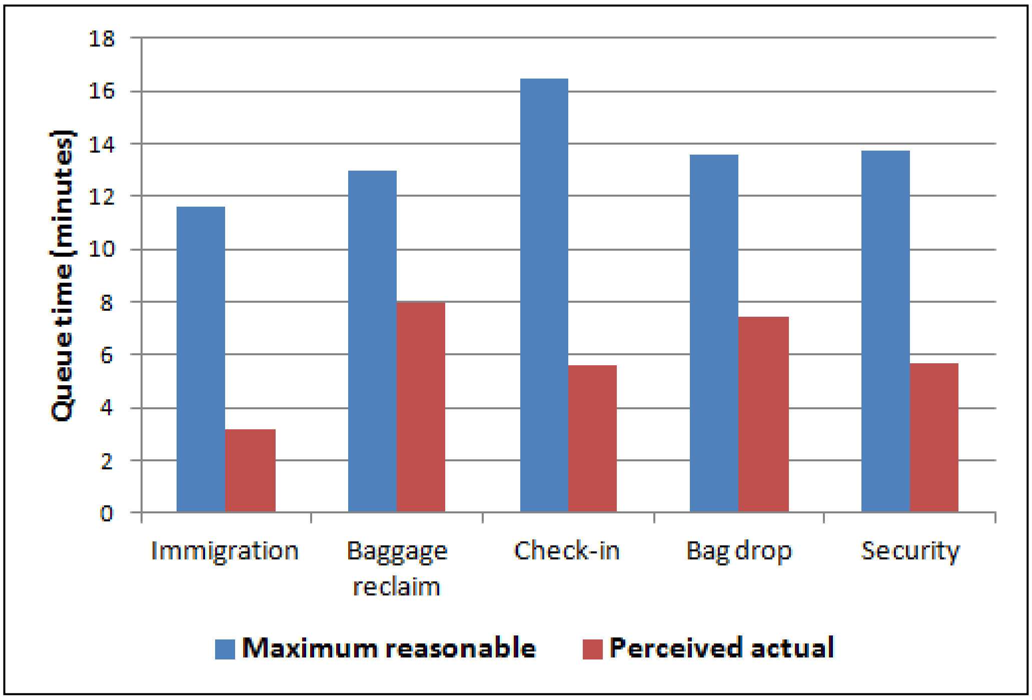
Passenger priorities

13.29 Chapter 3 of this document sets out how the CAA has reviewed available evidence and discussed findings with stakeholders in order to develop an understanding of the passenger interest for the purposes of Q6.

13.30 Whilst airport facilities are not a primary driver of airport choice, survey data and discussions with airlines indicate that once at the airport the passengers' concerns tend to focus on queue times and on-time performance.

13.31 Survey research suggests that current levels of passenger satisfaction with the airport experience are generally high. For example, in terms of specific processes, evidence indicates that the majority of passengers perceive their queue time to be less than the maximum they think is reasonable (see figure 13.4).

Figure 13.4: Maximum reasonable and perceived actual queue times



Source: CAA Q6 research, n = 297 arrivals, n = 656 departures

13.32 Recent work for the CAA, which is due to be published soon as part of the forthcoming consultation on how the CAA proposes to use its powers under section 83 of the Act regarding information publication, indicates that there are a number of areas where passengers regard access to information as useful. Whilst the key areas relate to prices and routing, there are a number of airline and airport service measures which are considered important by a substantial proportion of respondents.

Discussion of key issues

13.33 In this section, the CAA considers the service quality proposition within GAL's RBP (under regulation), the ACC's views and then presents its initial proposals.

Structure of the financial incentives

(1) Overall total of rebate

13.34 GAL's RBP proposal incorporates a total rebate of 7% of airport charges. The airlines consider that the performance of GAL has improved over Q5, partly as a result of investments made and partly as a result of management focus. On this basis, they argue that the risk of GAL failing the existing standards has fallen, and that the total rebate should be increased above 7%.

13.35 However, as with a number of other issues, there is not a consensus across the airlines as to how much higher the appropriate level of rebate at risk should be, with some airlines arguing for 100% of the airport charges to be at risk.

13.36 Given that GAL is meeting the current standards, this indicates that the amount of money at risk of rebate has sufficiently driven improved performance during Q5, and the CAA sees no justification for increasing it. The CAA proposes to maintain the current level of maximum rebate at 7%.

(2) Relative weighting of rebates

13.37 Both GAL and the ACC agreed that reweighting the rebate across the existing elements and simplifying the scheme where possible would be desirable. However, for the purposes of CE, the ACC did not present an agreed, single view on their preferred approach. GAL's proposals in the RBP did not allocate weightings, however these have been provided subsequently for the price commitments, and the CAA have presumed these weightings also apply to the RAB-based service quality proposals.

13.38 The ACC submission indicates that there is divergence of views on what should remain in the SQR, and the relative weighting thereof.

13.39 The CAA's proposal is for the Q6 weightings to be based broadly on the Q5 weightings with some changes to focus more on those areas identified as passenger priorities (for example a reduction in the level of rebate related to transfer passengers), and to introduce some events-based rebates for severe disruption to key processes.

13.40 The CAA's proposals also simplify the allocations by terminal such that track transit is the only element with a different rebate attached.

(3) Timing of rebates and bonuses

13.41 The CAA proposes to retain the Q5 arrangement whereby rebates are set according to an annual maximum but spread over 6 months. The CAA considers that this provides a greater incentive to GAL to address any service quality issues that arise. Repeated failure for a given element over 6 months may be better addressed through alternative means such as an enforcement investigation.

(4) Events-based rebates

13.42 The ACC has expressed support for the inclusion of events-based rebates, which focus on specific incidents of reduced service quality. The current metrics generally focus on monthly average performance, and the airlines consider that the avoidance of incidents of major disruption is a key passenger priority.

13.43 GAL considers it already has sufficient incentive to recover operations quickly, however in the case of its proposed outbound baggage availability metric is exploring its formulation with the airlines, and this may include an events-based measure. Similarly, GAL has noted it would like to enter into discussions with the airlines around improvements they suggest to the current ACT.

13.44 The CAA welcomes GAL's willingness to collaborate with the airlines on the development of the proposed outbound baggage system and airfield availability metrics, and considers this a helpful approach to addressing the airlines' concerns around consistent operations at the airport.

13.45 In response to the improved monthly average performance seen over Q5, the CAA proposes a reallocation of some of the rebate to a daily event based central security queue metric. The CAA considers it is in the passengers' interest to incentivise consistency in the service quality provided rather than drive further improvements in the average performance.

(5) Inclusion of bonuses

13.46 Bonuses were introduced in Q5 as an incentive to encourage ongoing service quality improvements at the airport, but particularly focused on bringing up performance in the worst performing terminal as a bonus can only be earned if performance in both terminals exceeds the lower level set. The amount earned in bonuses during Q5 has increased throughout the period as GAL has successfully improved in the targeted areas.

13.47 Bonuses are currently available on six elements in the SQR and take the form of increased airport charges to the airlines if service is delivered over targeted levels across both terminals in the airport. GAL considers that this should be extended and that bonuses should be available on all elements within the scheme. GAL's view is that bonuses encourage outperformance and that can help to incentivise service delivery.

13.48 The airlines opposed the introduction of bonuses in Q5, and remain opposed to them continuing in Q6. In the ACC submission, the airlines argue that the bonus arrangements are “contrary to the interests of passengers”, and commit the airlines to making payments for services they have not asked for. In the CE report, the ACC argue that where there is a passenger benefit from higher performance, this should be built into the standards on a case-by-case basis, or else particular airlines could negotiate bilaterally with GAL for a higher service level.

13.49 Of the measures in the SQR which are not currently subject to bonuses, these generally relate to asset availability which is already targeted at high percentages. The CAA does not consider that the benefit of increasing performance levels above these standards would sufficiently offset the costs of implementing such changes.

13.50 Where the QSM measures are currently at different levels across the terminals, the CAA considers that the use of bonuses provides an ongoing incentive to GAL to attain terminal equivalence in these measures of passenger satisfaction. The proposed levels are discussed later in this chapter.

13.51 Both of the asset availability measures of PSE (general) and arrivals baggage reclaim have a proposed standard of 99% time availability, which GAL has consistently attained. Consequently, the CAA does not consider that bonuses are appropriate to incentivise higher levels of service delivery. The CAA proposes the removal of bonuses on these measures in Q6. Consequently, while the total amount of airport revenue at risk through rebates remains at 7%, the maximum available through bonuses would fall from 2.24% to 1.44%.

13.52 For the purposes of the CAA's initial proposals, the CAA has fixed the allocation of bonuses and rebates for the five-year period. However, the CAA sees merit in having the ability to adjust the allocation of bonuses and rebates within the price control period to reflect changing passenger priorities. This is something that is possible with the new licensing framework which allows for the licence to include provisions to make modifications in specified circumstances. The CAA is keen to understand how stakeholders could envisage this approach working whilst respecting the need for regulatory certainty and avoiding unnecessary complexity, and whether they consider it to be in passengers' interest. For example, the licence could provide for modifications to be made where GAL, a representative proportion of the airlines and the CAA agree to the changes. There could also be scope for the CAA to direct changes if one party did not agree.

13.53 Another approach would be for the CAA to redeploy the bonuses removed from the two elements discussed above, and place the money at risk into a discretionary pot that could be allocated by the CAA to incentivise enhancements in GAL's performance that are revealed as necessary after the price control is set, instead of allocating them to specific elements at this point.

13.54 The CAA considers the operational resilience of the airport to be a key area of performance for the airport operator. However, the CAA considers that, at this stage, it is not a suitable area for deploying potential SQR bonuses as performance would not be dependent on a change in the level of service quality delivered, but rather a change in the circumstances under which it was delivered. To allow scope for bonuses to be earned for "business as usual" performance in times where this might be difficult to achieve for reasons outside of the airport's control would require developing new metrics around the circumstances impacting performance rather than performance itself. This has not been discussed as part of CE but the CAA would welcome views from stakeholders on whether it ought to consider linking financial incentives (bonuses) to operational resilience in the future.

Publication of results under the SQR scheme

13.55 The CAA considers that transparency of information provides an important non-financial incentive in the area of ASQ.

13.56 The CAA Q5 decision required the airport operator to "publish monthly, from April 2008, via a readily accessible part of its website, its performance against the specified service standards and details of the specified rebates paid and payable in respect of each terminal and for each category of service". The CAA proposes to maintain this requirement for Q6, alongside further requirements as follows to publish details of bonuses earned by the airport operator:

- on a monthly basis, identify those services by terminal where performance will lead to inclusion within the bonus calculation; and
- within two months of the regulatory year end to publish the full detail of the bonus calculation for the year, disaggregating by month and element.

13.57 The CAA considers that the information published within the terminal building should be a limited subset of the measures in order to help focus passenger attention. The CAA proposes the inclusion of the monthly target and performance of the following measures (to two decimal places), to be published within four weeks of the month end:

- departure lounge seating availability;
- cleanliness;
- wayfinding;
- flight information; and
- security (performance as per the moving annual average QSM score and the monthly objective queue time metric).

13.58 The posters should give clear directions to passengers as to where they can find the full performance publication on the website, and instructions as to how passengers can provide feedback to the airport operator.

Content of the SQR

(6) Overview

13.59 GAL's proposals in the RBP are for a SQR scheme which includes all the measures from the Q5 SQR bar the ACT, plus the inclusion of two new measures:

- outbound baggage system availability; and

- airfield availability (to replace the ACT).

13.60 The airlines' views diverge on the content of the SQR - some wish to see a reduced set of measures, others to see retention of the measures but an adjustment to the weighting of the rebates. The airlines are supportive of both the introduction of an outbound baggage system metric, and of the development of the ACT. However, as neither party has proposed a revised formulation for the airfield availability metric, the CAA has included the existing ACT in its initial proposals.

13.61 The CAA proposes to:

- retain the measures from the Q5 SQR, including the ACT;
- introduce an outbound baggage system availability metric; and
- introduce events-based rebates on security and the outbound baggage system.

13.62 The CAA also seeks the views of stakeholders on:

- how the flight Information element of the SQR might be developed to reflect passengers' changing expectations around information provision;
- how a suitable replacement for the ACT could be formulated, and the standard proposed; and
- the proposed level of events-based rebates.

(7) Passenger satisfaction measures - QSM

i. Inclusion of elements

13.63 The QSM is GAL's own survey which asks passengers about their satisfaction with a number of aspects of their airport experience. There are four elements within the Q5 SQR where performance is measured using the results from this survey - these are: departure lounge seating availability, cleanliness, wayfinding and flight information.[133] GAL's RBP proposes the retention of all four QSM measures in the SQR.

[133] Details of the QSM survey are set out in Annex H of Economic Regulation of Heathrow and Gatwick Airports 2008-2013, CAA Decision.

13.64 Although neither the airlines nor GAL has suggested making changes to elements of the survey, the CAA has given consideration to the views of the Consumer Panel and the indications from passenger research[134] regarding the importance of information to passengers (especially during times of disruption), and the growing expectation around access to information.

13.65 The Q5 SQR contains a flight Information measure which is based on passenger satisfaction levels with the flight information displays within the airport. GAL has performed consistently above standard on this measure some time. However, the CAA acknowledges that passenger expectations around information provision and accessibility have grown over time. For example, many passengers now expect wi-fi to be available.

13.66 With that in mind, the CAA seeks views from stakeholders on how it might widen the scope of the current incentive around passenger information incentive. This could be in the form of an additional standard or the development of the current flight information standard. Possible methods of measurement would be through the use of additional survey questions, or through objective measurement of wi-fi availability at the airport.

ii. Level of standards

13.67 Performance against standards is measured by a moving annual average score from GAL's QSM survey, where respondents are asked about their satisfaction with various aspects of their airport experience.[135]

13.68 GAL proposes retaining the same standards for the QSM measures as those in Q5, but in recognition of current performance, to move the bonus levels up to 0.1 to 0.2 QSM points higher than the standard.

13.69 The ACC response proposes the removal of bonuses entirely, and considers that the investment in Gatwick’s infrastructure in Q5 means that the current standards are now easier for GAL to achieve. They suggest either a tightening of the standards, or increased rebates for failure.

---

[134] CAA, August 2011, *Aviation's response to major disruption* http://www.caa.co.uk/default.aspx?catid=2107&pageid=12086

[135] Rated from 1 = extremely poor, 2 = poor, 3 = average, 4 = good, 5 = excellent.

13.70 Figure 13.5 shows the current standards and performance, and the proposals made by GAL:

Figure 13.5: GAL's proposals for standards for QSM measures in Q6

	Q5 standard/ bonus level	Dec 2012 performance	GAL's proposal for Q6
Departure lounge seating availability	3.8	N – 4.1 S – 3.9	3.8 (with bonus level increased to 4.0)
Cleanliness	4.0	N – 4.1 S – 4.1	4.0 (with bonus level increased to 4.2)
Wayfinding	4.1	N – 4.2 S – 4.2	4.1 (with bonus level increased to 4.2)
Flight information	4.2	N – 4.3 S – 4.2	4.2 (with bonus level increased to 4.3)

Source: GAL service performance reporting, GAL RBP

13.71 The CAA considers that the Q6 standards should not be set at a level over and above that which passengers are willing to pay for, however the standards should aim to capture the current performance achieved. Evidence suggests that passengers are generally satisfied with these aspects of the airport and that there is no pressing reason to increase standards where this would likely result in increased expenditure.

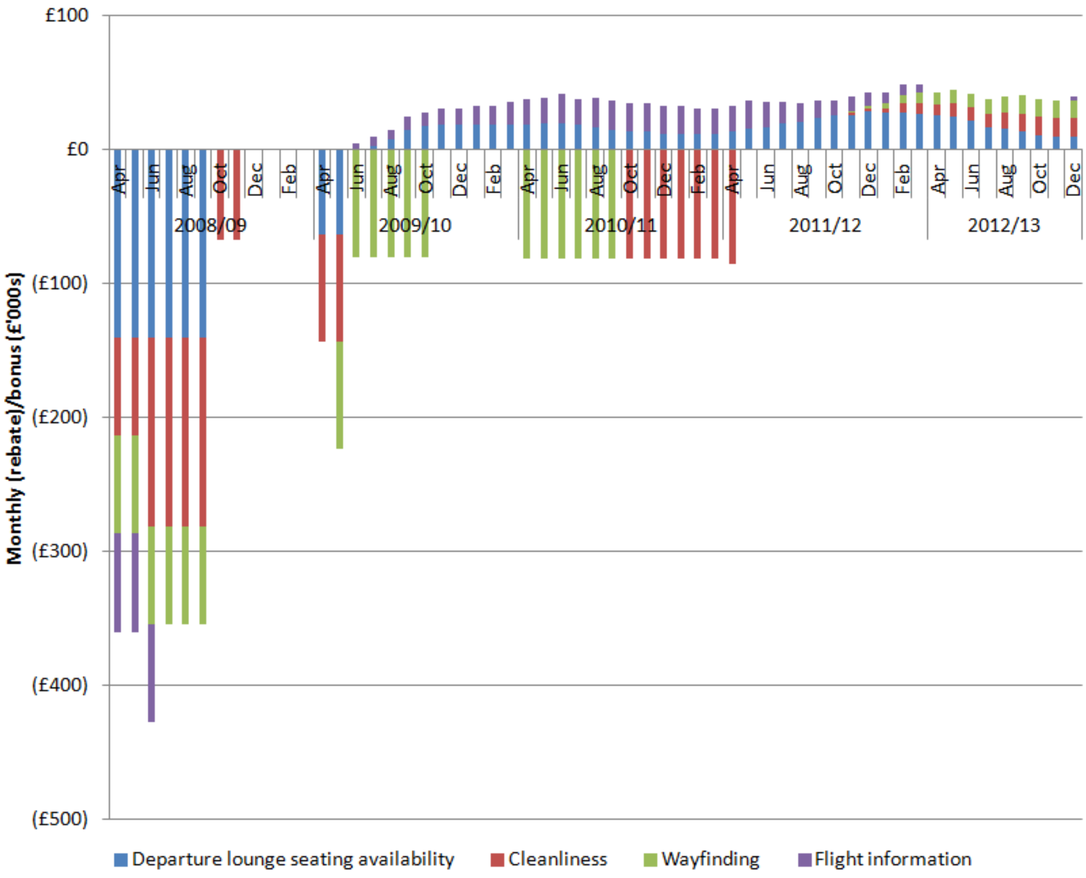
13.72 For the four QSM measures included in the Q5 SQR, the performance against standard has varied across the two terminals. This makes it more difficult to capture effectively the improvements in service quality whilst retaining terminal equivalence by maintaining consistent standards. Reviewing the performance of these standards in Q5 shows that, by December 2012, bonuses had been earned in all areas. The figure below shows where monthly rebates and bonuses have been earned over Q5 (rebates below the line, bonuses above).[136]

13.73 Generally over the course of Q5, the scores across the elements have increased by 0.1 to 0.2, with the exception of departure lounge seating

[136] Note that rebates are only paid for the first 6 months of a regulatory year, even if performance remains below standard.

availability, where the improvement has been 0.8 in the South Terminal, and 0.5 in the North Terminal.

