Civil Aviation Authority

Economic regulation at Stansted from April 2014: initial proposals

CAP 1030

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Enquiries regarding the content of this publication should be addressed to:
Regulatory Policy Group, Civil Aviation Authority, CAA House, 45 - 59 Kingsway, London, WC2 6TE

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Contents

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Executive Summary

Purpose of this document

1. This document sets out the CAA's initial proposals for the appropriate economic regulatory framework for Stansted Airport Limited (STAL) to apply when the present regulatory arrangements expire in April 2014. The present regulatory arrangements cover the financial years 2009/10 to 2013/14 and are known as the fifth quinquennium (Q5). The arrangements to apply beyond this date are commonly known as the sixth quinquennium (Q6) although the length of the regulatory period can be more or less than five years. The CAA is making these initial proposals in pursuance of its duties under the Civil Aviation Act 2012 (the Act).

2. 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.

3. The CAA would like to thank STAL, the airlines operating at Stansted (the airlines), and other stakeholders for their positive contributions so far to the CAA's review.

Next steps

4. Following its consideration of responses to this document, the CAA aims to publish its final proposals in October 2013. If a licence 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 new framework enables better targeted regulation reflecting the competitive position of the airport

5. The CAA's review has taken place alongside the government's reforms to the regulatory framework for airports as set out 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 protect users' interests and promote competition and by introducing a flexible licensing regime for airport operators with Substantial Market Power (SMP).

6. 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 transportation 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] This duty covers present and future users. 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]

7. The CAA considers that users' interests 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 SMP, the CAA needs to consider necessary and proportionate safeguards for users. 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 that the potential benefits of regulation by a licence outweigh the potential costs. Taken together, these factors form the basis of the Market Power Test (MPT) in the Act that is required to be satisfied by the CAA before it can impose the need to hold a licence on an airport operator.

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

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

8. The CAA considers that these conditions are likely to be met in the case of STAL. In January 2013, the CAA published an assessment of STAL's market power. Based on the balance of evidence presented in the MPT, the CAA said that it was 'minded to' conclude that the tests in the Act for continuing regulation of STAL were met. However, this assessment is subject to consultation and the CAA will review its position later this year, alongside any final proposals for any continuing economic regulation for STAL.

9. The CAA's found that for the short-haul passenger market (low cost carrier (LCC) and charter) STAL may have SMP at present and that it is likely to have SMP in the future especially as capacity constraints in the London area tighten as demand picks up in line with the economy. Although some airlines can switch their business to alternative nearby airports, this is not the case for all airlines and particularly those that require a significant base presence at Stansted given their high asset utilisation and flight turns. This means that competitive constraints are not sufficient to constrain STAL's pricing behaviour.

10. The CAA recognises there are some uncertainties in this judgement, given that it relates to how competitive constraints will develop in the future and not just the facts on the ground today. Principal uncertainties over the Q6 planning period (2014/15 to 2018/19) include: how the airport will develop under new ownership following its recent acquisition in March 2013 by the Manchester Airports Group (MAG); and whether it will develop more cohesive, long-term, commercial relationships with the incumbent airlines. This is especially the case given the present concentration of the airlines at Stansted, where two LCCs, easyJet and Ryanair, account for over 90% of passengers. The other uncertainty is how the demand for services at Stansted will be affected by the developments in the wider economy.

11. Despite these uncertainties, what is clear is that the nature and strength of STAL's market power does appear to be different to that of the other two regulated London airport operators, Heathrow Airport Limited (HAL) and Gatwick Airport Limited (GAL). For both these airport operators, the CAA's assessment that they hold SMP is relatively more clear-cut, with the CAA's 'minded to' view that they currently hold SMP, compared to STAL which may currently have SMP and is likely to acquire SMP in the period to 2019.

12. The CAA therefore considers that, although regulation is likely to be needed beyond April 2014 at STAL, the form that regulation takes should reflect the CAA's view's on STAL's market power.

13. The CAA has taken into account the government's Better Regulation principles, included in the CAA's general duties[3], namely that any regulation beyond April 2014 should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed. The CAA also has to avoid the imposition of unnecessary regulatory burdens on airport operators[4]. Given the different competitive and economic circumstances at each of the three regulated London airports, these principles imply that there should not be a presumption that the same regulatory model should apply for each of the airport operators.

14. The CAA has sought to inform its thinking around its primary duty by developing an understanding of users' interests at Stansted. It has also evaluated the different options for the most appropriate future regulatory model.

The CAA has sought to understand user interests in relation to economic regulation

15. The CAA has sought to understand passengers' priorities in three principal ways: by overseeing a process of constructive engagement (CE) between STAL and the airlines, by undertaking independent research of users' interests at Stansted; and by seeking challenge and scrutiny from the CAA's Consumer Panel. The CAA has also met with representatives of the cargo community.

Constructive Engagement between STAL and the airlines

16. The CAA oversaw a detailed constructive engagement process (CE) in which STAL was required to develop and discuss its business plan with the airlines. This process was premised on the assumption that airlines' commercial interests in these discussions about airport operation services often, but not always, reflect those of passengers.

[3] Section1(4) of the Act

[4] Section104 of the Act

17. The sale of the airport by BAA increased uncertainty around CE. This meant that the process was not as well advanced as at Heathrow and Gatwick and some important elements of the projected total cost base were not discussed in any detail, such as projections for traffic, operating expenditure (opex) and commercial revenues. That said, there was progress on other aspects such as service quality standards and the capital programme.

18. The incumbent airlines tended to consider that cost was the most important factor for their passengers. Ryanair, which flew 72% of total terminal passengers at Stansted in 2012[5], argued that STAL's price rises were the principal reason for the decline in passenger volumes experienced at Stansted in recent years.

19. By contrast, the airlines tended to view STAL's service quality as being of a satisfactory standard: there was a need to ensure that it did not deteriorate, but most airlines did not wish to pay for major improvements that they believed that their passengers would not value. Both STAL and the airlines were content to use the Q5 service quality arrangements as the basis for the Q6 arrangements.

Independent passenger research and validation of CE outcomes

20. Given that the commercial interests of airlines operating at Stansted could differ from passengers' interests, it is important for the CAA to form its own view on passengers' priorities to influence the CE discussions and validate the outcomes. For example, future passengers might have different priorities from current passengers. In addition, other types of passengers may not be represented effectively by the current airline interest at Stansted, which is dominated by two LCCs.

21. The CAA has undertaken considerable primary passenger research and surveys to inform its views. It has also evaluated the stock of research from third parties (such as the airport operators, airlines, and independent agencies) to which it has access.

22. The CAA has been able to draw out some key themes to influence its initial proposals for STAL. Broadly speaking, these themes, taken

[5] CAA, Airport Statistics.

from research of current Stansted passengers, validate the general themes advanced by the airlines during CE.

23. For example, passengers' satisfaction at Stansted is high. Most passengers, on most journeys, say they have a "good" or "excellent" experience. Very few passengers said they had a "poor" experience. It is noticeable that research suggests that passengers do not like things to go wrong or to experience inconvenience such as long and unexpected queues, but the quality of the airport itself ranks significantly behind passengers' primary concerns. These include ease of access to the airport, availability of airline routes, and the price of the airfare.

24. One aspect of passenger research for Stansted that stands out is the importance passengers place on the price. Importantly, so far as the primary duty in section 1(1) is concerned, passengers at Stansted tend to rank price as considerably more important than airport services. Airport charges at Stansted account for a higher share of the final airline ticket price than at Heathrow and Gatwick on average (owing to their different airline and passenger mix). Consequently passengers are likely to be particularly sensitive to increases in airport charges at Stansted.

Cargo

25. Unlike Heathrow and Gatwick, the vast majority of cargo that uses the airport uses dedicated freighter aircraft, rather than being carried in the bellyhold of passenger aircraft. Through discussions, the CAA's understanding is that cargo operators' main concerns are around reliability and resilience of the airport. Consequently the CAA considers that the interests of cargo owners appear to be aligned with the interests of passengers.

Challenge from the CAA Consumer Panel

26. The CAA Consumer Panel agreed that there is evidence to suggest current service quality at Stansted is generally satisfactory, but encouraged the CAA to consider the needs of different sub-groups and the importance of performance during times of disruption.

27. The Consumer Panel encouraged the CAA to consider a full range of options for the design of the regulatory model given the specific circumstances at Stansted.

28. The Consumer Panel challenged the CAA to consider enhancing reputational incentives, for example through greater transparency, especially where STAL's SMP was relatively weak compared to that of Heathrow and Gatwick. This enhanced transparency might encourage airlines and passengers to hold STAL more to account.

Evaluation of options for regulation of Stansted

Evaluation criteria based on CAA's statutory duties

29. From its SMP analysis and its understanding of users' interests, the CAA considers that the principal risk of abuse against which users' should be safeguarded is STAL's ability to raise and sustain its airport charges above the competitive level. The CAA notes that its own comparative research suggests that STAL's prices are already at, or above, what might be considered a competitive benchmark.

30. In the market power assessment, the CAA has set out its 'minded to' view that the benefits of regulation through a licence are likely to outweigh the adverse effects. The strength of the regulatory safeguards on STAL may not necessarily need to be as prescriptive as for Heathrow and Gatwick, which have a greater degree of market power. The CAA recognises that regulation can entail additional costs and hence it is important that its form – or model – of regulation safeguards users' 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.

31. Aside from an evaluation of possible regulatory options against its primary duty, the CAA has considered a number of other evaluation criteria related to its wider statutory duties. 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 proportional, accountable, consistent, transparent and targeted; and also whether they are practical, whether they can be implemented in a manner that has net benefits to users, and whether stakeholders can understand and implement them.

The CAA has considered a wide range of options

32. Starting in 2010, the CAA has undertaken a programme with stakeholders to identify the options for regulation at Stansted. The CAA notes that stakeholders, including STAL and the airlines, were not able to agree on a preferred option. Broadly speaking, the airlines were keen to retain the current system but with significant changes to reflect their view on forward looking efficient costs. STAL, on the other hand, was keen to pursue a more pragmatic option of a one year extension to the present price control (if it were found to have met the MPT).

33. The CAA was clear at the time it set the Q5 price cap, and in its communications since, that there should not be a presumption that it would use an approach based on using a Regulatory Asset Base (RAB) when the present arrangements for STAL expire in April 2014. Indeed, the approach the CAA adopted for the Q5 price cap calculation was based on a ‘dual’ methodology, taking into account a price profile consistent with promoting competition and a RAB-based calculation.

34. While the RAB is the standard model for calculating price caps in UK economic regulation of utilities, the CAA considers that there are good reasons why it is not appropriate to adopt a RAB-based price control for STAL in Q6, in light of its primary duty in the Act.

35. A RAB-based calculation requires the CAA to have a reasonable level of confidence over the input assumptions such as traffic and operating expenditure. But the CAA is concerned that despite its attempts to develop reasonable projections, the confidence level it can realistically expect to obtain in the resulting calculations for STAL, given its specific market uncertainties, for example around traffic growth, is far below that which it considers appropriate. This is further complicated by the recent acquisition of STAL by MAG in March 2013, which could lead to a different business strategy and different projections compared to those provided by STAL, and used in this document, when it was owned by BAA.

36. The CAA has identified a number of reasons why, specifically for Stansted, a RAB-based calculation may not reflect a competitive price. For example, the airport was designed to cater for a broad mix of airline business models and these costs are reflected in the RAB, but

the airport now predominately caters for LCCs, whose infrastructure needs are likely to be different from other airlines such as full service carriers. STAL's RAB also includes some costs of the abandoned second runway project which are still being recovered from users. Moreover Stansted's previous common ownership with Heathrow and Gatwick may have led to investment decisions, which were sub-optimal for STAL's customers.