Figure 13.6: Performance of QSM elements in Q5 – rebates and bonuses



Source: GAL performance reporting

DEPARTURE LOUNGE SEATING AVAILABILITY

13.74 This metric shows the most significant improvement over Q5 of the QSM scores - from 3.1 in the South Terminal in August 2008 to 3.9 by December 2012, (and 3.6 to 4.1 in the North Terminal). This is also the measure with the clearest sustained divergence between the two terminals.

13.75 The improvements to the IDLs in both terminals proposed in the RBP could raise the departure lounge seating availability score further. To capture the improvements over Q5 and to reflect the expected results of the investment, the CAA proposes to bring the standard up to a mid-point between current terminal performance at 4.0.

CLEANLINESS

13.76 The cleanliness metric has improved gradually over Q5, from around 3.9 to 4.1. Whilst the North Terminal has had a tendency to record slightly higher scores, the two terminals have both been at a level of 4.1 since March 2012.

13.77 The CAA proposes to increase the standard to 4.1 to capture performance which has been consistently delivered over the last year. The CAA does not therefore expect this to increase costs.

WAYFINDING

13.78 Similar to cleanliness, there has been a gradual improvement over Q5 in the wayfinding metric, (from 4.0 in South Terminal and 4.1 in North Terminal to 4.2 in both). Again, the North Terminal has recorded slightly higher scores.

13.79 Given the South Terminal has only just reached the level of 4.2, the CAA proposes to set the new standard at 4.1 but with a bonus margin slightly higher (at 0.3) than that applied to the other metrics.

13.80 The CAA proposes to increase the standard to capture performance which has been consistently delivered since April 2011, and is currently being exceeded, thus there are no expected associated cost increases.

FLIGHT INFORMATION

13.81 As with the cleanliness and wayfinding scores, there has been an improvement over Q5, with North Terminal having a tendency to score more highly than South Terminal.

13.82 In April 2008, the scores were 4.1 (South) and 4.2 (North). Since August 2011 the scores have consistently reached 4.2 (South) and 4.3 (North).

13.83 The CAA proposes to maintain the Q5 standard of 4.2, to capture performance which has been consistently delivered over the last year and a half, and is currently being exceeded in the North Terminal. Consequently there are no expected associated cost increases.

13.84 Given the current performance in the North Terminal is already above standard, the proposed bonus margin is slightly higher than the other measures at 0.3.

13.85 As noted above, the CAA recognises the growing importance of access to information for passengers, particularly in times of disruption. With that in mind, the CAA also seeks view on how it might widen the scope of the measure attached to flight Information.

SUMMARY OF QSM ELEMENT PROPOSALS

13.86 The CAA considers that service quality standards should capture improvements already made while driving terminal equivalence to a baseline standard. To avoid immediate bonus payments and incentivise genuine outperformance, the introduction of a 'deadband' above the standard is proposed, with bonuses only available where performance is substantially above the standard (and current performance) in both terminals.

13.87 The deadband proposed is 0.2 above the standard for departure lounge seating availability and cleanliness, and 0.3 for wayfinding and flight information. The differences reflect current performance compared with the proposed standard.

13.88 Given the proposed capital projects in both terminals in Q5 and Q6, and current performance levels, the CAA does not consider that increasing the standards should increase cost requirements.

13.89 The upper limit for bonuses has been set such that the range for each element is 0.3. This is generally a smaller range than it was in Q5 and allows for a larger bonus for each 0.01 increase in the performance of the QSM scores above the lower limit. This reflects the increased difficulty in achieving these higher levels of performance, and to a degree offsets the removal of bonuses from the asset availability measures of PSE and arrivals reclaim (baggage carousels).

13.90 Figure 13.7 shows the current standards and performance, and the CAA's initial proposals:

Figure13.7: CAA initial proposals for the four QSM standards

				CAA Q6 initial proposals			
	Q5 standard	**Dec 2012 perform -ance**	**Standard**	**Max annual rebate**	**Bonus level - lower limit**	**Bonus level - upper limit**	**Max annual bonus**
Departure lounge seating availability	3.8	N – 4.1 S – 3.9	4.0	0.36%	4.2	4.5	0.36%
Cleanliness	4.0	N – 4.1 S – 4.1	4.1	0.36%	4.3	4.6	0.36%
Wayfinding	4.0	N – 4.2 S – 4.2	4.1	0.36%	4.4	4.7	0.36%
Flight information	4.2	N – 4.3 S – 4.2	4.2	0.36%	4.5	4.8	0.36%

Source: GAL, CAA analysis

iii. Measurement issues

13.91 The CAA proposes that the current moving annual average measure for the QSM and pier service elements of the SQR should be retained. The basis for this proposal is as follows:

- a move to a monthly measure would have an impact on the sampling error of the estimate due to the reduced sample size. This is turn makes the measure 'riskier' as it becomes more volatile, increasing the chances of generating rebates or bonuses; and
- use of a moving annual average removes the impact of seasonality from the measures.

13.92 The precision of the QSM measures for rebates and bonuses needs to be rationalised to address an asymmetry evident in Q5 which arose from rebates being based on measures calculated to one decimal place, but bonuses to two decimal places. This had the effect of creating an effective reduction in the standards set. For example, if the standard was 4.0, 3.95 would not generate a rebate, but 4.01 would generate a bonus.

13.93 The CAA proposes that the QSM measures are reported to two decimal places on the website, in the airport terminal, and also for the purposes of rebate and bonus calculation.

(8) Central security and transfer search

i. Formulation of metric

13.94 GAL's proposals for both RAB-based regulation and commitments incorporate the existing Q5 security queue metrics, which are based on a single queue time measured every 15 minutes. During Q5, GAL has made progress in the installation of automated security queue measurement equipment in the South Terminal. This technology provides the opportunity for reformulating the metric in a way that uses this richer data source based on automated measurements of a much larger sample of individual passenger queue times. Automated queue measurement will start in the South Terminal in May 2013, with work being completed in the North Terminal in early Q6 to allow for similar reporting there.

13.95 The CAA notes that the introduction of the automated measurement system in the South Terminal (based on facial recognition software), has not been straightforward, and a number of practical problems have arisen during its implementation.

13.96 The CAA is keen to formulate a metric which can be developed once improved measurement technology is also available in the North Terminal, and which allows for calibration at a per passenger level.

13.97 Therefore the CAA proposes to retain the current metrics for central and transfer search for the first year of the price control, but then move (by agreement and CAA approval) to a per passenger metric by the end of 2014/15, targeting a similar level of performance, but based on the automated measurements from a sample of passengers.

13.98 Some members of the ACC have suggested that a metric which focuses on the maximum queue length would be an improvement on the current metric. The CAA recognises the importance of consistent delivery of service to both passengers and the airlines, and proposes to introduce an event based rebate related to days where performance is significantly below standard.

13.99 The proposal for 2014/15 is that for any day where a single reported

15 minute measurement is greater than a pre-determined number of minutes, a rebate would be payable of a proportion of the day's estimated airport charges (pro-rated across the month), subject to an annual maximum percentage of airport charges. As with the monthly performance measure, this metric will be subject to revision once basing it on automated measurement is practical.

ii. Level of standards

13.100 GAL’s proposals for both price commitments and RAB-based regulation incorporate the existing Q5 security queue standards. These are based on a single queue time measured every 15 minutes, with the standard set at 95% of measurements being of 5 minutes or less, and 98% of measurements of 15 minutes or less.

13.101 The ability to review more detailed data from the automated system in the South Terminal has highlighted the potential impact of variable passenger flows throughout the day on the current, time-based measure. Based on initial estimates made from a small sample of South Terminal data, 95% of queue times within 5 minutes, measured every 15 minutes, is broadly equivalent to 70% to 80% of passengers within 5 minutes. Further work will be required for more accurate calibration of a change in metric to retain current standards of service.

13.102 GAL's proposals are consistent with the evidence available on passenger satisfaction with current performance (e.g. CAA Q6 research). Figure 13.4 above indicates that the average perceived security queue time for passengers departing Gatwick (just under 6 minutes) is materially lower than the maximum time passengers considered reasonable (just under 14 minutes). From the same survey an estimated 93% of passengers experienced a queue time less than the maximum that they considered reasonable.

13.103 Consequently, the CAA proposes to retain the Q5 standards for the first year of Q6 for the monthly performance metrics. However, on moving (by agreement with the ACC and the CAA) to a per passenger metric by the end of 2014/15, a new standard will need to be developed. The new standard will aim to target a similar level of performance and will need to ensure that performance is incentivised at a high percentile of the per passenger queue time distribution to provide sufficient assurance to passengers around their expected queue time.

13.104 The CAA also proposes a daily event based performance metric which aims to incentivise consistency of service quality. For 2014/15, the proposal is such that for any day where a single 15 minute measurement is greater than 30 minutes, a rebate would be payable of 0.5% of the day's estimated airport charges (pro-rated across the month), subject to an annual maximum of 0.45% of airport charges. For example, if, in one month of 30 days, this occurred on5 days, the rebate payable would equal (5/30) x (5x0.5%) = 0.42% of the monthly airport charges. As with the monthly performance measure, this metric will be subject to revision once basing it on automated measurement is practical.

13.105 The CAA invites views from stakeholders on whether 30 minutes is the appropriate level of queue time used to trigger the daily event based performance rebate.

iii. Use of subjective measures

13.106 The current central search standards are measured objectively based on passenger queue times, and the airlines consider the objective measure of queue times to be of primary concern.

13.107 The CAA considers that for rebate purposes, an objective measure is preferable where it is available. Therefore the CAA does not propose to use the passenger satisfaction scores to base the measure of performance on. However, the CAA also acknowledges the importance of the passenger satisfaction with waiting times.

13.108 A question in GAL's QSM survey asks passengers how satisfied they were with their queuing time at security, on a scale of 1-5.[137] Considering historical results on a monthly basis (from April 2008 to December 2012), there is a reasonable correlation (approximately 0.6) with the security performance as measured by the proportion of 15 minute queue times in the month which are 5 minutes or under.

13.109 The CAA proposes the inclusion of the moving annual average measure from the QSM survey to be reported in the airport terminal alongside the other passenger satisfaction measures for which there is no objectively measured alternative.

[137] Where 1 = extremely poor, 2 = poor, 3 = average, 4 = good, 5 = excellent

Iv Safety and security requirements.

13.110 For the avoidance of doubt, in meeting these requirements GAL must also meet its legal obligations including in relation to safety and security.

(9) Outbound baggage availability

13.111 Both GAL and the airlines are keen to include a measure of the outbound baggage system in the SQR, but as yet no firm proposals have been made to the CAA as to what form this will take, and what the standard should be.

13.112 The CAA proposes a measure based on time available across the month, with the standard set at 99%. The CAA invites views from stakeholders on how this metric might be augmented with an event-based rebate similar to that proposed for security, and how this might be incentivised.

(10) Aerodrome Congestion Term

13.113 The ACC submission indicates that the airlines consider the ACT to be “overly complex and ineffective”, and suggest an event-based rebate for the non-availability of runways and taxiways, however there is no proposed formulation for this metric.

13.114 GAL’s RBP altered its initial proposals of a “snow SLA” and removal of the ACT, to a combination of the two into an airfield availability measure. Whilst the airport operator itself does not agree with the airlines that the ACT is ineffective, it has indicated that it is open to discussion around developing the measure.

13.115 In recognition that disruption can result from events other than the weather, the CAA welcomes GAL’s proposal to reintroduce some form of airfield availability measure, which extends beyond a snow SLA.

13.116 The Q5 rebate is a maximum of £30,000 per event up to a maximum of 1% of airport charges per year. During Q5 no rebate has been paid out.

13.117 The CAA invites views from stakeholders on:

- the reasons behind the performance of the ACT in Q5 - for example, is the level of rebate per event insufficient to warrant the resources required to ascertain the necessary operational details of any disruption? or was the performance of the airport operator such that no such event occurred? and
- the construction of an alternative metric to the ACT, which is an event-based metric and retains the cap on the rebate of 1% of airport charges.

Performance of other parties

(11) Financial incentives on airlines and handling measures

13.118 Within the RBP proposals, GAL has included two airline service quality standards: check-in queue times and arrival bags wait time. GAL proposes each passenger would pay a small surcharge (circa 3 pence per passenger) which would fund a quarterly rebate to those airlines meeting the minimum standards. Where an airline has not met the standard, it would forfeit this rebate and the money would be distributed amongst the airlines that had achieved it.

13.119 The CE report indicates the ACC's disagreement with GAL's proposal to include airline service measures within the Gatwick scheme. The ACC submission sets out their reasons for this.

- The SQR as it stands allows for a rebate of a proportion of charges paid by the airlines for services provided by the airport operator – it is not intended to be a compensation mechanism. On this basis, the airlines do not see an argument for placing a requirement on the airlines (who are not selling services to the airport operator).
- Placing service standards on airlines could undermine competition between airlines, and could be to the detriment of passengers' interests.

13.120 The CAA encourages the airport community to work together to deliver the best outcomes for passengers, and acknowledges that airlines are responsible for a number of aspects of the passenger experience. The CAA acknowledges that differentiation on check-in and baggage is an important choice consideration for passengers. By setting standards on airline services, the airport operator has the potential to reduce competition between airlines, which may be detrimental to passengers. However, such differentiation should be within reasonable limits, and it is in principle reasonable for the airport operator to indicate baseline levels of service expected from all airlines at the airport.

13.121 Whilst the CAA seeks to encourage mutual accountability between the airlines and airport operator for the passenger experience, it considers that further work would be required on issues of measurement and incentives before airline measures could be introduced. Therefore (although airline standards might find a place in a commitments-based regime), these ideas have not been included in the CAA's initial proposals.

(12) Publication of other measures

13.122 In the RBP, GAL also proposes the publication of two further measures, for monitoring purposes only with no financial incentives attached. These measures are:

- UKBF: immigration performance; and
- airport: ASQ ranking of the airport versus other European airports.

13.123 The CAA welcomes transparency of performance by all stakeholders in the end-to-end passenger journey process, and considers these to be useful measures for the airport operator to publish. The CAA notes that GAL has already been publishing the UKBF performance measures for some time.

13.124 The CAA notes that the sample size for ASQ scores is more limited than that of GAL’s own QSM survey, and that the calibration of the responses is skewed differently.[138] For statistical robustness the CAA would encourage the use of the bigger QSM sample, and for GAL to publish the methodology and questionnaires on line.

13.125 The CAA sees merit, outside of the SQR, in GAL aiding transparency for passengers and other stakeholders by publishing information related to third-parties operating at Gatwick. The CAA welcomes this initiative, especially if GAL and relevant third-parties can develop it voluntarily in the passengers' interest (although the CAA does not rule out using GAL's licence for this purpose - see chapter 14 on operation

[138] For ASQ, the response scale is: 1=poor, 2=fair, 3=good, 4=very good, 5=excellent.
For QSM, the response scale is: 1=extremely poor, 2=poor, 3=average, 4=good, 5=excellent.

resilience).

13.126 The CAA is currently considering whether it should use more formal powers to require the publication of information in the passenger interest. Under section 83 of the Act, the CAA has a duty to publish information "which it considers appropriate for the purpose of assisting users of air transport services to compare – services and facilities provided at a civil airport in the United Kingdom". The CAA's powers in this regard are subject to it consulting upon, and publishing, a policy in which the CAA must have regard to the principle that the benefits of publishing information should outweigh any adverse effects. The CAA is currently developing its policy in this area and expects to consult on this in May 2013.

CAA initial proposals

13.127 In summary, the CAA's initial proposals are to retain the SQR scheme for Q6, but to improve elements of the scheme, where there are likely to be clear passenger benefits.

13.128 The CAA proposes that the level of the rebates to airlines allocated to GAL's performance will remain the same as Q5 at 7% of airport charges per year. However, the CAA proposes to reconfigure the way bonuses are paid to avoid GAL receiving bonuses from the start of Q6 but providing it with such an opportunity should it achieve an acceptable minimum baseline of performance across both terminals.

13.129 The CAA proposes to remove bonuses from two SQR elements where GAL has been able to easily meet the standard and further improvements could add disproportionate costs. This reduces the overall bonus potential from 2.2% of airport charges per year to about 1.4%.

13.130 In response to improved performance over Q5, the CAA proposes to reallocate some of the rebate for central security to a daily event based measure where rebates would be paid if queues were longer than 30 minutes.

13.131 The CAA is inviting views on whether to redeploy the bonuses removed from the two SQR measures. The CAA is also inviting views on whether and how the allocation of bonuses and rebates should be reallocated during the Q6 period.

13.132 In terms of standards for the other SQR elements, such as those related to passenger satisfaction levels with certain issues such as wayfinding, cleanliness, and flight information, the CAA proposes that these should in the main reflect the performance levels GAL was able to achieve in December 2012. This will help consolidate the improvements GAL made in Q5.

13.133 The CAA proposes to maintain the existing level of publication of service quality performance on GAL's website but to focus publication in terminal on a more limited passenger facing subset of this information, including passenger satisfaction with security (rather than the queue measurement measure included in the SQR scheme).

13.134 GAL and the airlines agree that the SQR scheme should include a new measure based on outbound baggage availability. The CAA proposes a measure based on the time available across the month and invites views on how this might be augmented with an event based measure.

13.135 The CAA welcomes GAL's proposals to introduce some form of airfield availability metric and invites views on how such a metric could be constructed.

13.136 GAL has also proposed the inclusion of two measures on airlines: on check-in queues and arrival bags wait times. The CAA considers further work would be required on issues of measurement and incentives before airline measures could be introduced. The CAA will also need to consider whether such measures should be governed by the GAL licence or alternative arrangements, including voluntary arrangements.

13.137 GAL proposes the publication of two further measures, for monitoring purposes only with non financial incentives: UK Border Force (UKBF) immigration performance, and Airport Service Quality (ASQ) ranking versus other European airports. The CAA welcomes transparency of performance from all stakeholders, although the CAA notes that GAL's own QSM survey is likely to be more statistically robust and publication might therefore be preferable to the ASQ survey. The CAA sees merit, outside of the SQR, in GAL aiding transparency for passengers and other stakeholders by publishing information related to third parties operating at Gatwick.

13.138 Appendix A summarises the CAA's initial proposals for service quality standards.

CHAPTER 14

Operational resilience

14.1 This chapter sets out why the CAA considers that measures to ensure operational resilience are needed to develop a more collaborative and better planned approach to dealing with disruption and looking after the interests of passengers and cargo owners at such times. This chapter sets out what a licence condition would require and how it would work, should the CAA determine that the MPT was met.

14.2 This issue was not a feature of CE, but the CAA has, alongside CE, been in discussions with GAL, airlines and other stakeholders about how regulation could help to strengthen the prospects for operational resilience and passengers' interests in the event of service disruption.

14.3 The policy positions set out here are within the context of a RAB-based price cap. If the CAA accepts GAL's commitments as the main vehicle for airport operator-airline relations, it would expect GAL to also carry out the bulk of the policy on operational resilience.

Discussion of key issues

What do we mean by operational resilience?

14.4 Passengers and cargo owners can experience detriment at times of operational disruption, caused for whatever reason, such as reduction in runway capacity due to bad weather, a disruption in the supply of aircraft fuel or closure of terminals for security reasons, power cuts or strikes. Disruption leads to delays and cancellations causing uncertainty and, in some cases, distress to passengers.

14.5 The CAA's licensing approach for operational resilience is not about removing disruption; there may be safety or security reasons why delay is unavoidable and there is on-going work on operational freedoms to find better ways to manage the capacity constraints at such times. Rather, the CAA would like to explore how it can use the licence to ensure that disruption is managed and mitigated and hence improve outcomes for passengers.

14.6 There are many different parties other than GAL involved in the management of this disruption and airlines already have obligations regarding passenger welfare and compensation or onward travel under the EU denied boarding regulations (EC 261).[139] GAL also has health and safety responsibilities to people using its facilities and, as the operator of those facilities used by all other stakeholders, has a key role in coordinating the response to disruption.

Rationale for regulation

14.7 In bringing forward the Act, the government was keen to ensure that the CAA has a regulatory toolkit to tackle this issue. In its policy statement introducing the Bill[140], the government noted that the regulator lacks ability to respond in real time to events – be they ash, snow or anything else – as they emerge.

14.8 The government's intention was that "the reforms would give the CAA stronger and more flexible powers to respond to important passenger issues. The CAA could impose licence conditions which better target these issues, such as a general licence condition requiring acceptance of a code of practice relating to operational resilience (which could include resilience against severe weather) if the CAA considered it appropriate".

14.9 This view follows on from work the government led in 2008 following nation-wide flooding to ensure operational resilience and preparedness across each sector in the UK. Airport operators were already classified as "Category 2 responders" under the Civil Contingencies Act 2004 meaning that they have to contribute to their local council's resilience plans although this does not require them to prepare their own resilience plans. The 2008 flood resilience work did not focus on airports as no airport had been affected. A follow up government guidance document[141] noted that "the engagement levels from the aviation sector are expected to be higher once the all-

[139] Regulation (EC) No 261/2004 of the European Parliament and of the Council of 11 February 2004 establishing common rules on compensation and assistance to passengers in the event of denied boarding and of cancellation or long delay of flights, and repealing Regulation (EEC) No 295/91.

[140] DfT, November 2011, *Draft Civil Aviation Bill*.
https://www.gov.uk/government/publications/draft-civil-aviation-bill

[141] "Interim guidance to the regulated sectors" issued by the Cabinet Office in March 2010 can be found at https://www.gov.uk/resilience-in-society-infrastructure-communities-and-businesses

hazards approach begins in March 2010 [addressing storms/gales and heavy snow/low temperatures]".

14.10 Heavy snow falls in 2009 and 2010, and airspace closures due to the Icelandic ash cloud in 2010, exposed the weaknesses in planning for disruption at some airports and a lack of cooperation within the industry in general, leading to critical media coverage of the distress caused to passengers.

14.11 Several reports[142], including the CAA's own Winter Resilience report, made recommendations to improve the passengers' experience, such as developing contingency plans and getting better cross-industry cooperation to mitigate and manage disruption.

14.12 Over the last couple of years, the CAA has worked with GAL and airlines at Gatwick to improve their snow and welfare plans and has also been working to improve information for passengers through its transparency programme.

14.13 In 2011, the government's South East Airport Taskforce (SEAT) commissioned the CAA to lead a technical subgroup, the Airport Performance Facilitation Group (APFG) to take these recommendations forward through the development of bespoke Passenger Charters at Gatwick, Heathrow and Stansted.[143]

14.14 How disruptive incidents are managed and how passengers are treated is affected by a large number of different organisations, each with their own commercial interests and legal obligations. This has

[142] CAA – "Aviation's response to major disruption" http://www.caa.co.uk/docs/5/CAA%20review%20of%20snow%20disruption%20-%20Final%20Report%20-%20WEB%20VERSION%20_2_.pdf

"The Independent Review of Winter Resilience" – http://transportwinterresilience.independent.gov.uk/

"The Heathrow Winter Resilience Enquiry" http://www.baa.com/assets/Internet/BAA%20Airports/Downloads/Static%20files/BeggReport220311_BAA.pdf

Transport Select Committee 13th report: *Keeping the UK moving: The impact on transport of the winter weather in December 2010*
http://webarchive.nationalarchives.gov.uk/20111014014059/http://transportwinterresilience.independent.gov.uk/

[143] Reports and minutes of APFG meetings can be found on the CAA website at http://www.caa.co.uk/apfg

made it difficult to reach consensus. The CAA's report on the work undertaken through the APFG[144] in December 2012 noted that, so far, the three major London airport operators (GAL, HAL and STAL) have worked on developing these charters with their stakeholders, but progress has been slow and more could be done. The CAA notes that GAL has made more progress than others in a number of areas.

14.15 The CAA considers that a collaborative approach with proactive leadership is essential to coordinating the response to disruption, for both resolving the causes and looking after passengers. The CAA considers that proactive leadership must involve GAL taking the responsibility and having the ability to encourage and require certain activities and behaviours without cutting across existing obligations. GAL, as manager of the airport facilities, is best placed to take on this role and to coordinate the response through resilience plans underpinned by good day to day collaborative working.

14.16 The issue for the CAA is whether the prospects for improving GAL's performance in this area - and furthering the interests of passengers - will be improved by including obligations or incentives within a licence that comes into effect from April 2014.

14.17 The CAA considers that the prospects for GAL's performance and pace on this issue, and thereby the benefits for users, would be enhanced by having clarity on the expectations from the CAA. Clear, enforceable accountability may help enhance GAL's focus in this area and strengthen its ability to orchestrate airport wide collaboration with other relevant parties such as airlines, groundhandlers, etc. If the CAA decides that a RAB-based price cap through a licence is required, this clarity should be codified in a licence condition; if it accepts that the GAL commitments should be the main vehicle for setting out how GAL engages with the airlines, the CAA would still expect GAL to take these issues forward with more details in the commitments of the actions it will take.

14.18 This will, in part, formalise what GAL is already doing, but will provide greater accountability to its end users through the CAA, thereby incentivising continuing improvements. The CAA is mindful, however, that this should not cut across effective and largely voluntary

---

[144] CAA, November 2012,' Progress report for the Minister of State on the APFG. http://www.caa.co.uk/default.aspx?catid=589&pagetype=90&pageid=14206

arrangements that already work among the various actors on this issue. Nor should it be at a level of prescription that blurs the boundaries between GAL's accountability for the efficient operation of the airport and the CAA's regulatory role.

14.19 A licence condition can also help drive improvements where passengers lack sufficient information to make an informed choice, or where there are system-wide issues that individual airlines cannot address. In particular, having procedures in place for day-to-day business continuity planning will ensure that the right relationships are in place and there is proper knowledge of the risks, accountabilities and responsibilities already in place when disruption occurs. Passengers should benefit from better management of the incident, better information about their journeys and improved welfare arrangements.

14.20 In developing the draft licence condition, the CAA has been mindful that it should not duplicate or contradict other obligations under national or international law, especially safety and security requirements; in particular, it must not put GAL into a position where it must choose between breaching its licence and breaching its safety or security requirements. The licence should not oblige GAL to interfere with airline/customer relations and should not conflict with or duplicate with the airlines' own responsibilities, for example, under the EC 261.

14.21 The EU is currently reviewing both the Groundhandling Directive[145] and EC 261, and in both cases is considering including a requirement for airport operators to have contingency plans. These negotiations are likely to take some time to resolve but could mean that a licence condition either becomes the vehicle for implementation or becomes redundant. This, coupled with the complex and evolving nature of the industry relationships, means that this condition is likely to evolve over time.

14.22 GAL has already made good progress in developing plans but it is important that these are kept maintained and updated in the future and that GAL is accountable for them. The CAA therefore does not consider that a licence obligation will impose unnecessary burdens, and any additional costs will be outweighed by the benefit to

[145] Council Directive 96/67/EC of 15 October 1996 on access to the groundhandling market at Community airports.

passengers and cargo owners.

14.23 A licence condition will also enable the CAA to pursue its duty to further the interests of passengers with respect to the continuity of airport operation services.

14.24 The CAA notes that the issue of operational resilience has some parallels in other regulated sectors.

- Gas transporters must provide enough pipeline capacity to meet demand in a 1 in 20 year winter.
- The National Grid must maintain and efficient, coordinated and economical system of electricity transmission.
- In telecoms, the provider must take all necessary steps to maintain a proper and efficient network, with the fullest possible availability of the network and services provided in the event of catastrophic failure or force majeure.
- The Royal Mail is required to develop a contingency plan and to review it every two years.
- Network Rail does not have a specific resilience condition but it is required, through its price control to provide a specified level of performance where Network Rail must plan for the risk of adverse conditions.

14.25 The NERL licence also includes a requirement to provide core services and to maintain its assets, business and personnel so that it can carry out its activities.

Principles upon which to base the licence condition

An overarching focus on passenger outcomes

14.26 The draft licence condition sets a high level outcome requirement for GAL to secure the secure the availability and continuity of airport operation services to further the interests of passengers and cargo owners so far as is reasonably practicable, taking into account all relevant circumstances.

14.27 This means that it is clear that responsibility and accountability for performance rests with GAL and the licence will make it clear that merely complying with more detailed obligations relating to planning and consultation (as set out below) will not be considered as sufficient if there is evidence of GAL underperforming in a way that causes detriment to passengers.

14.28 However, in assessing this evidence, the CAA will take into account other factors such as the extent to which other parties contributed to or were culpable for that failure, or whether a best practice airport operator should reasonably have been expected to have planned for or managed the situation better.

Effective resilience planning

14.29 The CAA expects GAL to develop and use resilience plans in collaboration with relevant parties. These plans should clarify respective roles, responsibilities and set out more clearly commitments on all sides to underpin the interactions.

14.30 The plan would be tailored to the particular needs of the airport, giving GAL the flexibility to manage its operations effectively, whilst reducing the risk that it will put licence compliance over the interests of passengers or safety.

14.31 The CAA has given consideration to its role. It does not consider that it should approve GAL's resilience plans as such as this may lead to a blurring of accountability between the two organisations. It is for GAL to ensure its performance meets its obligations and for the CAA to ensure GAL is held to account for this.

14.32 Nevertheless, the CAA does consider that it should reserve a right to issue guidance (and revise it from time to time) on what should be included in such resilience plans.

14.33 The resilience planning work so far has concentrated on closure of one or more runways due to bad weather or volcanic ash. However, disruption can also be caused by a loss of terminal facilities or key staff, or loss of services from a key supplier such as fuel or electricity. The CAA considers that resilience plans should address these and other possibilities. For example, this might cover such issues as plans for the operational response to snow, security alerts, loss of a key supplier, strikes or cyber attack and plans for disseminating information and providing a 'backstop' level of passenger welfare where the airlines are slow or unable to do so.[146]

14.34 The CAA considers that, in order for contingency plans to work effectively within the high-pressure environment created by disruption, they must be underpinned by solid day-to-day working relationships, possibly through the development of formal business continuity models.

14.35 The government's guidance on resilience[147] states that "business continuity management must be regarded as an integral part of an organisation's normal ongoing management processes". Therefore, the requirement goes wider than times of disruption and the CAA would expect GAL to maintain clear working arrangements with relevant parties.

14.36 In addition to issuing guidance, the CAA considers that it should retain a right to be able to require GAL to review and revise the plan if it considered that the plan is likely to fall short of meeting the high level outcome or has been found wanting following practical experience.

14.37 The licence obliges GAL to develop the plan and only it will be subject to any enforcement action by the CAA against licence provisions. Therefore, the plan should primarily concentrate on those activities over which GAL has control, but it can also set out where any activities rely on other stakeholders.

14.38 Any investigation by the CAA into failures by GAL to meet the high level outcome is likely to look at the actions of all the relevant parties involved but any enforcement action would be aimed only at those elements over which GAL had control, taking into account the extent to which it had followed its plan or any reasons for diversion from it.

Effective cooperation and collaboration with relevant parties

14.39 The CAA considers that the resilience plan obligation should be complemented by a requirement on GAL, so far as is reasonably practicable, to get relevant parties to collaborate and cooperate in both planning for and dealing with disruption.

[146] The CAA will need to discuss with GAL and other stakeholders how the costs of this can be recovered. The CAA's initial view is that efficient costs incurred by G AL would be recoverable through airport charges.

[147] Cabinet Office, February 2013, *Resilience in Society: Infrastructure, Communities and Businesses*. https://www.gov.uk/resilience-in-society-infrastructure-communities-and-businesses

14.40 This obligation would require GAL to facilitate a governance forum for such relevant parties or their representatives and, so far as is reasonably practicable, to encourage those parties to participate in GAL's plans and to develop and implement their own, complementary, plans.

14.41 GAL has other obligations outside the licence relating to the health and safety of people using its property and facilities. The CAA considers that it is proportionate and in the interests of passengers and cargo owners that GAL is able to take reasonable steps to ensure that other stakeholders providing services at the airport should not take actions (or omit to take any action that they are obliged to do under national or international law) that will have an adverse impact on GAL's obligations.

14.42 The CAA therefore proposes that the GAL licence will require GAL to develop, in collaboration with stakeholders, 'rules of conduct' that it requires of airlines and groundhandlers using the airport. These could be set out in its conditions of use and the groundhandlers' licences.

14.43 To ensure that all parties are informed of the issues and plans outlined above, GAL must consult in a clear and transparent manner. The CAA recognises the limitations on GAL's ability to require engagement with its consultations and collaborative forum and notes that many parties rely on the AOC and ACC to deal with many, but not all, issues. The CAA considers that GAL should be able to accept the response from the AOC and ACC as representative of all relevant stakeholders unless an individual stakeholder has submitted a separate response. The CAA will consider whether to include a condition requiring GAL to set out a clear consultation policy.

14.44 The CAA considers that the licence should require GAL to collaborate with 'relevant parties' in developing its plans and coordinating a response to disruption. The CAA considers that relevant parties should include airlines, groundhandlers and NATS as these are directly involved in providing services to passengers and cargo owners or are responsible for the movement of aircraft at the airport. GAL should also seek to ensure, through its contractual arrangements, that key suppliers such as fuel and energy suppliers, retailers, car park operators and hotels have their own adequate resilience plans. The list of relevant parties is not exhaustive and may include others with an interest at Gatwick.

14.45 The CAA considers some parties may not be classed by GAL as relevant parties, given their specific roles and their alternative arrangements for dealing with disruption. For example, surface access providers, local councils or the police already liaise through the local council's plans under the Civil Contingencies Act. However, GAL should understand those parties' requirements in so far as they impact on airport operation services. GAL should also provide advice to those parties on the airport's operational requirements during disruption to inform the development of those parties' own plans.

Effective dissemination of information

14.46 To ensure that the interests of passengers are at the core of any response to disruption, the CAA considers there should be an obligation relating to providing information to relevant parties and to passengers so far as is reasonably practicable. This would require GAL to disseminate operational information to its stakeholders during disruption so they are better able to plan and coordinate their own responses.

14.47 GAL should make relevant information available to passengers about its own operations during disruption and, as far as it can, to pass on information about airlines' operations at such times. This would give passengers a central point of information, alongside the airlines' own channels, so they can make informed decisions about their options.