37. The CAA acknowledges that a RAB-based approach does impose some costs on stakeholders (both administrative costs and incentive distortion costs). A RAB-based approach could frustrate STAL and airlines from developing a more enduring, cohesive and commercial long-term relationship, for example if it leads to parties looking to the regulator to resolve disputes rather than resolving disputes themselves. It is important that there is a requisite level of assurance that these costs will be outweighed by the benefits to users. Given these uncertainties, the CAA has a low level of confidence that, at Stansted, the benefits of RAB-based regulation outweigh the costs. Despite these drawbacks, the CAA considers that the exercise of calculating, but not regulating by means of, a RAB-based price cap is prudent as it acts as a useful benchmark to evaluate the reasonableness and proportionality of other possible options.

38. The CAA has considered in detail a range of other potential options. Some suffer from the same drawback as a RAB approach in that they are subject to wide uncertainty based on certain input assumptions and judgements. For example, 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.

39. The CAA has considered options that would link Stansted's 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 potential debate over the composition of the index, the equivalence of comparators, the frequency of adjustment, etc. It is unclear whether it would be appropriate to use such an index to draw

a point estimate for a price cap calculation rather than provide a range upon which to judge the reasonableness of STAL’s prices.

40. For these reasons, the CAA does not propose to pursue either LRIC or benchmarking against a peer group index as a preferred candidate for STAL's Q6 regulatory model. Nevertheless, the CAA considers that they can be used as context or cross-check reference points to assess the reasonableness of its preferred option, taking into account the issues raised above.

41. 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 STAL. 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. This option may also be less relevant at Stansted given the current homogeneity of the airlines operating at the airport and their similar views on what is required in Q6.

42. There are a number of additional options that might be described as pragmatic as they do not rely on calculations as complex as RAB and LRIC, and they do not suffer from making comparisons as with pegging Stansted’s charges to a benchmark index. These options include: a short-term price control that is set for two or three years; and a price monitoring and transparency regime.

43. A short-term price cap for two or three years has the attraction that it would be based on the premise that the CAA would undertake a further review of SMP towards the end of that period, after some of the current uncertainties have reduced. For example, a licence condition would be granted to STAL which capped average prices at their current nominal level for up to three years. The licence condition could contain a sunset clause so that it expired unless modified by the CAA. The drawback of this approach is that it is, by definition, arbitrary and is relatively onerous as it does not enable flexibility within the period. That said, the CAA does not wish to dismiss this option, given its relative simplicity in the face of a wide range of uncertainty at Stansted.

44. A price monitoring and transparency regime would not set a price cap upfront but would provide clear expectations on when STAL’s pricing

behaviour would be likely to trigger an investigation by the CAA. It could include obligations on STAL to make certain information available to airlines beyond the basic requirements in the Airport Charges Regulations (ACR). Thus, it would put the onus on STAL to self-regulate and ensure that it does not abuse its market power, while providing a backstop for regulatory action along with useful and timely information for airlines to help them hold STAL to account. It may have the advantage of encouraging greater discussion between STAL and airlines on developing longer-term commercial relationships as well as facilitating flexibility, compared to establishing a fixed price cap in advance. The potential downside is that it could impose inappropriate administrative burdens unless suitably designed. Overall, it could be a more proportionate solution where the risk of abuse of SMP is relatively low but still above that level where it is appropriate to require STAL to comply with a licence granted by the CAA.

45. Based on its assessment against the evaluation criteria drawn from its statutory duties, the CAA considers that the most appropriate option, in the light of the circumstances that are expected to pertain for Stansted in Q6, is a price monitoring and transparency regime. CAA has therefore sought in this document to develop a working model for this type of regulation so that stakeholders can assess the details of what this might entail.

46. The CAA would be keen to understand from stakeholders whether they agree that the net benefits of this approach compare favourably with a RAB-based price control, or with a simple price cap for two or three years (based on setting a cap to avoid average regulated charges increasing in nominal terms over that period).

47. The CAA notes that STAL has not put forward voluntary undertakings for the CAA to consider, as has been the case with GAL. The CAA sees potential merits in voluntary undertakings for STAL given its weaker SMP assessment than Gatwick's and Heathrow's. For example, it may help move the airport and airline interface more into line with commercial norms and avoid the need to go through the regulator. A regulatory backstop could be provided if such undertakings were combined with a more basic licence granted by the CAA than that for HAL and perhaps GAL.

48. In the absence of agreement with airlines, any proposals would need to be consulted on before implementation and therefore STAL may only be possible to include voluntary undertakings during, rather at the start, of the next control period. Should MAG conclude mutually acceptable, long-term bilateral agreements with Ryanair and easyJet, the CAA would also expect to take this into account in finalising its market power assessment and its final proposals.

A price monitoring regime supported by timely and useful information disclosure and a credible regulatory backstop may provide the best balance between safeguarding passengers' interests and promoting effective competition

49. Price monitoring regimes have some precedent where regulators view the degree of SMP as strong enough to warrant a regulatory safeguard but not so strong as to warrant a full price cap ether through a RAB-based calculation or some other option. For example, price monitoring has been used to regulate Australian airports.[6] It has also been adopted recently by Ofcom in the UK to regulate Royal Mail.[7]

50. The CAA does not wish to duplicate the requirements on STAL arising from the Airport Charges Regulations (ACR). However, a price monitoring and information disclosure regime may help supplement these requirements. For example, the ACR only requires information disclosure at a high-level. The ACR does not impose controls on the overall level of charges and nor does it impose incentives on STAL to improve its efficiency.

51. The CAA's view is that the price monitoring and transparency regime should be based on a number of requirements on STAL.

[6] For example, see: http://transition.accc.gov.au/content/index.phtml/itemId/347781.

[7] For example, see: http://stakeholders.ofcom.org.uk/binaries/post/monitoring-update2011-12.pdf.

- Reporting requirements to the CAA – which enable the CAA to monitor STAL's pricing behaviour, with the possibility of the reintroduction of an explicit price cap should STAL's pricing behaviour cause concern. This information is quite detailed and includes metrics to gauge the evolution of traffic, costs, profitability, service quality;
- Enhanced transparency requirements to provide airlines with useful and timely information – which help empower airlines to hold STAL to account and provide useful information if they are seeking to develop longer-term commercial relationships with STAL. This is likely to include some, but not all, of the information provided to the CAA; and
- Publication requirements (through the CAA annual report) – which may impact on STAL's reputational incentives and are available to a wider group of stakeholders including passengers, cargo users and the general public.

52. To strengthen the incentives on STAL not to exploit any SMP which it holds over users in the setting of its airport charges, the CAA considers that it ought to adopt a 'show cause' trigger. This identifies a threshold for airport charges above which the CAA would expect to carry out a full investigation. The CAA's initial proposal is that this 'show cause' trigger ought to based on whether STAL's average prices rise by no more than half the rate of inflation per year measured by the change in the Retail Price Index (RPI).

53. The CAA considers that the design of the regime should be based on the following additional key features:

- established for a duration of no more than five years from April 2014 and subject to a review of its operation before the conclusion of its third year; and
- subject to an annual report published by the CAA based on the information provided by STAL to the CAA during the course of the year as well as other information to which the CAA has access.

54. The CAA recognises that it can consider many regulatory options for controls based on price monitoring and transparency. The CAA would welcome feedback from stakeholders on this as part of the consultation. It especially welcomes views from stakeholders on how

it can best further users' interests regarding the cost, quality, availability and continuity of airport operation services, where appropriate by promoting effective competition between airport operation services and having regard to Better Regulation principles.

There is a new economic licence for STAL that will enable the CAA to respond more effectively to passenger risks

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

56. 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. These terms define the airport operator, airport area and other terms used in the licence.
- 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 Conditions. These conditions will give legal effect to the CAA's final decisions on this issue. They have not been set out in the draft licence at this stage.
- Part IV: Service Quality Conditions. Although research indicates passengers are generally satisfied with the experience at Stansted, this research does not take into account passengers' experiences during times of service disruption. It is during these occasions that passengers can experience significant anxiety and detriment. The CAA therefore intends to use STAL's licence to strengthen its approach to planning for service disruption and its response to passengers in the event of disruption.
- Part V: Financial Conditions. These conditions relate to STAL's obligations to improve its financial resilience, such as maintaining a continuity service plan.

57. The CAA is committed to ensuring that any new licence obligations meet the better regulation principles and are transparent, accountable, proportionate, consistent and targeted. This includes adopting so-called 'sunset' provisions to ensure that other parts of the licence do not become inconsistent with the interests of users.

The CAA is committed to working closely with all stakeholders

58. 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 the very different commercial incentives both STAL and the airlines have in their desired outcomes from the Q6 review. 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 passengers and owners of cargo.

CAA

April 2013

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 STAL 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. This document also discusses other matters, including those aspects of the current regime of economic regulation of STAL that should be carried forward into Q6.

1.2 The CAA welcomes views on its initial proposals contained within this document by **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 on whether STAL satisfies the MPT in the Act.[8] Published alongside this document are a number of documents in which stakeholders may also be interested. These include a number of reports that the CAA has commissioned from independent consultants. All of these reports can be obtained from the CAA's website.[9] 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

[8] See section 6 of the Act: http://www.legislation.gov.uk/ukpga/2012/19/contents/enacted

[9] http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=14279.

CAA's website; some submissions have been made in bilateral and multi-lateral 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.

1.4 References to STAL's views in this document, unless otherwise stated, reflect those given to the CAA under BAA's ownership, before the airport was acquired by MAG in March 2013. References in this document to 'the airlines' means views submitted to the CAA by the representative body for airlines for the purposes of CE. In the case of Stansted, it means the Stansted Airport Consultative Committee (SACC). The CAA acknowledges that the views of individual airlines may differ on particular issues.

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

1.6 In this document, the term 'airport charges' means 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 the number of passengers on board the aircraft), including any separate charges for aerodrome navigation services. It also includes charges levied on aircraft passengers in connection with their arrival at, or departure from, the airport by air.

Questions for stakeholders

1.7 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 STAL from its research into the market and users' interests (see chapter 2).
- The appropriate form of price regulation for STAL post April 2014 and the CAA's evaluation of the various options (see chapter 3).

- The CAA's initial proposals for the design of a price monitoring and information disclosure regime to apply to STAL from April 2014 (see chapter 4).
- The CAA's initial proposals for the licence it would grant STAL from April 2014 (see chapter 5).

1.8 The CAA is currently working with the Department for Transport (DfT) to assess the effects of the Airport Economic Regulation functions 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 previous AA86? In particular, are there any benefits/costs at regulated airports in relation to future operating expenditure (opex), capital expenditure (capex) and the weighted average cost of capital (WACC)?

Contact details for your response

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

1.10 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.

1.11 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 established under various legislation such as section 59 and Schedule 6 of the Act, the Civil Aviation Act 1982, and the Freedom of Information Act 2000.

Next steps

1.12 Following its review of responses to this consultation the CAA will issue final proposals for consultation 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.

1.13 The planned period for representations on the December 2013 notice reflects the extensive consultation that will have taken place by that stage on the substantive content of the licence. The 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 in terms of how to express correctly the final proposals into the licence and how to make the licence and conditions fully workable. If any substantive changes are required, the CAA would need to reconsult in early January 2014.

1.14 In July 2013, the CAA Board will invite STAL and airline representatives to present their views on the appropriate regulatory arrangements to apply beyond April 2014.

1.15 The CAA intends to update its work and commission further consultancy support as required. It will also continue to engage regularly with STAL and the airline community

CHAPTER 2

Statutory, Market and User Context

2.1 This section sets out the process that has shaped the CAA's initial proposals and the CAA's research into the relevant statutory framework, market developments and users' interests. It concludes by drawing out a number of observations that the CAA considers provide important context to its initial proposals for the form of regulation beyond April 2014.

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.[10]
- The CAA's 'minded to' consultation in January 2012 on its view that STAL passed the MPT in the Act for continuing regulation beyond April 2014.
- A process of CE between May 2012 and December 2012, overseen by the CAA, whereby STAL 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 signed jointly by the co-chairs of the Stansted CE Working Group (CEWG).
- A stakeholder session with the CAA Board in November 2012 at which both STAL and representatives from the Stansted airline community explained their respective positions on whether STAL had SMP.

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

- Written representations received from stakeholders in the course of the CAA's process and regular meetings with stakeholders (some of these meetings were bilateral and some trilateral). Some stakeholders have also shared with the CAA consultancy studies they have commissioned.
- STAL's baseline business plan (BBP, May 2012) and business plan (BP, January 2013), which set out its view on the main building blocks that could be used to calculate future charges in the period April 2014 to March 2019.
- Several independent studies commissioned by the CAA on the efficiency and appropriateness of STAL's business plan projections.
- Advice from the CAA Consumer Panel.

Statutory context

The CAA's duties

2.3 The Act creates a new framework to govern the application of economic regulation to the airport sector. In essence, it modernises and replaces 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[11] 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 also has a range of other duties (figure 2.1). The Act enables the CAA to regulate through a flexible licensing approach.

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

Figure 2.1: 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 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: CAA

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.

Tests for continuing economic regulation

2.4 The Act prohibits an operator of a dominant airport area 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:

- 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;
- 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
- 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.

A licensing regime

2.5 The CAA may include in the licence any conditions that it thinks are needed to prevent the risk of abuse of market power as well as any other condition that it thinks is necessary or expedient to secure its statutory duties in the Act, including those which further the interests of users of air transport services with regard to, or (where appropriate) promote competition in, the provision of airport operation services.[12]

2.6 A licence must specify the airport area 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.[13] In addition, the licence may include obligations requiring payment of charges to the CAA.[14] It can also include provisions relating to activities carried on outside the airport area for which it is granted.

2.7 In January 2012, and at the request of the Secretary of State 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 set out those licence conditions that the CAA

[12] Section18 of the Act.

[13] Section17 of the Act.

[14] Section 20 of the Act.

considers are required in the STAL licence.

2.8 STAL and airlines have the right under the Act to seek leave to appeal the inclusion, or absence, of licence conditions to the Competition Commission (CC)[15] subject to certain qualifying criteria being met. In the event that an appeal is made which meets the qualifying criteria, the CAA's decision will stand until the CC determines the appeal, unless the CC has granted interim relief or the appeal relates to specific financial arrangements. While CC appeals should normally be determined within 24 weeks of CAA publishing a notice that it has decided to grant the licence, this can be extended if a relevant appeal on the market power test to the Competition Appeal Tribunal (CAT) is ongoing.[16]

Market context and SMP

2.9 The CAA is consulting on its 'minded to' position that the MPT is met by STAL in relation to the period April 2014 to March 2019.[17] In particular, the CAA made the following observations:

- in relation to the LCC and Charter passenger market, STAL holds a degree of market power which may currently be substantial, and is likely to become substantial over the period 2014 to 2019;
- in relation to the cargo market STAL currently has SMP in the Stansted cargo market;
- it was likely that some form of regulation under the Act would provide a more effective safeguard than competition law alone against the risk of exploitative abuse; and
- the benefits of some form of licence-based regulation were likely to outweigh the adverse effects.

2.10 Should the CAA confirm later this year that STAL passes the MPT in the Act, STAL will require a licence from April 2014 to lift the prohibition on it levying airport charges under section 3 of the Act.

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

[16] Details of the appeal process are set out in Schedules 1 and 2 to the Act.

[17] http://www.caa.co.uk/default.aspx?catid=1350&pagetype=90&pageid=14395.

Risk of abuse of SMP

2.11 It is important that the form of regulation developed for STAL addresses the risk of abuse of its SMP. As part of its 'minded to' SMP assessment the CAA considered the risks of abuse of market power by STAL to be the following.

- Excessive prices. As STAL is currently pricing at its regulatory cap, and there is evidence to suggest this may be above the competitive level, there is a reasonable expectation that if licence regulation were removed, its charges would rise. The CAA considered that the potential risks from setting prices too low under a licence were likely to be reduced by improved knowledge of the competitive price level. Also, Luton's airport operator appears to be taking forward investment plans irrespective of the uncertainty over future prices at Stansted, which suggests the risks of stifling investment are limited at present.
- Efficiency (which impacts on future prices). The mid-Q5 review of opex efficiency, commissioned by the CAA, found that, after allowing for the reduction in traffic, STAL had outperformed the regulatory settlement. Nevertheless, it found that substantial scope for operating efficiency improvements remained. STAL has subsequently introduced a series of measures to improve efficiency, particularly of security. The impact of regulation on efficiency is difficult to judge. However, the CAA has not seen evidence to suggest that competition has significantly increased efficiency at Stansted, and it appears unlikely that the removal of licence regulation would lead to an improvement in efficiency in and of itself. Given the potential tightening of capacity constraints in the London area during 2014 to 2019, the CAA considered that the incremental benefits of licence regulation on efficiency were likely to increase, although the CAA acknowledged the risk of distortion of incentives, in particular from RAB-based regulation.
- Service quality, in terms of the range and level of services. Since 2008, STAL's service quality performance seems to have improved over a range of measures. This improved service quality performance appears to coincide with greater regulatory scrutiny since the start of the Q5 review and the introduction of the service quality rebate (SQR) scheme in the second quarter of 2009. While

it is not certain that this improved service quality performance reflects the impact of regulation, the CAA has not seen evidence to suggest that competition itself has improved service quality performance. There is a risk that service quality could be set by regulation higher than passengers actually want, but evidence suggests this has not happened in practice.

- Investment incentives, which can affect future levels of service quality. Regulation can distort investment incentives, with a potential bias of RAB-based regulation towards capex, if the rate of return is set too high, or towards opex, if the rate of return is set too low. However, although such a distortion may exist in principle, the CAA has seen no evidence that it has had a significant impact on STAL's recent behaviour, although the CAA acknowledged that alternative approaches may weaken investment incentives. The CAA also highlighted the concerns about misdirected investment in the public interest finding from the CC that led to the consultation requirements on STAL contained in Annex D to the current price control decision.

Relationship between SMP assessment and Q6

2.12 The CAA undertook its 'minded to' assessment of the market power that STAL holds for airport operation services[18] 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".[19] This includes airport charges and other aeronautical services, the detail of which is set out in the product bundle of the STAL market power assessment.[20] 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 STAL market power assessment. The CAA is not

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

[19] Section 5(4).

[20] CAA, January 2013, *Stansted market power assessment*. http://www.caa.co.uk/docs/78/FINAL%20STAL%20Market%20Power%20Assessment%20(Summary,Tests%20A,B,C).pdf.

required to cover all airport operation services in its assessment. However, using a single till approach, the CAA seeks to take account of revenues from these services in setting regulatory controls on airport charges as it does at present.

2.13 Under its general duty,[21] the CAA must carry out its functions in a manner that it considers will further users' interests. Where a licence is issued,[22] the CAA can include such other conditions that it considers necessary or expedient having regard to its general duty and provisions relating to activities carried on outside the airport area for which the licence is granted.[23] These conditions and provisions do not need to be supported by a separate MPT under the Act.

Influence of Constructive Engagement

2.14 The objective of CE was for STAL and the airlines to work together to try and agree inputs to the CAA's setting of the price control for Q6 (if one was required), or else be very clear where differences of opinion lay. The CAA also hoped such a process would encourage greater dialogue between STAL and the airlines on the future direction of the airport.

2.15 The CAA established a formal process for CE by issuing a detailed mandate in April 2012.[24] The CAA conducted a mid-CE review in October 2012 and issued further guidance to the parties for the remainder of CE.[25] Compared to Q5, CE has been a much more extensive process, covering all elements of the price control building blocks. In January 2013, the STAL and airline co-chairs of the CEWG provided the CAA with a short report summarising progress.

2.16 CE at Stansted started with the publication of the BBP, which provided forecasts of individual regulatory building blocks (traffic, opex, etc) and

[21] In Section 1(1) of the Act.

[22] Under Section 18(1)(b) of the Act.

[23] Under Section 21(1)(f) of the Act.

[24] CAA, April 2012, *CAA Mandate for Constructive Engagement at Stansted*. This document can be accessed at: http://www.caa.co.uk/docs/5/StanstedCEMandate.pdf.

[25] CAA, October 2012, *Stansted Airport Mid Constructive Engagement (CE) Review*. This document can be accessed at: http://www.caa.co.uk/docs/5/20121002%20STNv4.pdf.

an indicative price profile using a RAB-based approach. The CAA acknowledges that STAL raised concerns over using a RAB-based approach to set the price control for Q6, given the uncertainty prevalent at Stansted over the forecasting period.

2.17 The airlines considered that while the BBP reflected the current situation, it was not strategic in the sense of giving the airlines choices for how different price profiles could affect traffic. The CAA wrote to the SACC to say that, in a strict sense, the BBP satisfied the requirements of the mandate, as it included forecasts in all of the required areas, although it would expect further detail to be released as part of CE.[26]

2.18 STAL and the SACC agreed a simplified consultation framework, with approximately monthly CE meetings, each discussing elements of the regulatory building blocks. During the course of CE, there were seven meetings of the CEWG. Meetings covered individual building block areas of traffic, service quality and capex. Given the Stansted sale process, STAL did not feel able to participate in CE discussions on opex. In addition, non-aeronautical revenues such as retail and car parking revenues were not covered in CE.

2.19 While there has been some progress during CE, apart from on service quality, there has been an absence of agreement on individual building blocks. There was no specific agreement on traffic forecasts. STAL and the SACC agreed that traffic could be affected by the level of airport charges, although the scale of impact was not agreed between parties. Towards the end of CE, STAL produced a revised set of traffic forecasts with increased growth reflecting growth-based discounts on airport charges.

2.20 STAL and the airlines agreed that the current Q5 SQR regime was fit for purpose. STAL considered that it provided a reasonable mechanism for incentivising it to deliver an appropriate level of service to passengers and airlines during Q6. The airlines considered that the recent traffic decline had provided ‘headroom’ for service quality. Nevertheless, they seemed content to continue with the current SQR scheme.

2.21 There has been no agreement between STAL and the airlines on the

[26] Letter from CAA to SACC, 20 September 2012.

capex programme, although they agreed that further engagement on key projects in 2013 would be beneficial. STAL and the airlines also agreed that it would be appropriate for the CAA to devise a separate regulatory treatment for strategic and capacity-related capital investment projects in Q6, where the costs of such investment are only reflected in the price cap at the time it is undertaken (which is subject to specified criteria) rather than being included at the time of the price control review.

2.22 There has been no agreement on opex as STAL did not feel able to participate in discussions while the divestment of Stansted was taking place. STAL and the airlines agreed that further engagement on opex in 2013 would be beneficial.

2.23 The CAA acknowledges that CE made some progress, although this has been complicated by the difficulties caused by the sale process of the airport. It is not the role of the CAA to broker agreement where fundamental differences remain. Ultimately, the CAA must determine the most appropriate regulatory safeguard in light of its duties. The CAA has, however, taken into account the outputs from CE in developing its initial proposals.

Users' interests

The CAA's general duty under the Civil Aviation Act 2012

2.24 Since the CAA published its Q6 Policy Update in May 2012, the Act received Royal Assent on 19 December 2012.

2.25 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[27] of air transport services regarding the range, availability, continuity, cost and quality of airport operation services” and to do so, where appropriate, by promoting competition in the provision of those services.

2.26 Alongside this statutory duty, the CAA has a strategic objective of

[27] 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.

improving choice, value and fair treatment for aviation consumers[28] at all UK airports, and is committed to ensuring that consumers get the best possible outcomes in terms of their aviation journey and experience.

2.27 STAL's airport charges to airlines and its service and investment decisions significantly affect overall passenger outcomes. The CAA has taken into account the impact on passengers' interests and those who own cargo throughout the development of its Q6 initial proposals.