14.48 The CAA considers that the licence could also be used in the future to require GAL to publish performance information relating to disruption, including those activities undertaken by third parties (such as baggage performance and check-in queue times). This may give passengers the information they need to make informed choices and may lead to improvements in service quality by all parties. The CAA may consider this as it develops this condition or may take it forward separately as part of the programme of work it is developing on how it will use its information powers in the Act.

CAA's initial proposals

14.49 The CAA considers that the GAL licence should contain a number of requirements to help strengthen its approach to managing and mitigating the effects on passengers from operational disruption, however caused. These include:

- an overarching responsibility to ensure, so far as reasonably practicable, the availability and continuity of airport operation services to further the interests of passengers and cargo owners;
- to consult on, develop and maintain plans setting out how it will do this, in line with any guidance issued by the CAA;
- to facilitate a governance forum to foster a more cooperative and collaborative approach to managing disruption;
- to develop rules of conduct for other service providers using the airport facilities to follow, particularly during disruption; and
- to provide information relevant to other service providers and passengers so far as possible to help them plan their response to disruption.

14.50 The CAA is also considering whether to include a requirement to publish performance information at the airport to allow passengers to make better informed choices.

14.51 This will help the CAA pursue its duty to further the interests of passengers with regard to the continuity of airport operation services. A draft of this licence condition is contained in Appendix B.

CHAPTER 15

Capital efficiency

15.1 This chapter contains the CAA's initial proposals for the regulatory framework around GAL's capex for Q6, including the financial incentives attached to the timely and efficient delivery of capex projects. It sets out the discussion during CE and the CAA's own assessment of the issues. The chapter also sets out the CAA's assessment of GAL's capital efficiency in Q5 and opening RAB allowance for Q6 before concluding with the CAA's Q6 initial proposals.

Constructive Engagement

15.2 During CE, the ACC proposed that the future capital programme should be split into core and development projects. Their discussion document highlighted the potential improvements to the existing capex process, including:

- improvements to project documentation and tollgate process, with greater airline involvement in earlier tollgates and improvements for the way that projects move through the process;
- improvements to the consultation process, with clarity on timescales for provision of documents and responses;
- potential involvement of specialised capital planning expertise;
- introduction of core and development capital programme, with only core capital for year 1 projects included in the settlement, with projects moving from development to core if they are at tollgate 4 (detailed design stage) by August with build starting the following financial year;
- triggers would still apply for significant projects; and
- capital spend from the settlement is checked against the forecast with the correction factor used to correct cashflow under spend.

15.3 During CE, GAL indicated that it does not support the core and development capex discussion document put forward by the ACC, as it considered that a veto of capex by existing airlines, with that decision then confirmed by the CAA, represented a move towards, rather than away from, interventionist regulation.

15.4 The ACC considered that a more flexible approach to capital planning would benefit passengers, airlines and the airport. The ACC considered that their approach is a credible vehicle to begin these discussions and is open to alternative proposals. In the CE report, the ACC noted their disappointment that GAL had been unwilling to enter into a meaningful discussion on alternative capital programme options.

GAL Revised Business Plan

15.5 In the RBP GAL stated that it considered that all current capital proposals as core and that the aim was to achieve tollgate 3 standard information for key projects by July 2013. GAL did however state that it was open to further discussion on how new projects could be introduced, although it repeated its concerns with the airlines' proposal for core and development capex. GAL also proposed that Annex G consultation arrangements for Q5 should be updated to take a more strategic consultative approach.

Discussion of the key issues

15.6 The CAA is disappointed that GAL and the airlines were not able to make more progress on developing a more sophisticated approach to capital efficiency. The CAA has carefully considered the arguments advanced by both sides. The CAA has also taken into account the lessons learned from Q5 as identified by its independent review undertaken by Currie and Brown (C&B) in 2011 and more recently by URS.[148]

[148] URS, March 2013, *Gatwick airport – review of Q5 capex*, http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=14279

A more flexible approach: core and development capex

15.7 A lesson from Q5 was that forcing all capital projects to be agreed at the time of the price review for the next five or six years did not reflect the dynamic nature of the industry and the need for flexibility in the capital investment plan (CIP).

15.8 The CAA considers that GAL and airlines would benefit from greater flexibility around capex, while GAL should have strong incentives to deliver projects efficiently and on time. The CAA considers that, under a RAB-based framework, a core and development capital programme would provide these benefits.

15.9 The ACC has suggested that projects should only be included within the core allowance at tollgate 4, with GAL suggesting that projects should become core at tollgate 3 (option selection stage). The CAA considers that to provide clarity for users on what outputs to expect, a significant proportion of capex should be defined as core before the start of the control period. While waiting until tollgate 4 would provide greater clarity on project costs and milestones, it is unrealistic to expect projects to achieve this gateway before the start of the control period. Consequently the CAA considers that projects should be included in the core programme at tollgate 3.

15.10 The ACC has also suggested that the cost of development projects should only be included in the price cap when they move from development to core. The CAA considers that, to provide clarity to users on the price that they will pay, both core and development capex should be included in the price cap.

15.11 Consequently the CAA proposes that capex allowance should be split into two components:

- core – containing fixed-price allowances for a basket of specified projects that GAL has been able to take through tollgate 3 in its internal project development process prior to the CAA's Q6 final proposals; and
- development – containing an indicative sum of money for planned but not yet committed capex projects.

Core capex – budgeting

15.12 At Heathrow, HAL and the airlines reached broad agreement during

CE that Q6 allowances for core capex projects should be set in line with current P50 cost estimates. In simple terms, this means that there would be an equal likelihood that actual costs in Q6 will turn out to be lower or higher than forecast.

15.13 The CAA considers that this is a fair basis for remunerating investments that GAL has had an opportunity to take through its project development process, and sees no reason to change the proposals for Gatwick.

Core capex – triggers

15.14 By tollgate 3, GAL should have a good understanding of the likely timetable to deliver capital projects. It is important that there are incentives on GAL to deliver to that timetable and not to delay investments, and the consequent benefits that flow to airlines and ultimately their passengers.

15.15 In previous regulatory settlements, the CAA has put trigger mechanisms into the price cap formula that automatically reduce GAL's charges if specified project milestones are not achieved by specified dates. The size of the penalty has typically been set so that GAL loses the financial return (i.e. the cost of capital allowance) on projects where deadlines have been missed. This return is then restored when milestones are finally achieved.

15.16 Under a RAB-based framework, the CAA considers that capex triggers should be retained to provide incentives for GAL for the timely delivery of specified outputs. Due to concerns cited during the Q6 review, the CAA proposes that capex triggers should be improved.

- Milestone definition – the experience in Q5 has been that it was not always possible to establish objectively whether project milestones had been achieved. The clear lesson is that Q6 milestones must be defined more tightly so that there cannot be any dispute about whether trigger payments are activated.
- Three-month lag – Q5 milestones were set at a lag of three months after the relevant dates in GAL's project plans. The flexibility that this gave GAL was justifiable in previous price controls because the triggers were applied to projects that were at various stages of development. In this review, triggers should only be fixed at the outset for core capex. This suggests to the CAA that it is

unnecessary and inappropriate to continue with the practice of placing triggers at a lag of three months from intended delivery dates. It would seem much more in keeping with the nature of core capex to hold GAL to its proposed deadlines as well as its proposed costs.

- Ceiling – the CAA does not propose to place a pre-determined ceiling on the proportion of capex that will be covered by triggers. Instead, the CAA sees no reason in principle why triggers should not be applied to the maximum extent that it is feasible, to define milestones beneficial to users to incentivise GAL to deliver to agreed timelines, and practical to administer the process. This needs to be balanced with increasing complexity and the regulatory burden. The CAA expects to review this balance before its final proposals.

Core capex – efficiency incentives

15.17 The costs of a project can turn out to be different from original estimates. In such circumstances, it is conventional regulatory practice to wait for a period of time after the completion of a project before adjusting the RAB and the price cap to reflect the actual cost incurred. This lag means that the regulated company takes the consequences of under or over spending for a number of years (because the capex allowance within the RAB and the price cap allowance reflects estimated rather than actual cost) before the under or over spend passes through to charges.

15.18 The CAA proposes to retain this broad framework of risk allocation and incentives in Q6. The CAA has historically adjusted the RAB for aggregate under and over spending in a symmetrical way. The CAA proposes to continue with this approach in Q6, with the proviso that GAL will not be able to recoup from airlines demonstrable waste and inefficiency.

15.19 The CAA would expect in future, when looking at efficiency/inefficiency, to look at differences between actual and projected spend at an aggregate portfolio level so that the GAL can offset lower than expected costs on some projects against higher than expected costs on other projects. This, in effect, allows GAL to diversify risk, contributing to a lower cost of capital. It will fall ultimately to the CAA to determine whether any outturn over spend in

Q6 is incurred efficiently or inefficiently.

15.20 The historical approach to calculating RAB adjustments has been to compare allowed and actual capex spend in each individual year. Any 'unders' and 'overs' are then taken out of the RAB on 1 April at the start of the new regulatory period.

15.21 This approach could mean that GAL would profit from delay to projects that are not subject to triggers. As an example of this, if GAL were to under spend by £100 million in year 1 of a control period and defer the £100 million of expenditure to year 5, the airport operator would earn four year's worth of return on investment that had not in fact been carried out. At the end of the control period, there would not be a net under spend and there would be no need for a RAB adjustment. GAL would therefore keep the benefit it obtained.

15.22 The CAA considers that this apparent reward for delay to investment should be removed in Q6. There are several ways in which this could be achieved. One approach would be to amend the calculation of net over/under spend within a control period so that the relevant amount includes any financing costs (i.e. the cost of capital) that the airport operator saves by delaying investment. In the example above, an under spend of £100 million in year 1, matched and offset by £100 million of overspend in year 5, would not sum to zero in NPV terms. If the CAA were to adjust the RAB so that the NPV of the under spending over five years comes off the RAB at the start of Q7, the CAA would effectively eliminate the financial benefit of delay.

15.23 An alternative approach would be to defer some adjustments to the RAB so that unders and overs are corrected gradually during Q7 rather than in one go at the start of the period. The CAA notes that it has sometimes been regulatory practice in other sectors to make RAB adjustments with a rolling five-year lag. In the illustrative example, this would mean that GAL would keep the benefit if its initial under spending for five years before the RAB is adjusted down by £100 million at the start of Q7, but would also suffer the cost of its over spending in year 5 for five years until the RAB is adjusted upwards by £100 million in year 5 of Q7. The net impact would be zero such that GAL no longer has an incentive to delay expenditure.

15.24 The CAA's present view is that either of these options might be a useful addition to the regulatory framework. The CAA's current leaning is towards the first approach on the grounds that it preserves the rewards for true efficiency at broadly the same level as Q5, whereas a switch to a rolling five-year adjustment mechanism is a higher-powered incentive with greater risk and higher rewards/penalties.

Development capex - budgeting

15.25 The initial Q6 allowance for development capex would, by definition, be an indicative amount. It is, however, necessary to give some thought to what this amount should be so as to ensure that GAL's charges are not initially set unreasonably high or unreasonably low and, hence, are not subjected to unduly large corrections within the five-year period.

15.26 In the RBP, GAL states that its aim is to achieve tollgate 3 standard information for key projects by July 2013. If all projects are at tollgate 3 by the time of the final proposals then the total capex allowance will be based on P50 estimates. However where projects have not reached tollgate 3 using a P50 allowance may not be reasonable, as projects will be at an early stage of development. For Heathrow, HAL and the airlines agreed that the CAA should make an indicative allowance for these works at their current P80 costings. The choice of P80 rather than P50 reflects an expectation that expenditure estimates will naturally increase rather reduce as investments progress through the costing and appraisal process. A P80 allowance may therefore be a fair or central estimate for projects at an early stage of development, whereas a P50 estimate might give an unreasonably low costing. The CAA has seen no reason to take a different approach at Gatwick.

15.27 As with Heathrow, the CAA would also look favourably on proposals to make some small provision now for investments that GAL and airlines have not yet thought about and where the passenger benefit is not yet apparent. It is important to make it clear that the flexibility around development capex should not extend to the adoption of completely new schemes rather than just the list of investments that have been identified prior to the start of Q6.

Development capex – flexibility

15.28 The CAA proposes to insert a mechanism into the price cap formula which will permit the allowance for development capex to change in real time over the course of the five-year period.

15.29 The freedom that this offers is not unbounded. The inclusion of new development projects in Q6 by GAL will require consultation with airlines and either the approval of airlines or the CAA, following GAL's consultation. Airlines also have an ability to suggest investments to GAL for inclusion. This, in effect, replicates the disciplines that GAL is subject to at the time of a price review to ensure that it cannot either shun or take on new capex unilaterally. At the point where approval is given, the relevant amount of capex will move from the development budget to the core budget. From then onwards, it will be as if the capex had been identified as core all along. More detail on the governance arrangements is discussed below.

15.30 For Heathrow the CAA is proposing that an adjustment to the price cap should be made annually if planned capex for the year ahead has changed and is now higher or lower than the CAA's allowance development capex in that year. As an example of this approach, if the CAA were to provide originally for £200 million of development capex in year 2 of Q6, but GAL made new fixed price commitments for new capex totalling only £100 million by 31 August 2014, there would be a downward adjustment to the originally determined value of the year 2 price cap. The scale of the adjustment would be of the magnitude required to put charges at the level that they would have been had the CAA known the correct year 2 amount from the outset. The same process would operate again before the start of years 3 to 5. The adjustment mechanism would work symmetrically so that there would be an upward adjustment to the price cap if investment commitments sum to more than the CAA's original allowance. The CAA has seen no reason to suggest that similar arrangements should not apply under a RAB-based framework for Gatwick.

Development capex – efficiency incentives

15.31 The efficiency incentives around development capex should be comparable to the incentives around core capex.

15.32 At the point where capex moves from the development budget to core capex, a cost allowance for that work will be fixed and GAL will take risk around over and under spending. The scale of those rewards and penalties will be dependent on the choice of RAB adjustment mechanism and whether the CAA makes a one-off adjustment for actual spend at the start of Q7 or a rolling adjustment with a continuous five-year lag, as set out above.

15.33 The CAA notes that the real-time award of cost allowances within the five-year control period imposes less risk on GAL than the current five-year fixed price settlement. In part this is because estimation risk is much lower when GAL only has to commit to a fixed price once it has got a project through tollgate 3 in its internal project development process. But it should also be recognised that GAL is exposed to much less in the way of macroeconomic risk if it has the opportunity to update both its programme of work and its costings in light of new information that emerges over the course of the five-year period. This is likely to be a benefit to shareholders in reducing risk (see chapter 10 for more detail on the cost of capital).

Development capex – triggers

15.34 To ensure that there are incentives for the timely delivery of projects that come out of the development capex allowance, the CAA considers that triggers should be placed on development capex at the point where a fixed cost allowance is agreed. The mechanism would be identical to the triggers around core capex, which the CAA has indicated above should be anchored to objectively assessable milestones and no longer incorporate an automatic three-month lag.

15.35 The CAA will need, in designing its price cap formula, to accommodate the setting of triggers on a rolling basis within the five-year period. The CAA considers that the best way of giving the necessary flexibility is to provide in GAL's licence for the CAA to specify new triggers, including amounts, dates and milestones, by serving notice under the licence. In order to minimise perceptions of regulatory risk, the licence can specify that the CAA's ability to introduce new triggers is constrained to expenditure and projects that have been agreed by GAL and airlines under the governance arrangements described below.

Governance

15.36 The CAA commissioned consultants URS to undertake a review of Q5 capex in terms of efficient project management and consultation. This review did not identify systemic issues with the GAL's current consultation arrangements. As part of its input to Test C of the market power assessment, GAL identified the significant cost to itself of the current consultation arrangements. The CAA also recognises that, if a RAB approach is implemented, existing arrangements may also need to be improved to deal with the move to a core and development capex programme. The CAA has set down some thoughts in this area in the Heathrow Q6 initial proposals. While the CAA is minded to roll forward the existing consultation requirements as set out in Annex G, it is open to suggestions, particularly if agreed between GAL and the airlines, on how the operation of these arrangements can be improved, while ensuring sufficient protection to users.

Capital investment expertise

15.37 At Heathrow, HAL and the airlines have jointly proposed that there should be an Independent Fund Surveyor (IFS) panel to review the efficiency with which HAL plans and delivers its capital investments. This would give the airlines greater visibility of the airport operator's efficiency and could usefully inform the CAA end-of period assessment of overall efficiency.

15.38 The IFS's work would include the processes being followed, the assumptions being made and the overall appreciation of the risks being managed at the project planning stage and the on-the-ground efficiency of expenditure at delivery. The IFS would be jointly appointed by the airport operator and airlines and have a duty of care to both parties and the CAA.

15.39 During GAL agreed to facilitate the airlines' proposal to bring in capital investment expertise via consultants. The CAA considers that, with a RAB-based framework, there would be merit in bringing greater capital investment expertise to the airlines. The CAA therefore welcomes suggestions, particularly if agreed between GAL and the airlines, on how this could be achieved.

Q5 Capital Efficiency

Review of Q5 Capital efficiency

15.40 In its 2008 Q5 decision the CAA set out its criteria for assessing capital efficiency during Q5 to be applied during both the mid Q review and the Q6 review. The tests as set out in the Regulatory Policy Statement (Annex E.47) were: (i) best practice management; and (ii) effective consultation with airlines in line with the Annex G protocol. The CAA also set out the basis for conducting the mid Q review which would consider the airport operator's progress on a number of specific issues including cost benchmarks, risk allowances and the progress towards management of certain risks at a portfolio rather than project level. In reaching its judgement for Q5 the CAA has considered the performance of GAL in relation to these criteria.