Scope of Q6 at Stansted

2.28 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 – these may be provided by the airlines (e.g. check-in and baggage reclaim) or by a third party such as UK Border Force (immigration and customs). The CAA cannot impose licence conditions on third parties.

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

2.29 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 passenger priorities in the context of the airport experience, through the use of research and evidence.

2.30 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 these views are not an infallible guide to what is in passengers' interests. There are a number of areas where the CAA is mindful that the airlines'

[28] This includes passengers and those with a right in cargo, current and future.

commercial 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). Future passengers may be of a passenger group who have interests that are not articulated by airlines currently operating at the airport.

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

- an initial review of available passenger research in mid-2012;
- use of the CAA's passenger satisfaction data;
- the CAA's further research into the airport experience for passengers (referred to as "CAA Q6 research");
- sense-checking passenger insights with stakeholders' own research;
- discussions with cargo operators; and
- seeking the views of the CAA Consumer Panel.

Review of available passenger research

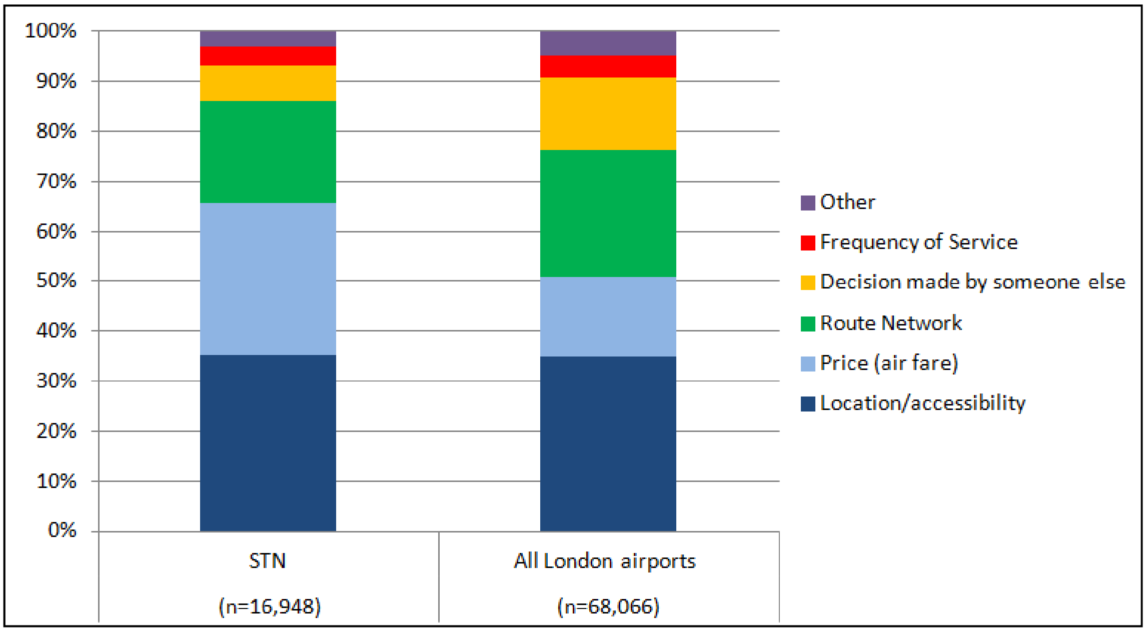
2.32 The initial review of available passenger research in mid-2012 enabled the CAA to: identify consistent themes; discuss these findings with the CAA Consumer Panel; and identify any gaps where further evidence would be useful.

2.33 The key findings from this review included the following.

- Airport service quality is not a key driver behind passenger airport choice (see figure 2.2). As part of the "other" category, it is rated significantly below the location and accessibility of the airport, the air fare, and the route network available.
- At the airport, the over-riding concern for departing passengers is that they depart on time and, for arriving passengers, that they leave the airport promptly once arrived. This is consistent with feedback 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 passengers themselves may not be aware of them.

Figure 2.2: Drivers of airport choice



Notes:

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

2. "All London airports" refer to Heathrow, Gatwick, Luton, Stansted and London City.

Source: CAA ongoing Passenger Survey, provisional results July - December 2012.

CAA passenger satisfaction data

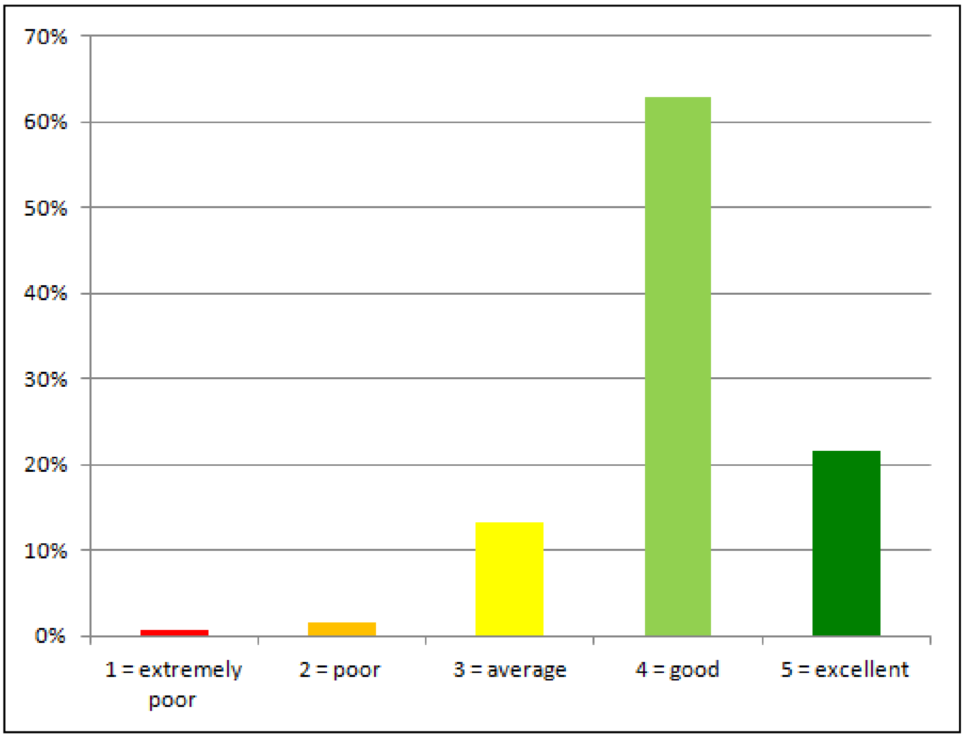
2.34 In July 2012, the CAA added a question to its ongoing Passenger Survey which asked passengers "How would you rate your overall experience in the airport terminal today?".[29] The question is structured in an identical fashion to STAL's own Quality Survey Measurement (QSM) question. For 2012, the CAA collected over 14,000 responses. The findings are shown in figure 2.3.[30] The provisional results for the second half of 2012 indicate that the

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

[30] This question will continue to be asked and over time will become a useful comparator to other data sources. It will also enable users to identify trends in satisfaction.

majority of passengers (85%) rate their experience as “good” or “excellent”.

Figure 2.3: Passenger satisfaction at Stansted, 2012



Note: Responses to the question, "How would you rate your overall experience in the airport terminal today?" (n=14,111).

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

CAA further research into the airport experience

2.35 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[31]; 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 research took place at the airport and differed from the CAA's main survey in that:

- arriving passengers were also targeted (the CAA ongoing Passenger Survey only interviews departing passengers);

[31] For example, the previously published Through Passenger Experience work carried out by ORC for the CAA in 2008: http://www.caa.co.uk/docs/33/Passenger_experience.pdf.

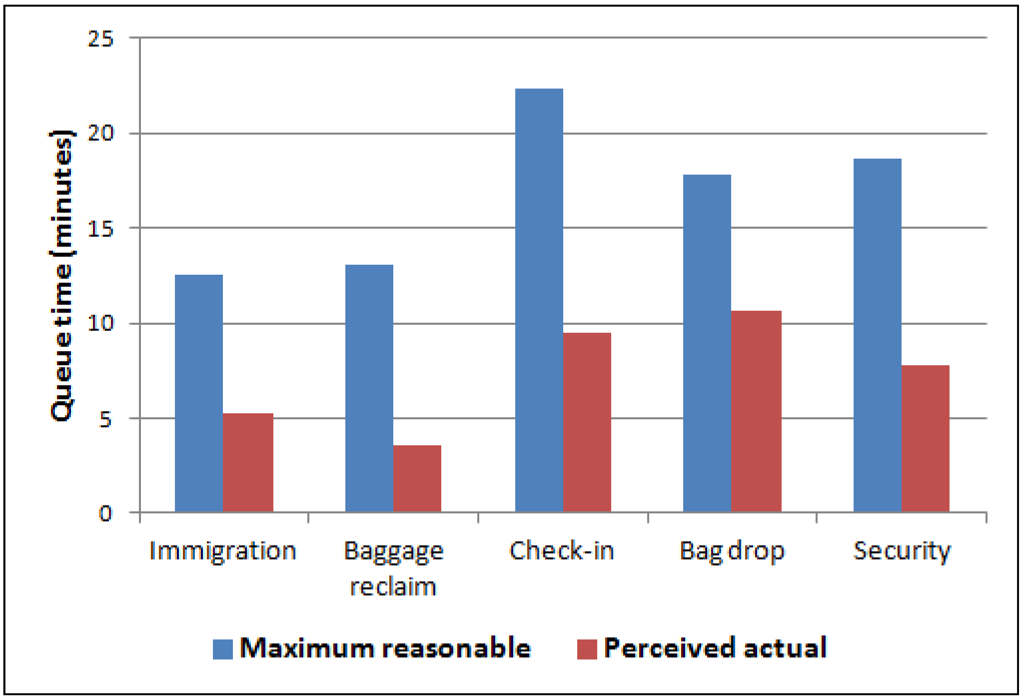
- passengers were asked open-ended questions about any sources of dissatisfaction to allow for recording of qualitative data (this was to avoid prompting of responses and potential biasing of data); and
- passengers were asked about perceived actual and acceptable maximum queue times for various airport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

2.36 At Stansted the sample size was relatively small at just under 350, and the results, while informative, should be considered in this context. Key findings included the following.

- High levels of satisfaction across the airport, with slightly more arriving passengers (94%) than departing passengers (90%) rating the airport as “good” or “excellent”.
- When asked whether there were aspects of their experience they were dissatisfied with, departing passengers were more likely to cite examples of dissatisfaction than arriving passengers (32%, compared with 19% of arrivals). Sources of dissatisfaction were primarily concerned with facilities and queue times.
- 45% of passengers answering the question "What single improvement would like to see at this airport?" responded with "no improvements".
- The maximum reasonable queue times for processing (check-in, bag drop, security, immigration and baggage reclaim) were higher for departing passengers than for arriving passengers. However, for most passengers, queue times experienced were less than the maximum they considered reasonable (see figure 2.4).

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

Figure 2.4: Maximum reasonable and perceived actual queue times



Source: CAA Q6 research, (n = 152 arrivals, n = 194 departures).