15.41 In 2010 the CAA appointed C&B to carry out a mid Q assessment of capital efficiency and consultation at the airport. In summary C&B identified shortcomings in the pre-Q5 planning process. In particular, there was a low level of maturity in risk reporting, there was limited use of external benchmarks, and there was no evidence of whole life costing.

15.42 Towards the end of 2012 the CAA appointed URS to provide a transparent assessment of capital efficiency at Gatwick during Q5 taking into account the criteria established by the CAA for Q5 and the conclusions of C&B at the mid Q review. In particular URS was requested to examine five specific projects.

URS' Findings

15.43 URS' main findings were that:

- the issues raised at the mid Q review have started to be addressed;
- the focus of consultation in Annex G has been at a project level and an intermediate level of reporting may provide benefits;
- obtaining the appropriate records for review from GAL has been difficult, partly explained by changes in project management procedures resulting from the change of ownership;
- each of the specific projects appears to have delivered an effective solution and the processes for specific projects have been reasonably applied when account is taken of the change of systems part way through the cycle; and
- the specific projects reviewed all contained periods where costs have increased substantially and this has been the subject of detailed review. Almost all of the changes are explicable in the light of the circumstances described.

15.44 URS recommended that:

- GAL should consider the completeness and storage of key records such that they can easily be referenced both during the project and thereafter;
- GAL should limit changes in the format of reports and records to maintain a transparent record. If necessary old systems should be run in parallel with new systems to maintain the audit trail;
- where projects are inextricably linked, there needs to be an appropriate level of management at the project group level both to manage interfaces and risk and aid reporting;
- some technical assistance should be provided to the stakeholder community to explain and challenge the proposals at the appropriate level during the various phases of the consultation process. This assistance should specifically be able to provide a view on the level of costs; and
- where projects are fundamentally different from those conceived, early tollgates should be repeated.

15.45 In their review URS identified two instances where projects may not have met the regulatory tests (it should be noted that the projects reviewed were not representative and tended to be those where potential issues had been identified):

- North Terminal extension, where URS identified that up to £4 million of expenditure where best practice project management may not have been followed; and
- crew reporting, where while consultation on the detailed scope appeared to be well managed, during a critical period there was no evidence to confirm consultation on cost changes, which did not appear to be consistent with the requirements of Annex G. The relevant expenditure was up to £7 million.

CAA Assessment

15.46 The CAA welcomes the work undertaken by URS, which suggests that the issues identified in the mid Q review have started to be addressed and that in general GAL has followed the requirements of efficient project management and effective consultation with users. The two areas were URS was not convinced that this was the case cover, at most £11 million of expenditure, which is relatively small in comparison to the overall capital programme of around £1 billion over Q5. Given that the CAA has included these costs in the opening Q6 RAB for the initial proposals, it would require further evidence from GAL that the regulatory policy tests of efficient project management and effective consultation have been met before including these costs in the opening RAB in the Q6 final proposals.

CAA's initial proposals

15.47 The CAA's initial proposals are that:

- the Q6 capex should be split between core and development capex;
- the allowance for core capex shall be based on the P50 cost estimates for individual projects;
- a continuation of Q5 risk allocation around under and over spending against cost allowances and the use of trigger mechanisms to incentivise timely delivery, with triggers set in line with the delivery dates in GAL's project plans;
- the principle that there should be an indicative allowance for development capex within the CAA’s Q6 price cap calculation, but with an adjustment mechanism so that charges reflect real-time capex plans for each year of the control period;
- the application of financial incentives and trigger mechanisms to projects that move from development to core within Q6;
- that it is minded to roll over existing consultation arrangements, although it recognises that there may be potential to make improvements particularly if agreed between GAL and the airlines.

15.48 The CAA requires further evidence from GAL before deciding whether to include up to £11 million of expenditure in the Q6 opening RAB that URS identified may not meet the twin tests of efficient project management and effective consultation.

15.49 The CAA is seeking views on:

- proposals to make GAL indifferent to the timing with which it carries out core capex;
- options for bringing in capital investment expertise to airlines; and
- the design of governance arrangements around approvals for projects funded as development capex before work takes place and to improve the working of existing arrangements.

CHAPTER 16

Other price control issues

16.1 This chapter discusses a number of other issues relevant to the CAA's initial proposals. This includes the approach to transparency, safeguarded assets, the security cost pass through mechanism, opex incentive mechanisms, and inflation indices.

Transparency condition

16.2 In 1991, the Monopolies and Mergers Commission made a public interest finding that GAL provided inadequate information to airlines and other companies based at the airport on a range of charges for facilities and services at the airport.[149] The finding led to the CAA imposing conditions on GAL to provide to the CAA and service providers information on the detailed costs and other factors it took into account when setting these charges. The charges were for the following activities: check-in desks, baggage systems, other desks, staff car parking, staff ID cards, fixed electrical ground power, hydrant refuelling, airside parking, airside licences, cable routing, maintenance, heating, utilities and bus and coach facilities (the Specified Activities). Historically these charges have been referred to as non-regulated (aeronautical) charges. GAL has provided information under the condition for each year since it was imposed.[150]

16.3 The projections for other charges (non-regulated aeronautical charges) that GAL provided for Q5 were based on a number of principles on which GAL had consulted its airline users. The CAA accepted GAL's forecasts on the basis that they had been generated on the application of these principles. The principles were:

[149] The same finding was also made with respect to HAL and STAL.

[150] In June 2011, after an allegation by Ryanair, the CAA found that GAL had not been providing the full amount of information required by the Condition for check-in desks for the years 2004/05 to 2009/10. 'Complaint to the Civil Aviation Authority under section 48 of the Airports Act 1986 made by Ryanair Limited about Gatwick Airport Limited's compliance with the Transparency condition with respect to check-in desks – the CAA's decision and proposed remedy' (June 2011). Available at: http://www.caa.co.uk/docs/5/TransparencyDecision.pdf

- full cost recovery for each of the charges to airlines during Q5[151];
- no offsetting or subsidising of such charges from one source with income from non-regulated charges from another source;
- under recovery of charge revenue against prior projections limited to recovery during the respective year or first subsequent year;
- in recognition of the fact that a number of the services provided, being based upon costs of services provided by outside suppliers to GAL, may inevitably change during the course of Q5, GAL would reflect such changes in its charges to airlines; and
- GAL to provide an annual update of estimates for the costs associated with charges to the airlines for the Q5 period, at least three months prior to the commencement of any revised charges.

16.4 Under the Act, unlike under the Airports Act 1986, the charges that the CAA can price regulate are not strictly controlled, so it could price regulate these charges if it thought this was warranted. Conversely, the CAA could decide not to have a licence condition requiring transparency.

16.5 In the CAA's view the current transparency condition has worked well, reassuring interested parties that these charges are based on appropriate criteria, and it has not imposed an unreasonable burden on GAL. It therefore proposes to include the condition in the licence. However, the CAA does not consider that it is necessary to include in Q6 all the activities that were required in the Specified Activities in Q5. Check-in, baggage handling and hydrant refuelling charges are already subject to transparency obligations in the AGR (which Ryanair has successfully used to challenge GAL's check-in and baggage charges).

16.6 The CAA also considers that it is not necessary to retain the requirement to explain any variations from the profit centre reports provided to the CAA as this may create an unnecessary additional burden and the CAA can seek further information if necessary.

16.7 The CAA continues to consider that the existing transparency

[151] Apart from staff car parking, which GAL proposed to move towards differential/market pricing in order to incentivise efficient use of assets, to promote more choice, and to reflect the value of car parks.

conditions provide benefits to users in terms of transparency and cost reflectivity.

16.8 The CAA's initial proposal is to retain the existing transparency arrangements for the other/non-regulated charges in Q6 with two exceptions. These are to remove check-in desks, baggage facilities and hydrant refuelling (which are covered by the AGR) from the services included in the arrangements and to remove the requirement to report any differences from the profit centre reports.

Safeguarded assets

16.9 In discussions with airlines, the CAA was encouraged to consider different ways of rewarding safeguarded assets. Safeguarded assets are created as part of a larger capex programme when it makes economic and construction sense to build an asset (or the space for an asset) for future use. The Q6 capex plan does not appear to include significant new safeguarded assets.

16.10 The current approach is to include such assets in the RAB, but not depreciate them. This has two consequences. The costs are borne by both current and future users while only future users will receive any benefit.

16.11 The CAA avoids, and stakeholders agree, that it should avoid retrospective adjustments to the treatment of assets in the RAB. The CAA considers that if any change is to be made then it should be prospective[152] only.

16.12 The current approach provides a real return on the assets, adds inflation to the assets and does not depreciate them until they are in use. Current users pays the finance costs (the real WACC), while future users (those that use the assets) pay for the asset including the increase in value because of inflation. The current approach in effect means that users bear the risk of stranded assets.

16.13 An alternative could be for GAL to invest in safeguarded assets at its own risk. If the assets ever came into use then they could be

[152] In this case, prospective could mean safeguarded assets created in Q6 or thereafter, or could mean assets created as part of projects which commenced in Q6 or thereafter.

transferred into the RAB and valued at original cost, plus inflation plus a cost of capital (higher than the WACC used in the price cap to reflect the stranding risk borne by GAL).

16.14 These two approaches are not mutually exclusive. Where airlines agree with safeguarding an asset and are willing to take the stranding risk then the current approach could apply. Where airlines did not agree, or it was agreed that the airport operator should bear the stranding risk then alternative approach could be followed.

16.15 The CAA seeks the views of stakeholders on whether it should take an alternative approach to future investment in safeguarded assets.

Security cost claim mechanism (the S-factor)

16.16 The risks arising from future security requirements are subject to relatively wide bounds of uncertainty. Rather than deal with this uncertainty by making conservative (i.e. high) estimates of future security costs in the base case for setting the price cap, it seems more reasonable for both users and airport operators to pass through more of the actual variances in costs as they arise.

16.17 The Q5 price control design included a pass through mechanism within the control period for security cost increases (or reductions) resulting from a security standard tighter (or looser) than that assumed by the CAA in setting the price cap. The pass through was set to 90% of the cost increase (or reduction) above the given deadband (£7 million).

16.18 The CAA's initial views are that:

- the security cost claim mechanism should be retained for Q6; and
- a pass through rate of 90% and a deadband of £8.5 million) (increased to reflect inflation) appear appropriate.

Opex efficiency incentive mechanisms

16.19 In other sectors, such as the CAA's economic regulation of NERL, a mechanism to increase the incentive on regulated companies to make opex savings has been introduced. Such mechanisms give the regulated company greater incentive to make savings because it is allowed to keep those savings for a longer period (i.e. into the subsequent control period). The mechanism can also equalise the incentive to make efficiencies in each year of the control period.

16.20 The CAA notes that an airport's commercial revenues are significantly greater than for NERL, and therefore opex could increase or reduce significantly during a control period due to changes in commercial activity rather than underlying opex and opex efficiency.

16.21 Incentive mechanisms also have drawbacks. They introduce complexity and once sufficient value is ascribed to them to alter management behaviour they are open to accounting judgement, changes in the application of accounting policy and/or changes in the policies.

16.22 Given that little progress has been made during CE on opex efficiency incentives, the CAA's initial view is that it should not introduce such mechanism.

Traffic risk sharing

16.23 The CAA floated at an earlier part of the review whether there was merit in introducing a traffic risk sharing mechanism. The CAA has introduced such a mechanism for its regulation of NERL.

16.24 During CE, neither GAL nor the airlines appeared very supportive of this concept, preferring to consider traffic risk through the medium of the traffic forecast and WACC. Given this lack of support for the concept and the parties' preference to handle traffic risk using alternative mechanisms, the CAA has decided not to pursue this concept for its initial proposals.

Within period traffic mix forecast correction (K) factor

16.25 The airport operator sets its structure of charges so that it expects to earn a revenue yield per passenger equal to, or less than, the price cap (permitted yield). In setting its structure of charges, the airport operator has to forecast traffic mix (for example, the share of domestic and international passengers who are subject to different charges, or the number of passengers per aircraft). Such mix cannot always be accurately forecast. The actual yield in a year is only precisely known at the end of the year, when charges for the next year have been set. Over- or under recovery of the permitted yield (in total) is currently subject to a correction factor applied two years later.

16.26 In Q5, the correction mechanism allowed for finance costs. Claims for previous under recoveries were uplifted by the Treasury Bill rate, while repayments for previous over recoveries were uplifted by the Treasury Bill rate plus 3%. The purpose of the asymmetric finance costs was to disincentive the airport operator from deliberate over recovery.

16.27 The CAA has not received any submissions which suggest a change to the Q5 approach, and therefore the CAA's initial proposal is for this mechanism to continue in Q6.

Inflation

16.28 Inflation has two functions in the price control design:

- to provide investors in the airport operator with an allowance to cover the erosionary effects of inflation on their investment (the RAB is indexed each year for this purpose) return; and
- to avoid the need to forecast inflation building blocks are modelled in real prices (i.e. excluding inflation) and the price cap is express as RPI±X%.

16.29 The two uses of inflation are independent of each other therefore it is not necessary to use the same measure of inflation for both. In previous control periods, the RPI has been used for both.

16.30 Investors require a return for inflation and in the current design this is included by indexing the RAB each year. An alternative would be to include inflation in the cost of capital. The measure of inflation that should be used is the same measure implicitly used in deriving the real cost of capital. Financial markets currently use RPI - for example ILGs are indexed to RPI, and the CAA’s estimate of the cost of capital, is based on market data and thus also implicitly assumes RPI inflation.

It would appear that RPI inflation is the appropriate measure of inflation for indexing the RAB during Q6.

16.31 The inflation measure used in the price cap should be the relevant inflation measure for the cost base.

16.32 The CAA notes that, while previously RPI was the measure of inflation most used, there has been a slow but gradual move towards CPI in some instances. The CAA considers that, in light of the lack of representation on this issue, its initial views are that the RPI is the most appropriate measure for indexing the price cap in the RPI±X% formula.

16.33 The CAA considers that linking both the RAB and the price to inflation substantially reduces GAL's exposure to inflation risk.[153] There is a risk that, during Q6 the Office of National Statistics (ONS) changes the definitions of some or all of the price indices. Without fettering the its discretion, the CAA considers that the risk of a change in indices' definitions should be borne by GAL and it would bear the gain or loss arising from any changes in the definition during Q6. For the avoidance of doubt, GAL has, in previous control periods, been exposed to this risk and the ONS makes frequent, relatively minor, changes to the definitions and therefore the CAA considers that no additional or explicit cost of capital allowance is required.

Non-passenger flights

16.34 A separate condition for non-passenger aircraft was introduced in Q4, and retained for Q5, in order not to disincentivise GAL from accommodating non-passenger flights. Before the introduction of the separate condition, the mathematics of the revenue per passenger price control condition led to the perverse effect that if GAL priced up to the cap it received no additional revenue from non-passenger carrying flights. The condition removed this oddity, and required charges for non-passenger aircraft to be no more than the charges for an equivalent passenger carrying flight.

16.35 The CAA has not received any submissions which suggest that the condition should not be retained and, therefore, the CAA's initial

[153] Inflation risk is the risk that actual inflation turns out to be different to what was expected.

proposal is for the condition to be retained in Q6.

CHAPTER 17

Licensing issues

Introduction

17.1 Earlier chapters of the CAA's initial proposals have discussed the potential licence conditions relating to price control, service quality requirements and operational resilience. The Act requires the CAA to include provisions relating to the revocation of the licence and explicitly allows the CAA to include conditions relating to the payment of its fees, as well as any other conditions that it considers are needed having regard to its duties. This chapter sets out what conditions the CAA considers would be necessary at this stage and why. In particular, it sets out the CAA's current views on the development of financial resilience licence conditions.

17.2 These potential licence conditions were not a feature of CE but in January 2012 the CAA published an indicative licence to assist with and inform the passage of the Civil Aviation Bill through Parliament. This included a number of draft conditions that the CAA considered would be necessary. Since then, the CAA has discussed the conditions with GAL and other stakeholders.

17.3 The latest draft of the GAL licence is contained within Appendix B to this document. The CAA will discuss this in more detail with stakeholders over the summer with the view to issuing its final proposals for the licence alongside its final proposals for the price control and service quality.

17.4 The CAA intends to develop a licence that is fit for purpose for the start of the new price control period from 1 April 2014. However, it is likely that the licence will evolve over time, as has been the case in other regulated sectors. In considering licence obligations the CAA will have regard to the principles of Better Regulation as set out in section 1(3) and (4) of the Act.

17.5 The sections below discuss the main aspects of the current GAL draft licence. The CAA has drawn on extensive benchmarking with the licensing approaches adopted by other UK economic regulators and with the equivalent licence of NERL which is administered by the CAA.

Part I: Scope and interpretation of the licence

17.6 This part of the draft licence is largely unchanged from that published by the CAA in January 2012 in the indicative licence. It specifies the operator, and as required by the Act, the airport area for which the licence is granted and the relevant airport. It should be noted that section 21(1)(f) of the Act allows the CAA to include licence conditions relating to activities carried on outside the licence area.

17.7 A person is the operator of an airport area if he has overall responsibility for its management. Where there is more than one operator using an airport area and it is not clear which one has overall responsibility for it, section 10 of the Act allows the CAA to make a determination for the purposes of the Act. The person subject to the determination may appeal against it to the CAT.

17.8 The CAA will determine the airport area for which the licence is granted based on those areas where the operator has overall control of the area and has market power in that area. The CAA will base this determination on the definition of airport in the Act and will consider whether GAL has overall responsibility for the management of the areas or facilities listed in line with the matters listed in section 9(4) of the Act. These matters are the types and quality of services that may be provided in those areas and the prices charged and access to and development of the area. The CAA will then apply the MPT to determine whether the operator has, or is likely to acquire, SMP.

17.9 This part also specifies when the licence comes into force. This must be at least 6 weeks after the date on which the notice of the licence grant was published. The licence will come into force on 1 April 2014 so that the new price control condition will take effect on the day immediately after the current price control ends.

17.10 The licence continues in force until it is revoked by the CAA in accordance with the provisions included within it and in accordance with the procedures in section 48[154] of the Act. The licence is not

[154] Section 48 requires the CAA to give notice of its intention to revoke the licence to allow the licence holder to make representations.

transferable.

17.11 Finally, this part of the licence sets out how the licence should be interpreted and includes definitions that are used throughout.

Part II: Conditions on fees and revocation

Condition 1: Payment of CAA fees

17.12 In common with other regulated sectors, the Act allows the CAA to require the licence holder to pay charges to the CAA in respect of its regulatory functions under Chapter 1 of the Act.

17.13 The Act allows the CAA to require the payment of charges determined under a scheme or regulations made under section 11 of the Civil Aviation Act 1982 (the 1982 Act). Therefore, Condition 1 of the draft licence refers to the scheme already operated by the CAA under the 1982 Act. This is consistent with the approach taken in the January 2012 indicative licence.

17.14 The current CAA charging scheme sets a monthly charge based on the number of passengers arriving at the airport (apart from those arriving and departing on the same aircraft as part of the same journey). The CAA normally amends the charges on an annual basis following a consultation with interested stakeholders. The current scheme of charges for 2013/14 can be found in the CAA's Official Record Series 5.

17.15 The CAA can require payment of the charges on the grant of the licence and whilst it continues in force. Under the charging scheme referred to in Condition 1, changes to the charges normally take place on 1 April each year. The CAA therefore considers that the payment of charges should begin at the end of the month in which the licence comes into effect.

17.16 In common with other regulated sectors, the payment of fees condition would be enforceable using civil sanctions as well as the enforcement powers in the Act.

Condition 2: Licence revocation

17.17 The Act requires the CAA to include, within the licence, provision relating to the circumstances in which the licence may be revoked and specifying that the licence can only be revoked in accordance with the procedures set out in section 48 of the Act.

17.18 The process at section 48 requires the CAA to first notify GAL of its intention to revoke the licence at least 30 days before issuing a revocation notice, in order to give GAL the opportunity to make representations. If the CAA then wishes to continue and revoke GAL's licence it must issue, and publish, a revocation notice that cannot take effect for at least 30 days. GAL, and any other person, has the right to appeal to the CAT against a decision to revoke the licence or the date the revocation takes effect. An appeal suspends the effect of the notice until the appeal is decided or withdrawn.

17.19 The draft licence condition lists a number of circumstances in which the CAA could revoke the licence. These are consistent with revocation conditions in other regulated sectors.

17.20 Many of the circumstances refer to situations where a licence is no longer required, such as if GAL requests or agrees that the licence should be revoked, or if it ceases to be the operator of all the licence area. It may also be revoked if, following a subsequent market power determination (MPD), the CAA determines that the licence area is no longer a dominant area or the airport is no longer a dominant airport and, if the determination is appealed, the CAT agrees.

17.21 Other circumstances relate to unacceptable behaviour by GAL where lack of compliance with regulatory requirements cannot be resolved through any other channel.

17.22 The draft condition provides for the licence to be revoked if GAL fails to comply with an enforcement order or confirmed urgent enforcement order to the satisfaction of the CAA or if it fails to pay a penalty imposed by the CAA.

17.23 Revocation would be the ultimate sanction in the overall compliance and enforcement regime that would typically only be used when all other approaches had failed to secure compliance. Although this might result in the closure of the airport, the nature of the non-compliance may be so serious that such action is in the overall interests of passengers and cargo owners.

17.24 GAL has some additional protection before the CAA can consider revocation in these cases. Section 47 of the Act allows it to appeal to the CAT against an order or a penalty on the grounds that the decision was based on an error of fact, was wrong in law or an error was made in the exercise of a discretion. The draft licence condition includes an additional check in that, after any appeal against an enforcement order or penalty is determined, the CAA must, by notice, give GAL at least 3 months to rectify the failure to comply with the order before issuing a revocation notice.

17.25 In addition, the draft condition also includes failure to comply with relevant orders made under the Competition Act 1998 or the Enterprise Act 2002 as a reason for revoking the licence. The CAA has concurrent competition law powers and must assess, at each stage of enforcement, whether it would be better to use its Competition Act 1998 powers instead of a power under the Act. It is therefore proportionate that the competition enforcement route has the same ultimate sanction as the route in the Act. Again, the CAA considers that this should typically only be used when all other approaches had failed to secure compliance.

17.26 Failure to pay the CAA's charges required under Condition 1 of the draft condition would also be grounds for revocation to protect the integrity of the regulatory regime. Again, this would typically only be considered when all other routes, either under the Act or through the Courts, had been exhausted.

17.27 Finally, the CAA could revoke the licence if it had penalised GAL for knowingly or recklessly providing false or misleading information[155] or if GAL had intentionally altered, suppressed or destroyed a document it was required to produce by the CAA in a notice issued under the Act.

17.28 Some licences in other regulated sectors include provisions allowing the regulator the discretion to revoke the licence due to insolvency of the regulated business. The CAA is considering whether this is necessary for GAL and welcomes views on whether it would be in the interests of passengers and cargo owners to include this option. In the event of insolvency, the CAA considers that it would most likely be in the interests of any receiver and in the interests of passengers to

[155] In accordance with a licence condition, in response to a notice issued by the CAA under the Act to provide information or if the licence holder knows the CAA will use the information to carry out its functions under Chapter 1 of the Act.

keep the airport open and running.

Part III: Price control conditions

17.29 These conditions will reflect the CAA's decisions on the price control, set out in previous sections of this document. The draft licence does not contain these conditions at this stage but they will be developed over the summer in the lead up to the CAA issuing its final proposals.

17.30 The current public interest condition on the transparency of charges for certain other services is retained in the draft Licence, with the charges for groundhandling facilities, that are already covered by the AGR, removed.

Part IV: Service quality conditions

17.31 This part of the licence will contain a condition to give effect to the CAA's decisions on the SQR scheme. The draft licence does not contain these conditions at this stage but they will be developed over the summer in the lead up to the CAA issuing its final proposals.

17.32 The CAA has also proposed a condition to give effect to its policy on strengthening GAL's approach to operational resilience, discussed in an earlier chapter. The CAA would like to make it clear that meeting the operational resilience requirements in the (economic) licence should not come at the expense of GAL meeting its safety obligations under its separate aerodrome licence issued under the Air Navigation Order

Part V: Financial conditions

Condition 7: Regulatory accounts condition

17.33 The CAA intends to combine the current regulatory accounts process with other financial reporting information provided by GAL. This will be put into effect by introducing a licence condition that requires GAL to produce audited regulatory accounts in accordance with Regulatory Accounting Guidelines.

17.34 Given there already exists a fully functioning process in place, capturing this in the licence is unlikely to create additional material costs and may give the opportunity for streamlining the process.

Condition 8: Financial resilience condition

17.35 The government has been keen for the CAA to consider whether the licence could be used to strengthen the financial resilience of airport operators, in line with the approaches commonly seen in other regulated sectors.

17.36 The Act does not contain specific duties to introduce financial resilience provisions per se. However, these are permitted by the Act, should the CAA consider that doing so would further its duties.

17.37 In pursuing its primary duty towards passengers and cargo owners the CAA must have regard to, amongst other things:

- the need to secure that the airport operator is able to finance its provision of airport operation services in its licensed airport area; and
- the need to promote economy and efficiency.

The CAA's Assessment

Ring fencing conditions

17.38 Most other regulated companies have 'ring fence' provisions in their licences that restrict the types of activities they can conduct and place limitations on the way that they set up their financial arrangements. Such licence conditions are designed to minimise the risk of financial distress and consequent adverse impact on end users.

17.39 The CAA is mindful that its evaluation of the pros and cons of introducing similar ring fencing provisions needs to recognise that GAL has previously put in place a highly complex financing structure. As things stand today, certain of the arrangements that GAL is using are not compatible with a complete suite of typical ring fencing conditions seen in other regulated industries' licences.

17.40 For example, GAL's asset base is charged to secure the debt obligations and lenders have already made it clear that they would not surrender their existing security rights. So the typical conditions prohibiting granting security over assets[156], restrictions on disposal of assets[157], or the prohibition of cross guarantees would immediately be a 'trigger event' and, if unresolved, risk putting GAL in breach of the licence and/or its financial arrangements.

17.41 The government recognised the conflict between a full regulatory ring fence and existing banking covenants and reached a policy position that a financial ring fence should be introduced to the extent that it did not cut across existing financial arrangements in place when the Act was commenced.

17.42 If the CAA were to introduce, but derogate, financial resilience conditions, such derogations would have significant legal protection, as there are additional tests in the Act for the removal of such derogations or the activation of 'dormant' conditions in respect of financial resilience.

17.43 There is, in the CAA's view, a reasonable argument supporting the inclusion of the standard ring fence restrictions in GAL's licence. For example, financial distress could cause detriment to passengers' interests in both the short and the longer term. The economics of an airport whose operator has SMP suggest that, even in time of financial

[156] Security over assets. This type of licence condition prohibits the licensee from offering its assets as security, because there is a risk that in the event of default the lenders will have control over crucial assets that might not then be available for the provision of services. However, in asset rich businesses such as airports, lenders tend to take significant comfort from having some control over the cash generating assets, and a credit enhancement such as this reduces lenders' risk and reduces the cost of debt. A licence condition that prohibits the granting of security over the assets would be in conflict with GAL's current financial arrangements, and therefore an introduction of such a requirement could lead to a re-pricing of debt or possibly even a complete re-financing of all GAL's borrowings. The CAA considers that this would not be in the interest of users at the present time.

[157] Restrictions over disposal of assets. This type of condition places restrictions on the licensee's ability to dispose of assets, and its purpose is to ensure that there remains a 'complete' business capable of providing services. While this condition does not explicitly conflict with the current financial arrangements restrictions imposed by the CAA on the disposal of assets could frustrate the ability to exercise that security. The incentive is likely to be, in both benign times and financial distress, for GAL to retain an asset that is crucial to supply the market in which it has market power. If GAL were to sell an asset in the airport area to another entity, that entity could be subject to a licence (subject to the CAA's assessment of market power). The CAA therefore considers that it is not appropriate to place restrictions on the disposal of assets in the licence at the present time because this could cut across existing financial arrangements and, in any case, it considers there are sufficient safeguards in place.

distress, the airport is likely to remain open because it is likely to generate a positive cash flow, there could be a temporary closure[158], for example, while an administrator resolves legal and operational issues. Financial distress may also lead to reduced expenditure at the airport with implications for future service quality.

17.44 However, a change to GAL's financial structure that would be consistent with the requirements of the licence conditions seen in other regulated sectors could require a complete re-financing of existing debt. The costs and risks of this might be passed on to passengers and airlines. Re-financing GAL's current debt (approximately £1.4 billion) to be compliant with ring fence conditions would likely have two categories of costs:

- transaction costs from redeeming existing financing and issuing new finance[159]; and
- on-going higher cost of debt in the absence of credit enhancements (such as security).

17.45 While the choice of financial structure is not binary, the CAA understands that most of the covenants and characteristics of GAL's current debt structure are not severable from the rest. Therefore, the CAA has considered the implications of introducing:

- a full ring fence; or
- a ring fence comprising only those element that do not cut across existing financial arrangements; or
- no financial ring fencing conditions at all.

17.46 As noted above, although there are benefits to users of a full ring fence, given the costs identified, the CAA concludes that it is likely to be in passengers' interest that any ring fencing conditions do not cut across GAL's current financial conditions.

17.47 The CAA notes that, the Act provides an additional protection in the

[158] To place the risk of airport closure in perspective, the CAA is unaware of any occasions in which the airport has closed because of financial distress compared to the relatively more frequent closures due to adverse weather conditions

[159] The incremental transaction cost might be lower if it coincides with re-financing for other purposes (say on a change of ownership, or when a large amount of debt reaches maturity

removal of derogations, namely that there must be a material change in circumstances and that the benefits must outweigh the costs.

17.48 The CAA considers that for airports such as Gatwick, which has a strong cash generation, the interests of users and the providers of debt finance are substantially aligned. Both want a financial structure that incorporates debt (and reduces the WACC) but not so much that it is insufficiently resilient to downside risk. They will both want Gatwick to remain open even in times of severe financial distress; from the financiers' perspective, the best use of an airport whose operator has SMP is for the airport to remain open and generate cash.

17.49 The CAA does not think it is necessary to impose the full suite of ring fence conditions - the incremental benefits to users could be significantly outweighed by the incremental costs. The GAL debt covenants already form a 'contractual ring fence', albeit one to which the CAA is not party. It is not clear that licence-based restrictions are necessary where lenders have similar safeguards in place to protect their investment (for example, through minimum credit rating requirements, etc).

17.50 It was noted that GAL's financing arrangements include an extensive covenant package designed to shield creditors from deterioration in their financial position by putting in place dividend lock-ups and other protections if ratings, cashflow or gearing triggers are breached. In addition, there are currently covenants that restrict the type of business that it can undertake.

17.51 The CAA considers that if it is to gain comfort from GAL's contractual ring fence, it would need to be informed if there were changes that subsequently reduced this level of comfort. The CAA proposes that if it is to rely on the contractual ring fence it would introduce a licence condition that would require GAL to notify the CAA of any relevant changes. The CAA's initial proposal is for the CAA to be notified before the changes come into effect.

17.52 An alternative approach could be for the CAA to introduce a full ring fence into GAL's licence but to derogate those aspects that cut across GAL's existing financial arrangements (effectively making the conditions "dormant" until new financing structures are introduced). The benefit of this is that they would provide greater certainty and clarity by setting out the restrictions on GAL's future financial arrangements.

17.53 It is not clear, however, how long these conditions would remain dormant, or indeed if they would ever be used. For example, GAL has bonds that will not be redeemed for many years. There is also a risk that the drafting of any dormant conditions was not fit for purpose when they were finally needed so would have to be amended through the licence modification process. The CAA proposes instead to rely on the licence modification process in the Act if additional restrictions are needed.

17.54 By permitting GAL to leave in place arrangements which would otherwise not comply with the standard regulatory ring fence, the CAA will not be able to secure the financial resilience that regulated companies in other sectors exhibit. It can, however, ensure that GAL does not take additional actions which might further jeopardise the airport operator’s financial position. These are set out below.

Restrictions on business activities

17.55 The CAA sees merit in proposing a restriction on business activities that would prohibit GAL from undertaking unrelated activities and placing the regulated business at risk.[160] While the Act defines an airport area, the definition is for a different purpose and is much narrower than the activities undertaken at an airport. A modern commercial airport carries out other commercial activities such as retail, car parks, property rentals, transport interchange as well as its aeronautical activities. Furthermore, at a geographically constrained airport, some of these activities might not be located at the airport itself.

17.56 The CAA therefore proposes to set the restriction quite widely to cover ‘the business activities of Gatwick Airport’ to allow GAL to carry out commercial activities at Gatwick that another operator would be able to do at a competitive airport. Although this definition appears loose, it does prohibit GAL from operating another airport or undertaking an unrelated activity.

17.57 At the margin the CAA is concerned that this might be against passengers' interests and prohibit GAL from using part of its land and property for an unrelated purpose. For example, the airport operator

[160] Other group companies may undertake whatever activities they wish.

could be prevented from renting out spare office space to a business completely unrelated to aviation, and including the income in the single till to reduce charges to users. The CAA considers that there may be merit in this condition including a *de minimis* qualification and/or the provision for the CAA to grant exemptions.

Certificate of adequate resources

17.58 This is a requirement on the company directors to certify annually to the CAA that it expects to have (or not to have) adequate resources (including financial, staff and other resources) to continue to operate for the following 24 months. The company must also tell the CAA as soon as possible if the directors become aware of reasons why the most recent certificate may longer hold true. This obligation may give the CAA early warning of potential problems so that where possible and appropriate the CAA can consider further measures.

17.59 Concerns were raised around the administrative and monitoring costs being significantly greater than any benefit. The CAA, however, considers that this requirement can be designed so as to minimise the administrative burden.

17.60 The CAA notes that GAL's price commitment proposals include the following 'the Directors of GAL will provide an annual certificate of adequate financial resources to operate the airport and provide the core services'.

17.61 The auditors provide an independent going concern opinion on the accounts of the company and although the CAA takes some comfort from this, it is unlikely to be sufficient and hence the CAA considers that the certificate of resources has merit. For example, the CAA notes that audit opinions are usually for a period of 12 months from the balance sheet date and it does not often take into account more than financial resources.

Parent undertaking

17.62 This type of licence condition places an obligation on GAL to obtain a legally binding undertaking from its ultimate parent company/ies (or controller/s) not to do anything that would put the licensee in breach of the licence. The CAA sees merit in requiring it for the licence.

Continuity of service plan

17.63 While the CAA's view is that if an airport operator has market power then the economic incentives are for the airport to remain open during financial distress as it is significantly cash generative, there is a risk that it might close or experience service disruption whilst operational or legal issues relating to that financial distress are resolved.

17.64 The CAA considers that this risk could be reduced if GAL has in place a continuity of service plan. Such a plan would enable the new management or an administrator to understand and respond to the major issues, which could threaten the temporary closure.

17.65 The CAA notes that requirements on regulated companies to hold plans in the event of financial distress have been adopted in other sectors. For example, in May 2012, the Financial Services Authority (FSA) made ‘recovery and resolution’ plans (‘living wills’) mandatory for financial institutions.

17.66 The CAA has included a condition in the draft GAL licence requiring it to develop and maintain a continuity of service plan.

Minimum credit rating

17.67 This type of licence condition places a requirement on the licensee to use its best endeavours to maintain an investment grade credit rating. It is most effective when it applies to the rating of an issuer (i.e. the licensee) rather than the issuance (i.e. the debt).