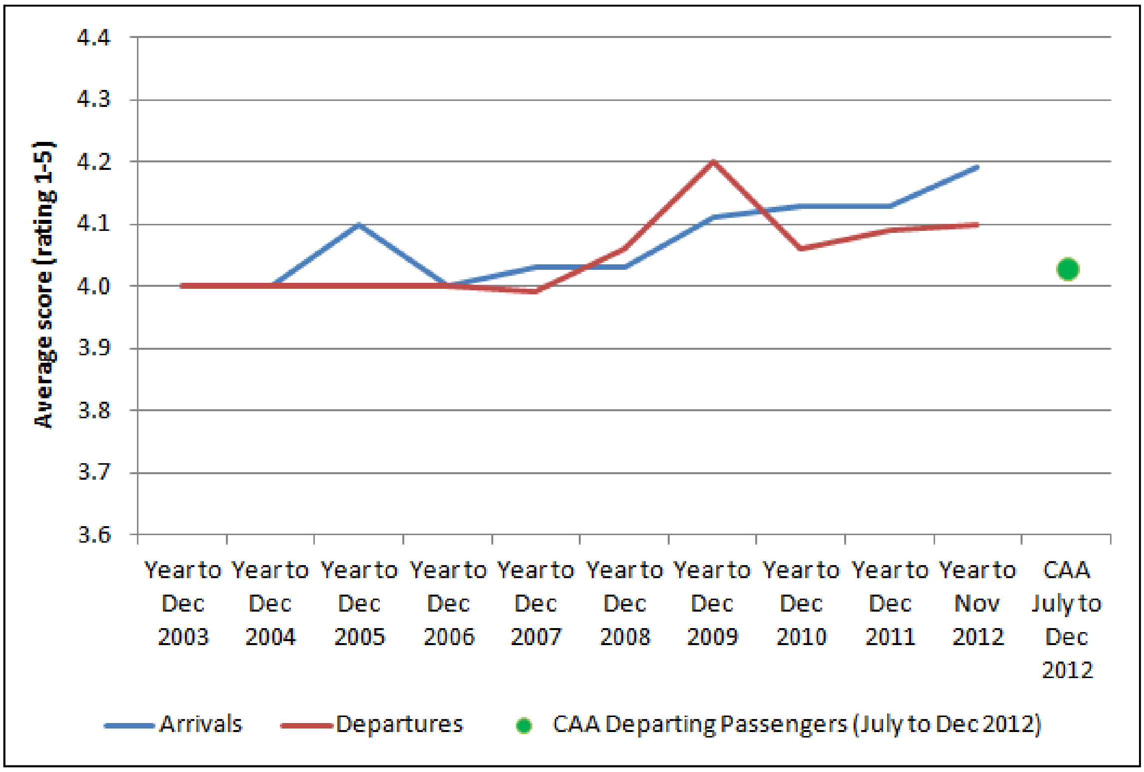
Airport research

2.38 STAL carries out ongoing monitoring of service quality through its QSM survey. This survey consists of approximately 10,000[32] interviews per year (split between departing and arriving passengers), and has been running continuously since 2003.

2.39 A number of specific performance measures from this survey are used within the Q5 SQR scheme. The survey includes the more general question (which has been replicated on the CAA ongoing Passenger Survey since July 2012), “How would you rate your overall experience in the airport terminal today?”. The time series of the average responses indicates that there has been some increase in the level of passenger satisfaction since 2007 (figure 2.5).

[32] Sample size increased from approximately 8,000 per annum in 2008.

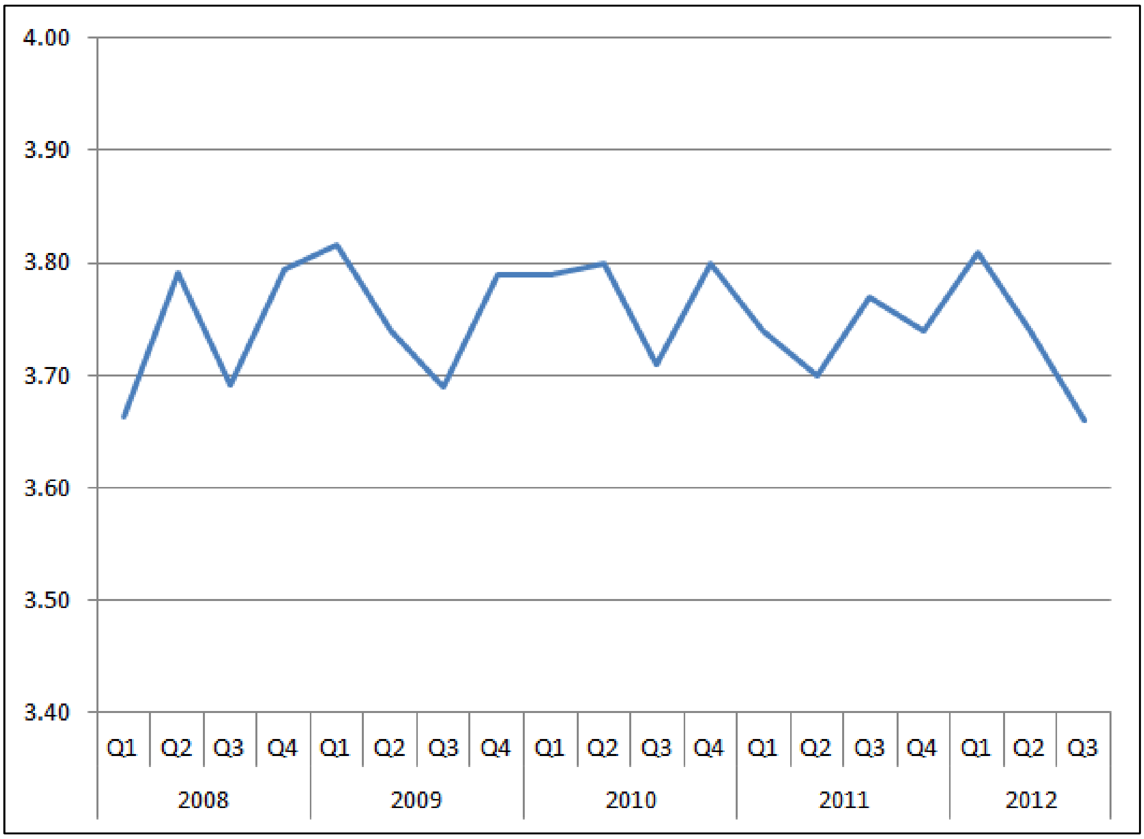
Figure 2.5: Stansted, annual overall passenger satisfaction scores



Source: STAL annual QSM data, CAA ongoing Passenger Survey, July – December 2012 (provisional).

2.40 STAL also participates in the Airport Service Quality (ASQ) survey, which allows it to compare its own performance with global comparators that are also participating. The results of Stansted indicate fairly constant scores since Q1 2008 (figure 2.6).

Figure 2.6: Overall passenger satisfaction with Stansted, ASQ



Source: STAL

Cargo

2.41 The CAA's primary duty also relates to the interests of those who own goods being sent by air - these may include businesses, non commercial organisations, and individuals.

2.42 The air freight market is more complex than the passenger market. Airlines may operate cargo-only flights using dedicated freighter aircraft, or they may sell bellyhold space on passenger flights. The space may be sold directly to the owner of the cargo, or to a freight forwarder who sells it on. For the air freight user who owns the cargo being flown, there is a range of suppliers in the UK competing on price, service and reliability. At Stansted, approximately 8% of the flights carry cargo only, yet these account for 98% of the cargo flown in and out of the airport by weight. This makes cargo-only flights a much more significant part of the airport's operations than at Heathrow and Gatwick, where the vast majority of cargo is carried in the bellyhold of passenger flights.

2.43 Through discussions with cargo operators, the CAA's understanding is that, in line with those using their services, the operators main concerns are around reliability and resilience of the airport, which potentially impact on the time of delivery for cargo carried. The CAA considers these aspects of the airport's operations to be aligned with the interests of passengers.

Conclusions from the research

2.44 Although such research is informative, the CAA acknowledges the limitations of inferences drawn from it. Due to the nature of the airlines operating at Stansted and the more homogenous mix of passengers, the range of potential passenger interests is arguably narrower than at other airports, with air fare being more important to airport choice than across the London airports in general (see figure 2.2 above).

2.45 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 that the CAA has done indicates that the consistent themes in passenger priorities tend to over-ride the areas where there is greater variation.

2.46 The CAA has drawn the following insights for this review:

- the importance of price (air fare) for passengers travelling from Stansted;
- a need to maintain current levels of service provision around the critical aspects of the airport experience, for example, queue times; and
- any proposed improvements should be focused on areas where user benefits demonstrably outweigh the costs.

CAA Consumer Panel

2.47 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. It considered that, in the delivery of airport operation services, there is generally a reasonable alignment of airlines' and passengers' interests. However, this may not necessarily hold in certain areas, which the Consumer Panel asked the CAA to consider further (for example, passenger welfare in times of disruption).

2.48 In terms of the CAA's review of research, the Consumer Panel agreed that there is evidence to suggest that, on average, current service quality is generally satisfactory, but the Consumer Panel encouraged the CAA to consider the possibly varying needs of different passenger sub-groups (for example, passengers with reduced mobility (PRMs)).

2.49 The Consumer Panel supported monitoring service quality within a price monitoring regime, if this was considered appropriate for an airport operator with less market power than HAL or GAL. Within service quality monitoring, the Consumer Panel emphasised the importance of ensuring transparency (and potentially data availability). In this context, the Consumer Panel saw a need to ensure that things that matter to consumers and not just airlines are considered. Where a price monitoring regime was in place, the Consumer Panel would expect an annual review of performance by the CAA with a credible threat of re-regulation should this prove necessary.

Experience of the Q5 Service Quality Rebate Scheme

2.50 The Q5 SQR for STAL is structured differently from those in operation at Heathrow and Gatwick in three key ways. First, the rebates are payable on a monthly (rather than quarterly) basis, based on the actual monthly airport charges. Second, the SQR allows for rebates based on incidents of disruption to key processes, which the schemes at Heathrow and Gatwick do not. Third, rebates are heavily weighted towards the central search elements than at Heathrow and Gatwick.

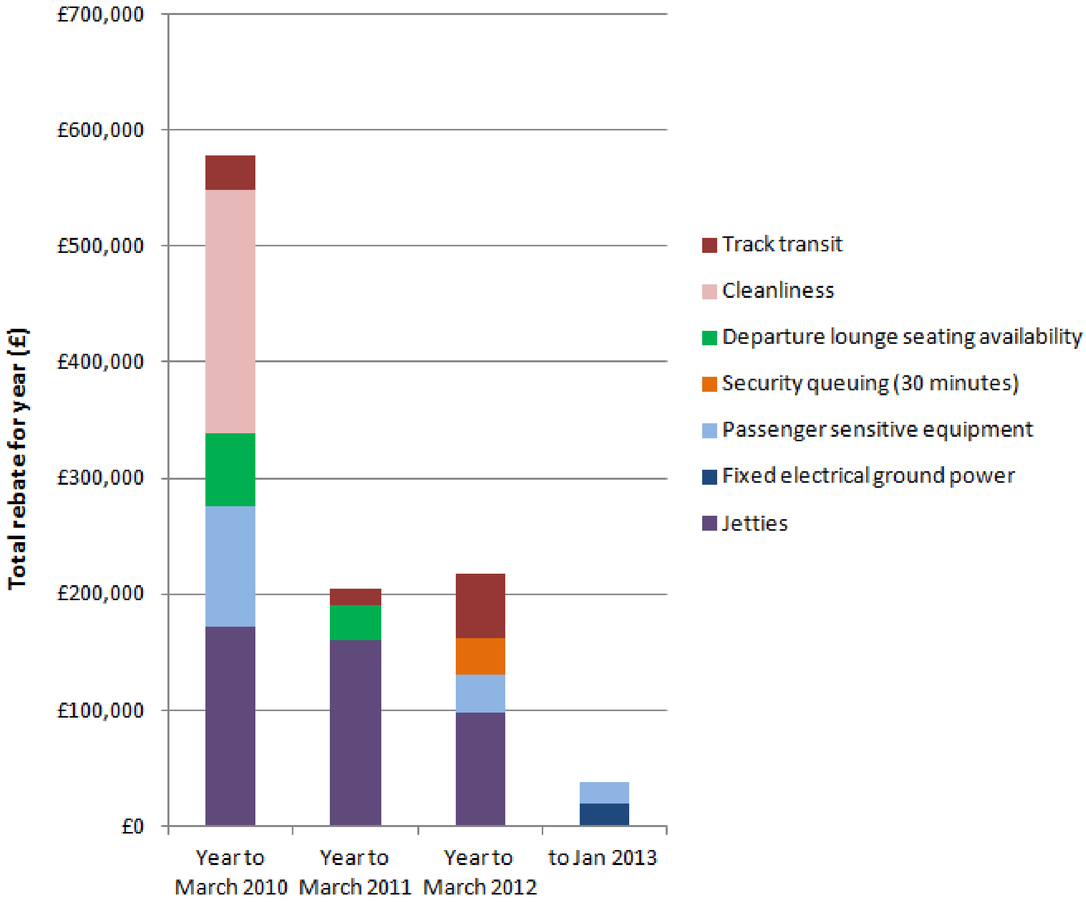
2.51 The elements contained within the Q5 SQR scheme are made up of four areas.