17.68 Unlike HAL (which as different classes of debt with different credit ratings), GAL has two investment grade bonds. GAL's price commitment proposals include 'GAL will undertake at all times not to take any action which would result in the loss of an investment level credit rating for GAL'. The CAA understands that this is very similar to a covenant in GAL's financial arrangements.

17.69 The CAA seeks views on whether it should include a licence condition a minimum credit rating. The CAA notes that it is not proposing such a condition for HAL, because of the complexity of HAL's financial arrangements and the fact that such a condition would, on the whole, duplicate the banking covenant.

Prohibitions on cross guarantees

17.70 The purpose of a prohibition on cross guarantees is to avoid ‘risk bridges’ from unregulated businesses to the regulated business. GAL already has cross guarantees between it and other group finance companies and, therefore, any blanket prohibition would be in conflict with the current financial arrangements.

17.71 There are two options:

- no prohibitions or restrictions on cross guarantees or similar obligations in the licence; or
- a prohibition on cross guarantees except for those that currently exist (this could be defined by the companies or by current financial arrangements).

17.72 The benefit of the second approach is that no new cross guarantees can be given and therefore no new risk bridges can be created. The disadvantage of this is that it is likely to be complex and, therefore, require significant monitoring and raise significant risk of non-compliance if one of the cross obligations is overlooked. The CAA is concerned that any changes to cross guarantees will require the CAA to examine whether or not it is, in substance, a 'new' obligation or merely a 'minor technical' change. The CAA is concerned that this could create a significant burden on the licensee, significant costs for all parties concerned which would ultimately be borne by users and increased uncertainty as to licence compliance. It would also involve the CAA in GAL's actual financing at a level of detail rarely seen in economic regulation, and therefore inconsistent with the CAA's position that actual financing is a matter for the company (for example, the CAA uses a simplified notional financial structure for calculating the WACC).

17.73 The CAA considers that these disadvantages are likely to outweigh the benefits. The initial proposals for the licence therefore do not include a prohibition against of the granting of any further cross guarantees, although the CAA would especially welcome feedback on this issue.

Costs and benefits of the CAA’s initial proposals

17.74 The CAA is mindful of introducing and administrating such a package of measures in a cost effective manner. The potential benefits for users should outweigh the costs. However, quantifying the benefits and costs may not be possible to a high level of confidence (or at least risks a spurious level of precision) and hence a qualitative assessment may be more pragmatic and appropriate.

17.75 The CAA considers that the proposed licence conditions in respect of restriction on activities and parent company undertakings will have minimal costs of introduction and administration and, therefore, the benefits as set out in this chapter are likely to be substantially in excess of costs.

17.76 The annual certificate of adequate resources will incur some costs for GAL, although these can be reduced if the timing is aligned with the airport operator's annual reporting. The CAA considers that these costs will be more than outweighed by the benefit of the early warning on potential resource issues and the 'no surprises' culture that will facilitate CAA's proportionate and appropriate regulation.

17.77 The continuity of service plan, both in its preparation and review, is likely to create costs for GAL. However, these costs can be reduced if the plan builds on and complements existing plans and procedures, including operational resilience requirements of the licence. Given the significant costs associated with service disruption for GAL, the airlines and for passengers, the benefits of a plan are expected to be significantly higher than the cost of preparing the plan.

17.78 The CAA therefore only proposes to include the following elements of the standard financial ring fence in GAL's licence (figure 17.1). Draft conditions are included in the draft licence contained within Appendix B.

17.79 The CAA will continue to engage with GAL and other stakeholders following publication of its initial proposals with a view to refining its proposals for its final proposals in October 2013.

17.80 Although at this stage the CAA is proposing to replicate similar provisions at all the airports that may be granted a licence effective from April 2014, it welcomes feedback on whether it should tailor its approach to the degree of market power of the airport. Should there be a move away from a RAB based price control at Gatwick? Would this change the need for, or type of, financial resilience licence conditions?

Figure 17.1: Summary of initial proposals for financial resilience ring fencing

	Is the typical form consistent with GAL's existing financial arrangements?	Could it be re-drafted to avoid a conflict with GAL's financial arrangements?	Are benefits to passengers expected to outweigh the costs?	Included in CAA initial proposals?
Prohibition on the granting of security	No	No	No	No
Prohibition on the disposal of assets without CAA approval	No	No	No	No
Restriction on business activities	Yes	-	Yes	Yes
Prohibition on granting of cross default guarantees	No	Yes, but could be very complex	No, costs may outweigh benefits	No
Parent company undertakings	Yes	-	Yes	Yes
Credit rating requirement	No	Yes, but could be very complex	No, incremental benefits low	No
Certificate of adequacy of resources	Yes	-	Yes	Yes
Continuity of service plan	Yes	-	Yes	Yes
Report changes in private ring fence	Yes	-	Yes	Yes

Source: CAA

Part VI: Other licence conditions

17.81 The CAA considers there may be merit in considering other licence conditions for GAL. The CAA will need to exercise judgement over those issues that are pursued for the initial licence from April 2014 and those issues that can be considered after that date.

17.82 Of the issues that the CAA will consider further are the following. It should be noted that this list is not exhaustive and that the CAA may decide not to pursue certain issues upon further consideration. As such, the draft licence does not contain draft conditions at this stage.

17.83 A provision, possibly in the interpretation section, stating that, in meeting the licence conditions, the licensee should not breach any other legal obligations for example in relation to safety or security requirements. This may be required to ensure that the licensee does not consider there is a choice between breaching the licence and breaching those other requirements.

17.84 A provision to reopen the price control within the regulatory period.

- The CAA notes that some regulators such as Ofwat have specific conditions relating to the conditions in which they will reopen the price settlement within the regulatory period. Some others do not have such specific conditions but may make reference to their approach in a regulatory policy statement.
- The CAA recognises that it is important that it does not undermine the incentive properties of the price settlement and therefore any reopening of the price control should only be in extreme circumstances. Some regulators specify exactly how the price control will change for a change in another variable (for example the NERL licence includes a specific risk sharing mechanism for traffic being different to forecast).
- The CAA welcomes feedback from stakeholders on both the principle of specifying a reopening condition and the form in which such a condition should take.

17.85 A mechanism to adjust the SQR scheme within the regulatory period. GAL and the airlines may negotiate changes to the levels and rebates so there will need to be a mechanism to allow for this either specified in the licence or else through the licence modification processes.

17.86 Consultation protocol. The CAA will need to consider whether the licence should seek to contain a condition akin to the present Annex G that set out its expectations on how GAL will consult airlines on various matters.

17.87 Complaints handling. The CAA would like to consider whether the licence should contain clear requirements on GAL in relation to how it deals with passenger complaints.

17.88 Non-discrimination conditions. The CAA may need to consider whether the licence should contain any non-discrimination type conditions. The CAA notes that it has dealt with several recent cases of discrimination under section 41 of the Airports Act 1986, which will be repealed by the Act by April 2014. If the CAA pursues this, it will need to avoid duplication or cutting across existing obligations such as the ACR or the Competition Act 1998.

17.89 Revocation. In addition to the reasons for licence revocation set out above, the CAA considers there may be merit in including a discretionary provision that would enable the CAA to revoke the licence in the event that the licensee becomes insolvent. This is commonly seen in licences for other regulated companies.

CAA initial proposals

17.90 The CAA proposes to establish a licence for GAL to take effect from 1 April 2014 (contained in Appendix B). This licence sets out a number of requirements. Some are simply to make the licence work (operable conditions); some give effect to the CAA's policies with regard to price controls, service quality regulation, operational resilience and financial resilience. Overall, the CAA considers that these conditions imply a positive cost/benefit case for passengers.

17.91 There are a number of other potential issues the CAA could consider on which it also invites feedback, such as reopeners for the price control and the service quality regime, a consultation protocol, complaints handling and non-discrimination.

Appendices

APPENDIX A

Summary of CAA proposals for service quality standards and rebates during Q6

17.92 Unless specified otherwise, definitions apply throughout this figure as set out in Annex H of the Economic Regulation of Heathrow and Gatwick Airports 2008 - 2013 - CAA Decision (Annex H), and any subsequent amendments, reflecting current operation of financial incentives in Q5.

i) Passenger satisfaction measures (bonuses & publication in terminal also apply)

	Element	Metric	Standard	Rebate: annual max Q5		Rebate: annual max proposal Q6		Bonus level	Changes from Q5	Publication in terminal
				North	South	North	South			
1	Departure lounge seating availability	QSM scores – moving annual average	4.0	0.36%	0.36%	0.36%	0.36%	4.2	Varying increases in standards for both rebates and bonuses from Q5.	Yes – as Q5
2	Cleanliness		4.1	0.36%	0.36%	0.36%	0.36%	4.3		Yes – as Q5
3	Wayfinding		4.1	0.36%	0.36%	0.36%	0.36%	4.4		Yes – as Q5
4	Flight information		4.2	0.36%	0.36%	0.36%	0.36%	4.5		Yes – as Q5
5	Security			-	-	-	-		New element for publication	Yes - new
	Total			**1.44%**	**1.44%**	**1.44%**	**1.44%**			

Source: CAA analysis

ii) Security

	Element	Metric	Standard	Rebate: annual max Q5		Rebate: annual max proposal Q6		Changes from Q5	Publication in terminal
				North	South	North	South		
6	Central search	As Q5 for 2014/15, then x% of pax < y mins (as estimated until full automation)	(Equivalent to) 95% of 15 minute measurements < 5 minutes	0.7698%	0.7698%	0.85%	0.85%	Maintain service level as Q5. New formulation of metric from year 2015/2016 onwards	Include
		As Q5 for 2014/15, then x% of pax < y mins (as estimated until full automation)	(Equivalent to) 98% of 15 minute measurements =< 15 minutes						Include
		Single queue time measure	(Equivalent to) day when any single time slice measure > 30 minutes	-	-	0.45%	0.45%	New metric in Q6.	Include

	Element	Metric	Standard	Rebate: annual max Q5		Rebate: annual max proposal Q6		Changes from Q5	Publication in terminal
			0.5% applied to pro-rated airport charges for number of days in month affected,						
7	Transfer search	As Q5 for 2014/15, then x% of pax < y mins (as estimated until full automation)	(equivalent to) 95% of 15 minute measures < 10 mins	0.4002%	0.4500%	0.20%	0.20%	No change	Remove
8	Staff search (T)	x% of 15 minute measurements < y minutes	95% of 15 minute measurement < 5 minutes	0.3102%	0.3498%	0.33%	0.33%	No change	N/A
	Staff search (J&A)		95% of 15 minute measurement < 10 minutes						
9	Control posts	x% of vehicles < y mins	95% of 15 minute measurements < 15 minutes	0.3102%	0.3498%	0.33%	0.33%	No change	N/A
	Total			**1.7904%**	**1.9194%**	**2.16%**	**2.16%**		

iii) Passenger operational measures

	Element	Metric	Standard	Rebate: annual max Q5		Rebate: annual max proposal Q6		Changes from Q5	Publication in terminal
				North	**South**	**North**	**South**		
10	Passenger-sensitive equipment (general)	% time available	99%	0.4002%	0.4002%	0.35%	0.35%	Bonus removed	Remove
11	Passenger-sensitive equipment (priority)	% time available	99%	0.4002%	0.4500%	0.35%	0.35%	Unchanged	Remove
12	Inter-terminal transit system	% time 1 car available	99%	0.3102%	0	0.30%	0%	Unchanged	Remove
		% time 2 cars available	97%					Unchanged	Remove
13	Arrivals reclaim (baggage carousels)	% time available	99%	0.4002%	0.4002%	0.35%	0.35%	Bonus removed	Remove
	Total			**1.5108%**	**1.2504%**	**1.35%**	**1.05%**		

Source: CAA analysis

iv) Airline operational measures

	Element	Metric	Standard	Rebate: annual max Q5		Rebate: annual max proposal Q6		Changes from Q5	Publication in terminal
				North	South	North	South		
14	Outbound baggage	TBA		-	-	0.2%	0.2%	New metric	No
15	Stands	% time available	99%	0.3102%	0.3498%	0.25%	0.25%	No change	N/A
16	Jetties	% time available	99%	0.3102%	0.3498%	0.3%	0.3%	No change	N/A
17	Pier service	Moving annual average % passengers served	Subject to exceptions to be agreed by GAL and the AOC	0.4002%	0.4500%	0.3%	0.3%	No change	Remove
18	FEGP	% time available	99%	0.2202%	0.2502%	0.15%	0.15%	No change	N/A
	Total			**1.2408%**	**1.3998%**	**1.2%**	**1.2%**		

Source: CAA analysis

v) Aerodrome congestion term

	Element	Metric	Standard	Rebate: annual max Q5	Rebate: annual max proposal Q6	Changes from Q5	Publication in terminal
19	Aerodrome Congestion Term	As per Q5	As per Q5	1%	1%	CAA seeks views on revising this metric	N/A

Source: CAA analysis

Summary of CAA proposals for SQR scheme during Q6 - rebate by category

		North	South	North	South
i	Passenger satisfaction measures	1.44%	1.44%	1.44%	1.44%
ii	Security	1.7904%	1.9194%	2.16%	2.16%
iii	Passenger operational measures	1.5108%	1.2504%	1.35%	1.05%
Iv	Airline operational measures	1.2408%	1.3998%	1.20%	1.20%
V	Aerodrome congestion term	1.0%	1.0%	1.0%	1.0%
	Total	**6.9820%**	**7.0096%**	**7.15%**	**6.85%**

Source: CAA analysis

APPENDIX B

Draft Licence Conditions
Gatwick Airport Limited Licence

Part I: Scope and interpretation of the licence

Licensed Operator

1. Licensed Operator means Gatwick Airport Limited (the Licensee).

Airport Area

2. The Airport is Gatwick Airport (London).

3. The Airport Area is [to be determined following the market power assessment]

4. Specifically, the Airport Area [includes/excludes]:

   a) xxx

Licence duration

5. This Licence shall come into force on 1 April 2014 and shall continue in force until revoked in accordance with Condition 2 of this Licence.

Interpretation of the Licence

6. Unless specifically defined within this Licence or in the Act or the context otherwise requires, words and expressions used in the Conditions shall be construed as if they were an Act of Parliament and the Interpretation Act 1978 applied to them. References to an enactment shall include any statutory modification or re-enactment thereof after the date of the coming into effect of this Licence.

7. Any word or expression defined for the purposes of any provision of Part I of the Act shall, unless the contrary intention appears, have the same meaning when used in the Conditions.

8. Any reference to a numbered Condition or Schedule is a reference to the Condition or Schedule bearing that number in this Licence, and any reference to a paragraph is a reference to the paragraph bearing

that number in the Condition or Schedule in which the reference occurs.

9. In construing the provisions of this Licence, the heading or title of any Condition, Schedule or paragraph shall be disregarded.

10. Where the Licensee is required to perform any obligation by a specified date or within a specified period and has failed so to perform, such obligation shall continue to be binding and enforceable after the specified date or after expiry of the specified period, but without prejudice to any rights or remedies available against the Licensee under the Act or this Licence by reason of the Licensee's failure to perform by that date or within the period.

11. The provisions of sections 74 and 75 of the Act shall apply for the purposes of the publication or sending of any document pursuant to this Licence.

Definitions

12. In this Licence:

a) the Act means the Civil Aviation Act 2012

b) the CAA means the Civil Aviation Authority

PART II: Conditions on fees and revocation

Condition 1: Payment of CAA fees

1. The Licensee shall pay to the CAA such charges and at such times as are determined under a scheme made under section 11 of the Civil Aviation Act 1982 in respect of the carrying out of the CAA's functions under Chapter I of the Act.

Condition 2: Licence revocation

1. The CAA may revoke this Licence in any of the following circumstances and only in accordance with the process set out in section 48 of the Act:

    a) If the Licensee requests or otherwise agrees in writing with the CAA that the Licence should be revoked.

    b) If:

        i) the Licensee ceases to be the operator of any part of the Airport Area; or

        ii) the Airport Area ceases to be a dominant area located at a dominant airport (or part of such an area) and does not include all or part of such an area.

    c) If the Licensee fails:

        i) to comply with an enforcement order (within the meaning of section 33 of the Act) or an urgent enforcement order (within the meaning of section 35 which has been confirmed under section 36), and (in either case) such a failure is not rectified to the satisfaction of the CAA within three months after the CAA has given notice in writing of such failure to the Licensee – provided that no such notice shall be given by the CAA before the expiration of the period within which an appeal under section 47 could be brought in relation to the validity or terms of an order or the CAA's finding or determination upon which it is based, or before the proceedings relating to any such appeal are finally determined; or

        ii) to pay any penalty (within the meaning of sections 39, 40, 51 or 52 of the Act) where

iii) the Licensee has failed to pay the penalty by the due date for any such payment; and

iv) such payment is not made to the CAA within three months after the CAA has given notice in writing of such failure to the Licensee – provided that no such notice shall be given by the CAA before the expiration of the period within which an appeal under sections 47 or 55 could be brought in relation to the imposition of a penalty, the timing of the payment of the penalty, the amount of the penalty or before proceedings relating to any such appeal are determined.

d) If the Licensee fails to comply with:

i) an order made by the court under section 34 of the Competition Act 1998;

ii) an order made by the relevant authority under sections 158 or 160 of the Enterprise Act 2002;

iii) an order made by the Competition Commission under sections 76, 81, 83, 84 or 161 of the Enterprise Act 2002; or

iv) an order made by the Secretary of State under sections 66, 147, 160 or 161 of the Enterprise Act 2002.

e) If any amount payable under Condition 1 of this Licence is unpaid three months after it becomes due and such a failure is not rectified to the satisfaction of the CAA within three months after the CAA has given notice in writing of such failure to the Licensee; or

f) If the conduct of the Licensee has resulted in a penalty imposed by the CAA under section 52(1) or 52(3) of the Act - provided that no notice under section 48 for the Act proposing to revoke the Licence shall be given by the CAA before the expiration of the period within which an appeal under section 55 could be brought in relation to the imposition of a penalty, the timing of the payment of the penalty, the amount of the penalty or before proceedings relating to any such appeal are determined..