- Passenger satisfaction elements: departure lounge seat availability, cleanliness, wayfinding and flight information.
- Security: central search, including an event rebate, staff search and control posts search (monitoring only).
- Passenger operational elements: passenger sensitive equipment, arrivals reclaim (baggage carousels) and tracked transit system.

- Airline operational elements: the availability of stands, jetties, pier service and fixed electrical ground power.

2.52 In Q5 to date, rebates have been paid on 7 out of the 13 elements that are included for rebates. Figure 2.7 shows how these have decreased over Q5 from a total of £578,000 in the year to March 2010, to £37,000 in the 10 months to January 2013. The majority of the rebate paid (over 40% across the period) relates to jetty availability.

Figure 2.7: STAL Q5 SQR performance



Source: STAL

CAA initial proposals

2.53 The CAA has drawn the following observations to provide context for its initial proposals for STAL.

- As the CAA is currently minded to conclude that STAL passes the MPT in the Act, the CAA must consider the appropriate design of regulation beyond April 2014.
- STAL's level and nature of market power in the passenger market would appear different to that of Gatwick and Heathrow and the risks of abuse of this market power should be taken into account in the appropriate form of regulation.
- The main aim of any regulatory arrangements should be to safeguard users' interests with regards to airport charges and service quality. However, price may be a more significant issue than service quality for many passengers given the importance of the airfare in their choice set.
- Given the nature of the CAA's SMP assessment for STAL, the CAA considers it appropriate to take into account its duty to promote competition in airport operation services when designing the appropriate price control arrangements.
- Enhanced transparency may help to strengthen the incentives on STAL not to abuse its market power.

CHAPTER 3

Form of Regulation

3.1 The previous Chapter set out the statutory framework, market developments and users' interests for the design of the appropriate form of regulation beyond April 2014. This included ensuring passengers and those with a right in cargo have safeguards against STAL abusing its SMP in relation to its airport charges, whilst ensuring any arrangements promote competition in airport operation services. This Chapter evaluates the potential options for the form of regulation.

3.2 The options have been evaluated against a clear set of criteria drawn from the CAA's statutory duties. Options have also been evaluated against a counter-factual of a RAB-based price control for STAL for the planning period of Q6 (2014/2015 to 2018/19).

3.3 The Q5 price control for STAL was set on a 'dual' basis. It was a product both of the 'building block' single till RAB-based analysis carried out by the CC and of the CAA's assessment that the resulting price cap profile should be consistent with the development of more effective competition between airports over time. At the time of the Q5 decision, and in its communications since, the CAA has stated that there should be no presumption that it would adopt a RAB-based price control for Q6.

The CAA's process to develop regulatory options

3.4 In 2010, the CAA began a process of exploring alternative regulatory options with stakeholders. The CAA held several workshops and produced a number of stock-takes. Since then, the CAA has worked with stakeholders to narrow down the options, especially with its Setting the Scene for Q6 consultation document in July 2011 and its Q6 Policy Update consultation document in May 2012.

3.5 In the May 2012 consultation document the CAA stated that there could be problems with setting a RAB-based price control for STAL for Q6. This was because of the significant uncertainty about the assumptions for the 'building blocks' for the RAB calculation, such as traffic forecasts. In response to these concerns, the CAA set out a number of alternative approaches that it could consider in addition to a RAB-based approach.

- Comparator based price cap - where the price would be set in comparison to the prices at other comparable airports. The CAA noted that Stansted had more similarities with some other UK airports than perhaps Heathrow and Gatwick.
- Price monitoring - where the CAA would monitor rather than set prices and service quality with the threat of price control regulation if it considered that STAL was abusing its SMP. The CAA noted this option was most applicable where the risk of abuse was sufficiently low.
- A default settlement - where the price cap was set based on a minimum level of service, allowing airlines to pay for higher service quality if required. The CAA noted that this may be less relevant in relation to Stansted given the homogenous nature of airlines at the airport (Ryanair and easyJet accounted for 91% of total number of passengers carried in 2012).[33]
- A simple and pragmatic approach such as constant real or nominal prices - which could be used as a transitionary approach given the uncertainty surrounding STAL's market position. It could be put in place for a shorter duration than five years, giving the CAA the option to review the market situation when some of the present uncertainties have been resolved.

3.6 The CAA did not explicitly rule out setting a price cap for STAL based on LRIC, although it noted that this approach had significant practical difficulties in relation to airports.

Stakeholder views

3.7 STAL said that it was concerned about the high level of uncertainty associated with the key inputs to a RAB-based model in relation to Stansted. This would make it difficult to set a price cap that would enable it to earn a reasonable return. It would also be time

[33] CAA Airport Statistics.

consuming and disproportionate to the level of STAL's SMP. Finally, it could have a negative impact on competition.

3.8 STAL supported the development of a one year transitional licence based on the CAA's proposals for a simple and pragmatic approach. STAL also supported further work on price controls based on airport comparators, price monitoring and voluntary undertakings.

3.9 Ryanair expressed concern that a RAB-based price control could lead to unviable price levels due to what it considered was an inflated RAB, high operating costs and the recent decline in traffic (following the doubling of airport charges in 2007).

3.10 Ryanair raised concerns with the valuation methodology of the RAB, in particular the inclusion of certain costs related to STAL's preparations for the aborted second runaway project (SG2), such as a portfolio of houses acquired by STAL. Ryanair also did not support the indexation of the RAB to inflation. Ryanair supported consideration of alternatives to a RAB-based approach, but did not express a preference apart from raising concerns that a transitional approach appeared to prejudge the CAA's SMP assessment.

3.11 easyJet supported the development of a default price cap based on the economic value of airport services or profiling STAL's returns over time.

Evaluation criteria

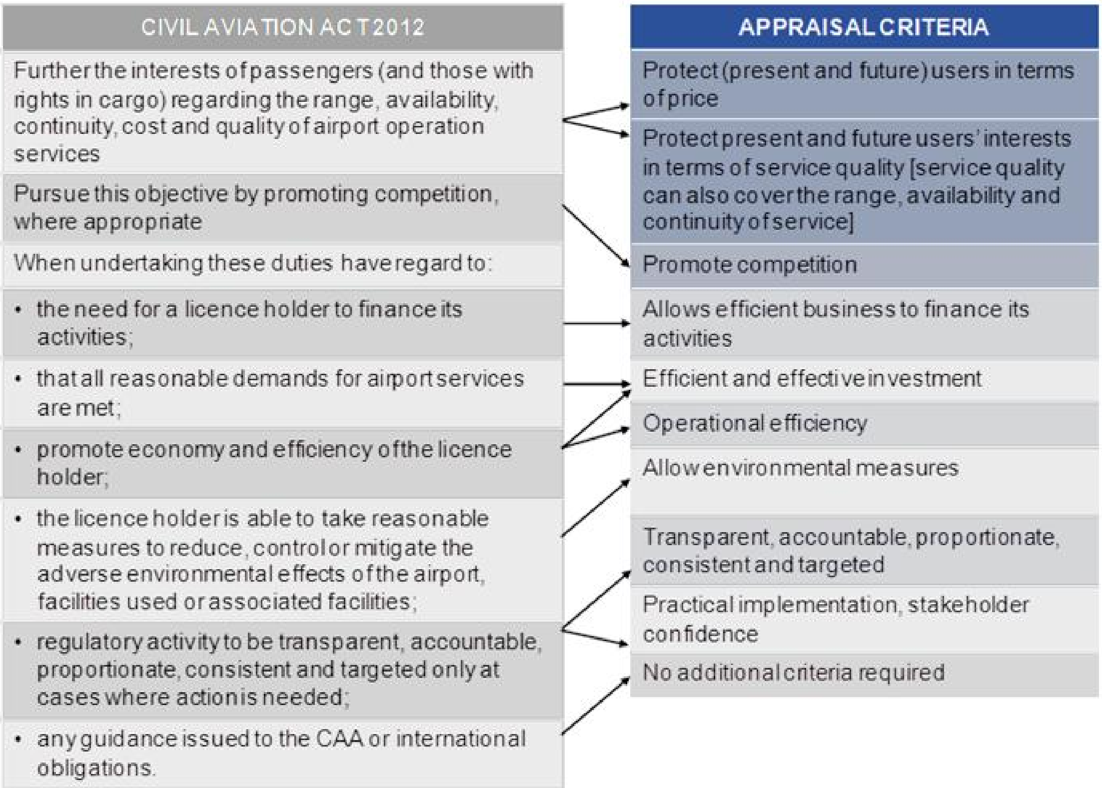
3.12 The CAA has developed a set of evaluation criteria based on its duties under the Act (figure 3.1).[34] The primary criterion is protection of the interests of passengers and those with rights in cargo from the abuse of SMP regarding the provision of airport operation services, and to do this, where appropriate, by promoting competition.

3.13 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

[34] 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.

impose unnecessary regulatory burdens).

Figure 3.1: Evaluation criteria for assessing regulatory options



Source: CAA

Assessment of alternative forms of regulation

3.14 The CAA has assessed each of the alternative forms of regulation against its evaluation criteria. While the CAA has identified separate markets for the passenger and cargo market, the passenger market dominates the airport, with passenger flights accounting for 92% of flights. The evaluation of different forms of regulation has therefore focused on the protection of the passenger market, although within each form of regulation, the CAA will need to ensure adequate protection for cargo owners given the degree of market power held by STAL in this market.

3.15 The evaluation has taken into account the key observations drawn from Chapter 2, especially the need to recognise that the CAA's minded to conclusion that, in relation to the LCC and Charter market, STAL holds a degree of market power which may currently be substantial, and is likely to become substantial over the period 2014 to 2019. Consequently, the nature of STAL's SMP is not the same as for Gatwick's and Heathrow's and hence the risk of abuse may be lower than at these other regulated airports. The CAA has considered how various options might rank compared to a counter-factual of the five-year RAB-based price cap (based on information the CAA currently has available). The assessment also draws on discussions which the CAA has had with stakeholders and a number of CAA commissioned consultancy studies.

RAB-based price cap

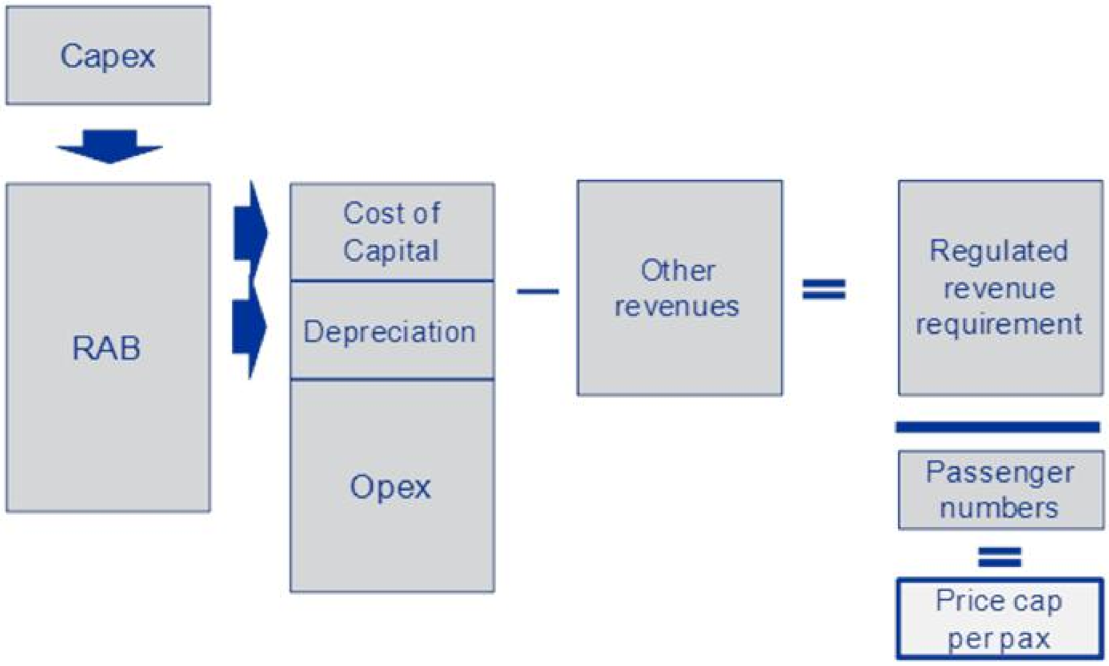
3.16 A RAB-based price control is the standard model used by other UK economic regulators and it has been the dominant model of regulation for UK airports. It is well understood by regulated companies and investors.

3.17 Its basic premise is that the charges that a regulated company levies should permit the company to recover its historical investment in assets. The RAB is a measure of the cumulative value of capital investment that has been undertaken but has not yet been charged to users.

3.18 Technically, the RAB-based calculation allows for a capital charge[35] (return on the RAB) and a depreciation charge (return of the RAB). For airports, there are a number of other relevant 'building blocks' that make up the final price cap (figure 3.2). This includes opex and other/commercial revenues (the latter is deducted from the calculation as airport charges are calculated on a single till basis). As the price is fixed for the duration of the price control, a RAB-based control can provide strong incentives for improving opex efficiency and increasing commercial revenues.

[35] Based on multiplying the RAB by WACC per year.

Figure 3.2: Building blocks for single till RAB-based calculation



Source: CAA

3.19 Figure 3.2 shows the importance of the traffic forecasts. These make up the denominator in the final calculation of maximum average airport charges and are a key influence on the level of several building blocks such as opex and commercial revenues.

3.20 In its May 2012 Policy Update document the CAA stated that, where it applied a RAB-based approach in the future, it would consider taking advantage of the new flexibilities in the Act to introduce more flexibility in this particular form of regulation. For example, the new Act enables the CAA to evolve and improve the RAB model by adopting a duration other than five years and to respond to exceptional circumstances within the price control period.

3.21 Given the market and passenger context explained in Chapter 2, a RAB-based price cap applied for STAL in Q6 poses some very considerable challenges.

3.22 First, it is not clear that the market context of STAL is of the type commonly seen in the other regulated sectors that apply RAB-based price controls, such as water, energy and rail sectors. Although the CAA is minded to conclude that STAL does pass the MPT in the Act, its finding is that the degree of passenger market power is less than for the other two regulated London airports and is subject to a degree of uncertainty in terms of how changing market conditions could affect STAL's position. Another key difference from other sectors, and with Heathrow and Gatwick, is Stansted's lower requirement for capital investment. The STAL business plan for Q6 (albeit under its previous ownership) included only a limited capital budget when compared to Heathrow and Gatwick.

3.23 Second, there is considerable uncertainty surrounding some key assumptions that have to be made for setting a RAB-based price control for STAL in Q6. For example, the projection for traffic is subject to wide uncertainty as Stansted's traffic is more sensitive to changes in economic growth than Heathrow's and Gatwick's and because it is not yet clear whether MAG will develop commercial relationships with airlines to drive more rapid traffic growth. Uncertain traffic forecasts could lead to significant swings in the price and to a counterproductive scenario if prices rose sharply to reflect falling passenger numbers (e.g. if there were a simple rebasing of the calculation to reflect the significant traffic decline over recent years). Although the CAA could consider supplementing the basic RAB model with a traffic risk sharing mechanism, this is likely to add additional complexity and it does not in itself improve on the difficulties in forecasting traffic.

3.24 Third, the very recent acquisition of Stansted by MAG in March 2013 is likely to lead to a different business strategy and different projections compared to those produced by STAL when it was owned by BAA. Basing a RAB price cap on numbers submitted under BAA's ownership (albeit with CAA scrutiny) may be inconsistent with the business strategy under new ownership. This could be especially costly if it frustrates STAL and the incumbent airlines from developing a more enduring, cohesive and commercial long-term relationship.

3.25 Fourth, the CAA’s January 2013 'minded to' view of STAL’s SMP identified a number of reasons why a RAB-based price in the context of STAL may not reflect a competitive price[36] and could be significantly different. These included:

[36] Paragraph 6.43, Stansted market power assessment.

- the airport was designed and built to cater for a broad mix of airline business models and these costs are reflected in the value of the RAB. Its capital investment and infrastructure reflected this. The capital investments were included in STAL's RAB. However, Stansted is now catering predominantly for short-haul LCCs and it is uncertain whether a modern equivalent asset valuation (MEAV) for their infrastructure needs would be equivalent to the current STAL RAB;
- STAL, consistent with government policy at the time, started to develop a second runway to ensure sufficient capacity going forward. Some of these costs were included in STAL's RAB. While this long-term project has been abandoned, these costs are being recovered through current users of the airport. It is unlikely that a business in a competitive market could charge its customers for such a major item of expenditure which they did not use, without losing a significant amount of revenue to its competitors; and
- Stansted's previous common ownership with Heathrow and Gatwick may have led to investment decisions by STAL which were sub-optimal for its customers. The value of that investment would be reflected in its RAB.

3.26 Fifth, given the lack of confidence in the assumptions that would underpin such a calculation at present, in addition to the other issues identified above, there is a real risk that the resulting price profile may neither protect users in terms of prices nor promote competition in airport operation services. This is especially relevant for STAL given the CAA's views on the nature of its SMP.

3.27 Sixth, the CAA acknowledges that a RAB-based approach imposes some costs on stakeholders (both administrative costs and incentive distortion costs) and it is important that there is an appropriate level of assurance that these will be outweighed by benefits to users. Given the uncertainties described above, the CAA doubts that this will be the case.

3.28 Some of these drawbacks were identified by the CAA and the CC in the Q5 review. Due to concerns over the use of a RAB-based framework, the CAA stated in its Q5 decision that there should be no presumption that a RAB-based approach would be used in future price controls at Stansted.[37] Since then, Stansted has seen its passenger numbers fall from about 24 million per year to a little below 18 million per year.

3.29 Given the nature of its view on STAL's SMP and the reasons identified above, the CAA does not consider that the imposition of a RAB-based price cap would be appropriate for STAL for Q6 (figure 3.3). Nevertheless, the CAA will continue to undertake a RAB-based calculation, which will be used as one reference route, amoung several, to assess the reasonableness of other proposed forms of regulation.

Figure 3.3: Evaluation of RAB-based price control for STAL Q6

Criteria	**Assessment**
Price protection	In principle, a RAB-based price cap could ensure that users only pay for efficient costs. This is dependent on the inputs to a RAB-based calculation being efficient and appropriate for users of the airport. It is far from clear this is the case for STAL. This is further complicated by uncertainty over the level of key building blocks such as traffic. Moreover, given the significant decline in traffic over recent years, a simple rebasing of the RAB calculation could lead to significant increases in prices, which would not be in passengers' interests. In summary, there is a risk a RAB-based price cap would not meet this criterion in practice given the characteristics of Stansted.
Service quality protection	Service quality requirements can be specified as part of the licence, although care is needed to ensure that they meet the needs of users.
Promote competition	The uncertainty over some inputs to the calculation risks setting prices that could frustrate rather than promote competition. In addition, depending on how it is set, RAB-based regulation can distort investment incentives at both regulated and unregulated airports, which can have an adverse impact on competition (though this does not currently appear to be the case for Stansted).
Allows efficient business to finance its activities	The regulated business would receive a pre-set return on historical investment, although their actual returns would be

[37] Paragraph 19, http://www.caa.co.uk/docs/5/ergdocs/20090313StanstedPriceControl.pdf.

Criteria	Assessment
	subject to some traffic risk.
Efficient and effective investment	A RAB approach can promote investment as regulated business will earn a return, although it can distort investment incentives. A more flexible RAB approach may improve incentives for the planning, delivery and efficiency of capex.
Operational efficiency	A RAB-based control gives the company incentives to outperform regulated settlement, although the market power assessment identified that some inefficiencies remained.
Allows environmental measures	A RAB-based control would effectively make no change to the status quo with respect to these costs.
Transparent, accountable, proportionate, consistent and targeted	Setting of a RAB-based price cap is transparent and consistent. The scope can be targeted on areas of harm, although the RAB approach can be complex, time consuming and introduce rigidities into processes. Consequently, a RAB-based framework is likely to be most appropriate where there is significant risk of the abuse of SMP. This is unlikely given the degree and extent of market power held by STAL.
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. However, some stakeholders have raised significant concerns in relation to the use of a RAB approach at Stansted for Q6.

Source: CAA

Long-run incremental costs

3.30 Price caps based on LRIC, which is sometimes referred to as long-run average incremental costs (LRAIC), 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

- 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.

3.31 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.

3.32 The main potential benefit of a LRIC approach is that it signals 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.[38] Price protection for users is assured by setting a price cap based on LRIC and fixing it for a number of years.

3.33 The CAA commissioned consultants Europe Economics (EE) to provide advice on the application of LRIC estimates to Gatwick and Stansted airports.[39] EE stated that LRIC provides the best indication of the competitive price where it is based on the MEAV of existing assets.[40] In addition, EE suggested a LRIC approach may increase efficiency as the regulated company will only be reimbursed for efficient investment.

3.34 In the May 2012 Policy Update the CAA identified a number of drawbacks from a LRIC approach.

- A LRIC price cap is data intensive and requires considerable regulatory judgement to define the increment and specific approach. This can lead to significant uncertainty over future price profiles and it may be possible to generate large increases or decreases depending on the assumptions used, limiting protection to users and its use as a calculation that reflects a competitive

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[38] LRIC has tended to be used to set the cost standard for multiproduct firms to test potential abuse of SMP.

[39] Europe Economics, December 2012, *Advice on the application of long run incremental cost estimates for Gatwick and Stansted*, available at: 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.

[40] Although this to some extent depends on how demand relates to available capacity.

price.

- 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 similar 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 to any other 'smoothing' effect, for example that existing passengers may be asked to pay for future improvements from which they may not benefit.

- It has 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.

3.35 EE also identified a number of further drawbacks from using a LRIC approach for Stansted including the following:

- difficulties in determining the appropriate increment to use. 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). However, it noted that since Stansted was a relatively new airport, these problems may be less severe;

- 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, the regulated company can be uncertain about the remuneration of its investment, particularly if the current configuration of the airport is sub-optimal; and

- greater potential for volatility, for example if input prices or technology changes.

3.36 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 the UK.

3.37 In summary, although the CAA recognises the potential benefits of this approach, it also acknowledges it has serious drawbacks in relation to an application to airports for Q6. The CAA is concerned that a combination of the following will mean that the implementation of a LRIC based control at Stansted 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 STAL's airport charges in Q6 given the risk it could undermine, rather than support, protection for users and the promotion of competition.

3.38 A summary of the CAA's evaluation against its criteria is given in figure 3.4 along with an assessment of whether this option compares more favourably (+), less favourably (-) or broadly the same (=) as the RAB counter factual discussed earlier.

Figure 3.4: Evaluation of a LRIC based price control for STAL Q6

Criteria	Assessment	Relative to RAB?
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.	=

Criteria	Assessment	Relative to RAB?
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 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 recoveries of revenue over time. Stakeholders raised concerns whether sufficiently precise results could be	-/=

Criteria	Assessment	Relative to RAB?
	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

Price caps based on pegging tariffs to comparator airports

3.39 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.