PART III: The price control conditions

Condition 3: Price control

1. Further information to follow

Condition 4: Charges for other services

1. By [31 December 2014] and by [31 December] in each subsequent year the Licensee shall inform the CAA of the system used by it to allocate costs to the specified facilities. The Licensee shall make any amendments to its cost allocation system if so requested by CAA by [31 March] prior to each charging year commencing on [1 April].

2. By [31 December 2014] and by [31 December] in each subsequent year the Licensee shall provide to the CAA statements of actual costs and revenues in respect of each of the specified facilities in Condition [5.]7 for the year ending the previous [31 March].

3. By [31 March] each year, the Licensee shall provide to the CAA and to users of the specified facilities or their representatives prior to implementing any price changes a statement of the pricing principles for each item charged including the assumptions and relevant cost information adequate to verify that the charges derive from the application of the pricing principles.

4. Where charges for the specified facilities are not established in relation to cost the Licensee shall provide to the CAA and to users of the specified facilities or their representatives a statement of the principles on the basis of which the charges have been set with full background information as to the calculation of such charges including statements of any comparables used.

5. Where in respect of any year forecast revenue for any of the specified facilities differs from that forecast for the purposes of the price control review for the period [1 April 2014] to [31 March 2019] (as specified by the CAA), the Licensee shall provide to the CAA and to users of the specified facilities or their representatives detailed reasons for the differences.

6. This Condition 4 shall continue until [31 March 2019] unless, before that date, it is modified or withdrawn.

Definitions

7. In this Condition 4 the specified facilities are: desk licences (other than check-in desks), staff car parking, staff ID cards, fixed electrical ground power, airside parking, airside licences, cable routing, maintenance, heating and utility services and facilities for bus and coach operators.

PART IV: Service quality conditions

Condition 5: Service quality levels and rebates

1. Further information to follow

Condition 6: Operational resilience

1. The purpose is to secure the availability and continuity of airport operation services, particularly in times of disruption, to further the interests of users of air transport services in accordance with best practice and in a timely, efficient and economical manner.

2. The Licensee shall achieve the purpose so far as is reasonably practicable having regard to all relevant circumstances.

3. The following obligations in this Condition 6 are without prejudice to the generality of Condition [6.]2 and compliance with these obligations shall not necessarily be treated in itself as sufficient to secure compliance with Condition [6.]2. In fulfilling these obligations the Licensee shall at all times comply with Condition [6.]2.

Resilience plans

4. By [1 October 2014] the Licensee shall publish one or more plan(s) or other documents setting out the principles, policies and processes by which it will comply with Condition [6.]2.

5. As a minimum, the plan(s) should include those elements set out in any relevant guidance issued by the CAA as revised from time to time.

6. In particular the plan(s) must include details on how the Licensee, in cooperation with providers of air transport services using the Airport, will seek to ensure the welfare of passengers during disruption.

7. Prior to publishing any plans or other documents under Condition [6.]4 the Licensee shall consult all relevant parties on those plans or documents.

8. The Licensee shall allow a reasonable time for relevant parties to respond to any consultation issued under Condition [6.]7

9. The Licensee shall, from time to time or when so directed by the CAA, review and, if necessary and following consultation, revise any plans or other documents published under Condition [6.]4 so that they may better comply with Condition [6.]2.

10. No revision of any guidance under Condition [6.]5 or direction under Condition [6.]9 shall have effect unless the CAA has first consulted the Licensee and any relevant parties.

Coordination and cooperation

11. The Licensee shall so far as is reasonably practicable coordinate and cooperate with all relevant parties at the airport to meet the requirements of Condition [6.]2.

12. The Licensee shall set up and facilitate a committee of relevant parties or organisations representing those relevant parties. All relevant parties shall have the right to be on this committee or, if they so wish, to be represented on it by an organisation appointed to that effect.

13. As operations coordinator, the Licensee shall develop rules of conduct for providers of air transport services and groundhandlers to follow particularly during disruption. The rules of conduct should be set out in the Conditions of Use and the Groundhandling Licences and must comply with the following principles:

    a) they shall be applied in a proportionate manner to the various providers of air transport services and suppliers of groundhandling services; and

    b) they shall relate to the purpose in Condition [6.]1;

14. The Licensee shall, so far as reasonably practicable, take steps to ensure that the providers of air transport services and groundhandlers comply with the rules of conduct.

Provision of information

15. In the event of service disruption however caused the Licensee shall so far as is reasonably practicable:

    a) coordinate the communication of operational information, conditions and decisions to relevant parties;

    b) provide, or ensure the provision of timely, accurate and clear information about its operations to, and adequate communication with, users of air transport services; and

c) provide clear and relevant information to users of air transport services including, but not limited to, their relevant rights under the denied boarding regulations during disruption.

Definitions

16. In this Condition 6:

a) Conditions of Use means the Gatwick Airport Conditions of Use including airport charges, issued by the Licensee on an annual basis.

b) The denied boarding regulations means Regulation (EC) 261/2004 of the European Parliament and of the Council of 11 February 2004 establishing common rules on compensation and assistance to passengers in the event of denied boarding and of cancellation or long delay of flights, and repealing Regulation (EEC) No 295/91.

c) Groundhandling Licences means the licences issued by the Licensee to setting out the requirements for groundhandling companies at the Airport.

d) relevant parties means those providing a service to users of air transport services at the airport including providers of air transport services, groundhandlers, the provider of aerodrome air navigation services, fuel and energy suppliers and the Border Agency.

PART V: Financial Conditions

Condition 7: Regulatory accounting requirements

1. This Condition applies for the purpose of making available, in a form and to a standard reasonably satisfactory to the CAA, such audited regulatory accounting information as will, in furtherance of the requirements of this Licence:

    a) enable the CAA and providers and users of air transport services to assess on a consistent basis the financial position of the Licensee and the financial performance of provision of airport operation services and associated services provided in connection with the airport to which the licence relates;

    b) assist the CAA and providers and users of air transport services to assess performance against the assumptions underlying any price control conditions in the Licence; and

    c) inform future price control reviews.

2. The Licensee shall keep and, so far as it is able, procure that any related undertaking keeps the accounting records required by the Companies Act 2006 to keep in such form as is necessary to enable the Licensee to comply with this Condition and the Regulatory Accounting Guidelines.

3. The Licensee shall prepare on a consistent basis from the accounting records referred to in Condition [7.]2, in respect of the financial year commencing on [ ] and each subsequent financial year, regulatory accounts in conformity with the Regulatory Accounting Guidelines for the time being in force in accordance with this Condition. The first financial year of the Licensee shall run from [ ] to [ ], and thereafter each financial year of the Licensee shall run from [ ] to the following [ ] unless otherwise agreed with the CAA.

4. The Regulatory Accounting Guidelines prepared pursuant to Condition [7.]6 shall, without limitation:

    a) provide that, except so far as the CAA reasonably considers otherwise, the regulatory accounts shall be prepared in accordance with applicable law and International Financial Reporting Standards (IFRS) as adopted by the EU from time to time; and

b) state the accounting policies to be adopted.

5. The Licensee shall:

a) procure, in respect of the regulatory accounts prepared in accordance with Condition [7.]3 in respect of a financial year, a report by the Auditors addressed to the CAA stating whether in their opinion those accounts including accompanying commentary on performance have been properly prepared in accordance with this Condition and the Regulatory Accounting Guidelines and on that basis fairly present the financial position and the financial performance of the Licensee;

b) deliver to the CAA the Auditors' report referred to in sub-paragraph (a) and the regulatory accounts referred to in Condition [7.]3 as soon as reasonably practicable, and in any event not later than six months after the end of the financial year to which they relate; and

c) arrange for copies of the regulatory accounts and Auditors' report referred to in Conditions [7.]5(a) and (b), respectively, to be made publicly available and, [so far as reasonably practicable, to do so when the annual statutory accounts of the Licensee are made available.]

Definitions

6. In this Condition 7 Regulatory Accounting Guidelines means the guidelines, published by the CAA so as to fulfil the purpose set out in Condition [7.]1], which govern the format and content of such regulatory accounts and the basis on which they are to be prepared as from time to time amended by the CAA.

Condition 8: Financial resilience

Certificate of adequacy of resources

1. The Licensee shall at all times act in a manner calculated to secure that it has available to it sufficient resources including (without limitation) financial, management and staff resources, to enable it to comply with its obligations under this Licence.

2. The Licensee shall submit a certificate addressed to the CAA, approved by a resolution of the board of directors of the Licensee and signed by a director of the Licensee pursuant to that resolution. Such certificate shall be submitted within four months of the end of the Licensee's financial year. Each certificate shall be in one of the following forms:

   a) "After making enquiries based on systems and processes established by the Licensee appropriate to the purpose, the directors of the Licensee have a reasonable expectation that the Licensee will have available to it, after taking into account in particular (but without limitation) any dividend or other distribution which might reasonably be expected to be declared or paid, any amounts of principal and interest due under any loan facilities and any actual or contingent risks which could reasonably be material to their consideration, sufficient financial and other resources and financial and operational facilities to enable the Licensee to comply with its obligations under its Licence to which the Licensee is aware or could reasonably be expected to make itself aware it is or will be subject for a period of two years from the date of this certificate."

   b) "After making enquiries based on systems and processes established by the Licensee appropriate to the purpose, the directors of the Licensee have a reasonable expectation, subject to what is said below, that the Licensee will have available to it, after taking into account in particular (but without limitation) any dividend or other distribution which might reasonably be expected to be declared or paid, any amounts of principal and interest due under any loan facilities, and any actual or contingent risks which could reasonably be material to their consideration, sufficient financial and other resources and financial and operational facilities to enable the Licensee to comply with its obligations under its Licence to which the Licensee is aware or could reasonably be expected to make itself aware it is or will be subject for a period of two years from the date of this certificate. However, they would like to draw attention to the following factors which may cast doubt on the ability of the Licensee to comply with its obligations under such Licence for that period…….”

c) “In the opinion of the directors of the Licensee, the Licensee will not have available to it sufficient financial or other resources and financial and operational facilities to comply with its obligations under its Licence of which the Licensee is aware or of which it could reasonably be expected to make itself aware or to which it will be subject for a period of two years from the date of this certificate.”

3. The Licensee shall inform the CAA in writing as soon as practicable if the directors of the Licensee become aware of any circumstance which causes them no longer to have the reasonable expectation expressed in the then most recent certificate given under Condition [8.]2(a) or (b).

4. The Licensee shall obtain and submit to the CAA with each certificate provided under Condition [8.]2 a report prepared by its Auditors stating whether or not the Auditors are aware of any inconsistencies between, on the one hand, that certificate and the statement submitted with it and, on the other hand, any information which they obtained during their audit of the relevant year end accounts of the Licensee.

Restriction on activities

5. The Licensee shall not, and shall procure that its subsidiary undertakings shall not, conduct any business or carry on any activity other than:

a) the Permitted Business; and/or

b) any other business or activity for which the CAA has given its written consent for the purposes of this Condition, such consent not to be unreasonably withheld or delayed.

6. For the purpose of this Condition, "Permitted Business" means:

c) any and all business undertaken by the Licensee and its subsidiary undertakings as at [1 April 2014];

d) to the extent that it falls outside condition 8.[x], the business of owning, operating and developing the airport and associated facilities by the Licensee and its subsidiary undertakings (including, without limitation, any and all airport operation services, provision of facilities for and connected with aeronautical activities including retail, car parks, advertising and surface access and the infrastructure development thereof); and

e) any other business, provided always that the average of any expenses incurred in connection with such businesses during any one financial year is not more than 2 per cent of the value of the RAB at the start of the financial year.

Parent company undertakings

7. The Licensee shall procure from each Covenantor a legally enforceable undertaking in favour of the Licensee in the form specified by the CAA that that Covenantor will:

a) refrain from any action, and procure that every subsidiary of the Covenantor (other than the Licensee and its subsidiaries) will refrain from any action, which would then be likely to cause the Licensee to breach any of its obligations under this Licence;

b) promptly upon request by the CAA (specifying the information required) provide to the CAA (with a copy to the Licensee) information of which they are aware and which the CAA reasonably considers necessary in order to enable the Licensee to comply with this Licence.

8. Such undertaking shall be obtained within seven days of the company or other person in question becoming a Covenantor and shall remain in force for so long as the Licensee remains the holder of this Licence and the Covenantor remains a Covenantor.

9. The Licensee shall:

a) deliver to the CAA, within seven days of obtaining the undertaking required by Condition [8.]8, a copy of such undertaking;

b) inform the CAA as soon as practicable in writing if the directors of the Licensee become aware that the undertaking has ceased to be legally enforceable or that its terms have been breached; and

c) comply with any direction from the CAA to enforce any such undertaking.

Change to contractual ring fence

10. The Licensee shall not amend, vary, supplement or modify or concur in the amendment, variation, supplementation or modification of any of the finance documents in respect of credit rating requirements (whether in each case in the form of a written instrument, agreement or document or otherwise) (a “Variation”) unless it has given prior written notice thereof to the CAA. The Licensee shall, as soon as reasonably practicable:

a) notify the CAA of the possibility of any such Variation; and

b) provide a summary of the executed change.

11. The provisions of this Condition shall not apply to any administrative or procedural Variation.

Definitions

12. In this Condition 8 the Covenantor means a company or other person which is at any time an ultimate holding company of the Licensee

Condition 9: Continuity of service plan

1. The purpose of the continuity of service plan shall be to describe in detail the legal, regulatory, operational and financial information that an administrator, receiver, new management or similar could reasonably be expected to require in order for it to efficiently carry out its functions and to remain compliant with its aerodrome licence.

2. The Licensee shall prepare and at all times maintain a continuity of service plan fulfilling the requirements of condition [9.]1.

3. The continuity of service plan prepared under Condition [9.]2 shall be submitted to the CAA as follows:

   a) the first continuity of service plan shall be submitted as soon as practicable, and in any event not later than [1 October 2014];

   b) subsequent continuity of service plans within [ ] business days of the CAA's written request.

4. The form, scope and level of detail of the plan referred to in this Condition shall be approved by the CAA, (such approval not to be unreasonably withheld or delayed).

5. At least every 12 months the Licensee shall review the appropriateness of its continuity of service plan and submit to the CAA a certificate addressed to the CAA, approved by a resolution of the board of directors of the Licensee and signed by a director of the Licensee pursuant to that resolution. Such certificate shall be submitted [within four months] of the end of the Licensee's financial year in the following form:

   "The Licensee has reviewed its continuity of service plan. In the opinion of the directors of the Licensee the continuity of service plan is fit for purpose and complies with its obligations under its Licence."

APPENDIX C

List of terms

ACC	Airline Consultative Committee
ACD	Airport Charges Directive
ACR	Airport Charges Regulations
ACT	aerodrome congestion term
AGR	Airports (Groundhandling) Regulations 1997
AMD	archway metal detectors
ANS	air navigation services
APD	air passenger duty
APFG	Airport Performance Facilitation Group
APP	Airport Passenger Panel
ARR	accounting rate of return
ASK	Available Seat Kilometre
ASQ	Airport Service Quality
ATMs	air transport movements
BAL	Birmingham Airport Limited
C&B	Currie and Brown
CAGR	compound annual growth rates
capex	capital expenditure
CAPM	capital asset pricing model
CAT	Competition Appeal Tribunal
CC	Competition Commission

CE	Constructive Engagement
CEPA	Cambridge Economic Policy Associates
CEWG	constructive engagement working group
CF	Consensus Forecasts
CIP	capital investment plan
CIPD	Chartered Institute of Personnel and Development
COPI	construction price inflation
DB	defined benefit
DC	defined contribution
DECC	Department of Energy and Climate Change
DfT	Department for Transport
DL	Davis Langdon
EE	Europe Economics
EIU	Economist Intelligent Unit
ERP	equity risk premium
FE	First Economics
FFO	funds from operations
GAL	Gatwick Airport Limited
GATCOM	Gatwick Airport Consultative Committee
Gatwick	Gatwick airport
GDP	Gross Domestic Product
HAL	Heathrow Airport Limited
IBP	initial business plan
ICR	adjusted interest cover
IDL	International Departure Lounge

IFS	Independent Fund Surveyor
ILGs	index-linked gilts
IMF	International Monetary Fund
JSG	Joint Steering Group
LEMS	Labour, Energy, Materials and Services
LF	Leigh Fisher
LRIC	long-run incremental costs
MAG	Manchester Airports Group
MEAV	modern equivalent asset value
MPD	market power determination
Mppa	million passengers per annum
MPT	market power test
NERL	NATS (En Route) plc
NPV	net present value
OBR	Office of Budget Responsibility
OECD	Organisation for Economic Co-operation and Development
OLS	Ordinary Least Squares
ONS	Office of National Statistics
opex	operating expenditure
PMICR	post-maintenance interest cover ratio
PRMs	passengers with reduced mobility
PSE	passenger sensitive equipment
PwC	PricewaterhouseCoopers
Q5/Q5+1	the fifth quinquennium
Q6	the sixth quinquennium

QSM	Quality of Service Measure
RAB	Regulatory Asset Base
RBP	revised business plan
RPI	retail price index
RUOE	Real Unit Operating Expenditure
S&P	Standard & Poor's
SDG	Steer Davies Gleave
SEAT	South East Airport Taskforce
SH&E	ICF SH&E
SLA	service level agreement
SMP	substantial market power
SQI	Service Quality Incentives
SQR	Service Quality Rebate
STAL	Stansted Airport Limited
TFP	Total Factor Productivity
the Act	Civil Aviation Act 2012
the airlines	the airlines operating at Gatwick airport
UKBF	UK Border Force
WACC	weighted average cost of capital
WTP	Willingness to Pay