3.40 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.

3.41 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.

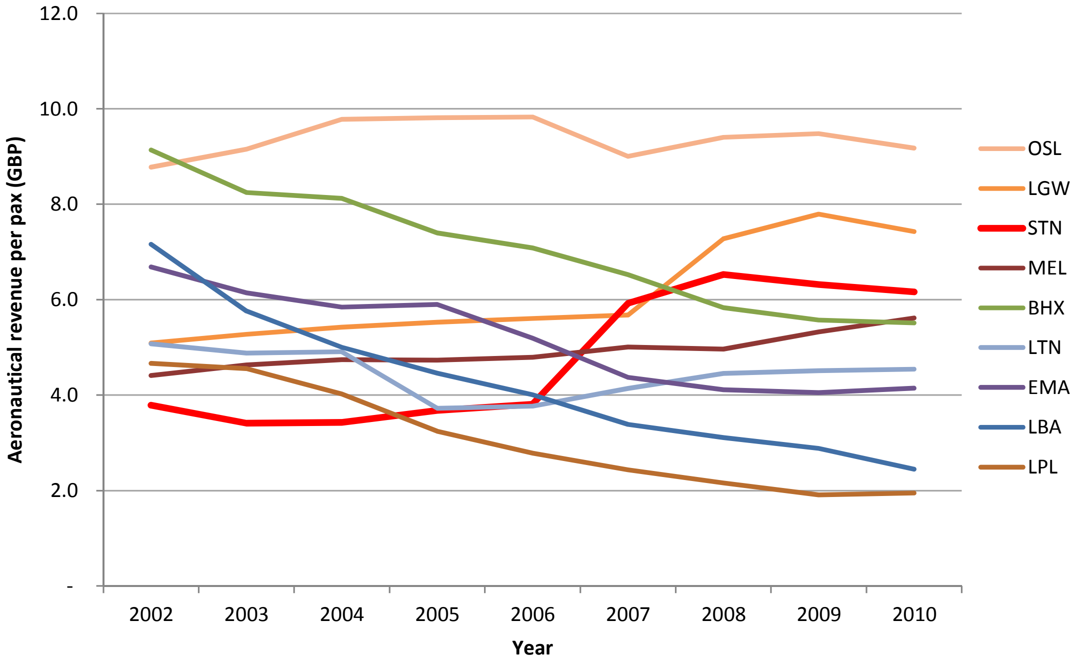
3.42 The CAA commissioned consultants Leigh Fisher (LF) to identify whether it was possible to benchmark prices at comparable airports in order to regulate airport charges at Gatwick and/or Stansted. LF identified a potential comparator set of airports separately for Stansted, Gatwick and Heathrow.[41]

3.43 Based on this comparator set, LF benchmarked STAL's aeronautical revenues per passenger over the last ten years (figure 3.5). This showed that STAL's average aeronautical revenues per passenger increased from being at the bottom of the comparator group to well

[41] Leigh Fisher, April 2013, *Comparing and capping airport charges at regulated airports: updated final report*, available at: http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=14279.

above the average of the group.

Figure 3.5: Aeronautical revenue per passenger for the Stansted comparator basket



Source: LF

3.44 In developing the comparator basket, LF found that trends in aeronautical revenue per passenger were robust against variations in the airports chosen 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. These include:

- 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.

3.45 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 problems with comparator based price caps could be reduced by averaging across airports and might be resolved through agreement on the comparator set and/or parameters between STAL and the airlines. Nevertheless, LF recommended that it may be better for the comparator benchmark to be considered as a range rather than as a point estimate.

3.46 Based on the above analysis, the CAA does not consider that it would be appropriate to set precise price caps based on comparator benchmarks. The CAA considers that comparator benchmarks would provide a useful indicator of the possible range for a competitive price (as long as the comparators are themselves subject to effective competition).

3.47 A summary of the CAA's evaluation against its criteria is given in figure 3.6, along with an assessment of whether this option compares more favourably (+), less favourably (-) or broadly the same (=) as the RAB counter factual discussed earlier.

Figure 3.6: Evaluation of linking prices to comparator airports for STAL Q6

Criteria	Assessment	Relative to RAB?
Price protection	In principle, the price cap ensures users only pay a proxy for the competitive price based on prices at comparator airports. However, due to potential measurement and statistical issues the benchmark may not be sufficiently precise to set price caps. Given the wide uncertainty of the RAB approach, a comparator airport index may provide users with more confidence of price protection, although there is no guarantee that charges are cost reflective	+

Criteria	Assessment	Relative to RAB?
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 the 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 be needed to allow an efficient business to 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 from costs, this should create incentives for efficiency as STAL will effectively be a price taker rather than a price maker. STAL will therefore retain any gains made from reducing opex. STAL would benefit from such gains 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	-/=

Criteria	Assessment	Relative to RAB?
	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.	=
Practical implementation and stakeholder confidence	LF has demonstrated that it is possible to identify a set of comparator airports for Stansted, which include a number of airports that operate under light-handed regulation. The comparator benchmark is also robust to small changes in the comparator set. 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 STAL and other stakeholders.	=

Source: CAA

Price monitoring

3.48 Price monitoring would not involve the CAA setting an explicit price cap to apply from April 2014. Instead, the CAA would expect STAL to self-discipline 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.

3.49 The CAA's role would be to monitor STAL's performance, including its prices, service quality, investment and efficiency - with the threat of reintroducing tighter regulation if STAL's performance raised concerns about the exercise or abuse of its SMP.

3.50 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 STAL to act as if it faced effective competition. If monitoring is effective, it would incentivise STAL 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.

3.51 Monitoring, if effective, has a number of potential benefits in application to STAL. It allows greater flexibility, reduced regulatory specification and reduction of the regulatory burden. It also encourages STAL and the airlines to develop a more cohesive relationship than relying on the regulatory process for setting prices.

3.52 The CAA commissioned consultants First Economics (FE) to develop and assess alternative forms of a monitoring regime.[42] 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 under which the airport operator would enter into a voluntary code of conduct before the start of Q6. The approach would include less frequent reviews of outcomes. Such a code of conduct would go well beyond the requirements of the ACR and would involve meaningful commitments to cost transparency, information provision, dispute resolution and agreement on charges.

3.53 FE considered that monitoring could be an effective form of regulation for STAL, if:

- STAL accepts and understands the need for self regulation (within the context of a price monitoring framework);

[42] First Economics, December 2012, *Price Monitoring as an Alternative to RAB-based Price Cap Regulation*, available at: http://www.caa.co.uk/docs/1350/First%20Economics,%20Price%20Monitoring%20as%20an%20Alternative%20to%20RAB-based%20Price%20Cap%20Regulation.pdf.

- there is a credible and understood threat of ex-ante price control regulation, if STAL is found to be abusing its market power;
- the reputational consequences to STAL of being found to have abused SMP are unattractive; and
- the financial consequences of ex-ante price control regulation are unfavourable.

3.54 FE considered that, of the three options, option A would be less beneficial than the other two. FE considered that, as option A included an automatic movement to ex-ante price control regulation, it would effectively be regarded 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 before comparative data becomes 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 its customers, the airlines and passengers.

3.55 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. Option B would avoid this by having greater CAA involvement through regular reporting and monitoring of performance.

3.56 The CAA's market power assessment for STAL indicated that it is likely it will not face effective competitive constraints across the majority of its revenue base, especially as capacity constraints tighten over time in the London market. Consequently, the CAA has focused its assessment on Option B, price monitoring based on an annual ex-post review of prices and outcomes.

3.57 Given the nature of STAL's SMP, the CAA considers that price monitoring could have a number of benefits. It first and foremost has the advantage of giving STAL responsibility for managing airline and user satisfaction. The recent purchase by MAG provides an opportunity for a fresh start in the relationship with incumbent airlines at Stansted. MAG successfully reduced airline opposition to the deregulation of Manchester airport and has experience of agreeing bilateral contracts at its existing airports.

3.58 The CAA considers that this is preferable to an alternative in which the regulator is required to set a price cap for STAL which ensures in advance that the airport does not price above the competitive level. As noted above, a new regulator-determined price cap, whether RAB-based, LRIC-based or anchored to some other methodology, would require the CAA to exercise significant judgment and could result in arbitrary and sub-optimal outcomes in comparison to an alternative process in which STAL sets prices in real time in relation to the market and in which the airport, airlines and users work together more generally to plot the future direction for the airport.

3.59 This approach also has the advantage of enabling the CAA to allow for the degree of uncertainty about future market conditions identified in the market power assessment by not locking into a form of regulation that might be suitable for STAL now but not in the future (or vice versa).

3.60 It should be acknowledged that price monitoring is not without potential risks. For example, it is important to impress on all parties that the intention is that there should be less rather than more regulatory involvement. This will be particularly important at the start of the control period if the boundaries of the regime are tested, although an annual reporting mechanism could provide a means of explaining emerging issues.

3.61 In addition, given the CAA findings from its market power assessment that STAL's prices at either at, or above, the competitive level, this option may require a credible regulatory backstop or a threshold for intervention that is not too wide. For example, the CAA could supplement this approach with a so-called 'show cause' trigger, which specifies in advance a threshold above which STAL's current price path would invite further scrutiny by the CAA.

3.62 Overall, the CAA considers that price monitoring could be an appropriate form of regulation for STAL for Q6.

3.63 A summary of the CAA's evaluation against its criteria is given in figure 3.7 along with an assessment of whether this option compares more favourably (+), less favourably (-) or broadly the same (=) as the RAB counter factual discussed earlier.

Figure 3.7: Evaluation of price monitoring for STAL Q6

Criteria	Assessment	Relative to RAB?
Price protection	Given the level of market power held by STAL, price monitoring could lead to effective self-regulation of charges if there is a credible regulatory backstop and deterrent. If self-discipline is not evident, there will be a switch to tighter price control regulation. It may therefore provide a requisite level of price protection whilst avoiding the uncertainties associated with an explicit price cap (e.g. RAB or LRIAC).	+
Service quality protection	Service quality could be transparently monitored where poor performance could lead to a switch to a regulatory default. By not explicitly controlling minimum service standards, this form of regulation may encourage greater airport/airline dialogue on these issues.	=
Promote competition	The intention of price monitoring is that STAL would behave in the same way as airport operators without SMP. Price monitoring is likely to cause fewer distortions to competition than other forms of price cap regulation.	+
Allows efficient business to finance its activities	There is no reason why STAL would set prices at a level that does not permit it to finance its activities. By avoiding the uncertainties of a RAB-based calculation it may provide for a better investment climate.	=/+
Efficient and effective investment	STAL would not be constrained from bringing forward efficient new investment plans, which could be taken into account	=

Criteria	Assessment	Relative to RAB?
	when assessing prices. The move away from a RAB-based framework may put greater onus on STAL to ensure investment is required and efficient.	
Operational efficiency	By disciplining prices, this form of regulation may incentivise cost efficiency. Cost inefficiency would be one of the indicators that could trigger a switch to tighter price control regulation. However, the absence of a fixed cap might see drift towards ex post justifications of cost increases. This can be mitigated by the CAA specifying in advance a 'show cause' trigger.	=
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 perhaps may risk more unpredictability than a RAB-based option, but this might dissipate over time as expectations and boundaries are clarified.	=
Practical implementation and stakeholder confidence	As this option does not set a price cap it is relatively straightforward to implement. This option requires STAL and the airlines to work together and be assured that there is a regulatory backstop rather than the regulator designing the maximum price and minimum service offering up front.	=

Source: CAA

Short-term price cap

3.64 In the May 2012 Policy Update document, the CAA suggested that, given the uncertainty around STAL's market position, there may be merit in adopting a simple or pragmatic solution or a transitionary price control (say two or three years) with prices linked to a simple benchmark. Prices might be held constant in real or nominal terms or compared to some index of comparator airports determined by the CAA.

3.65 STAL has suggested that, if it was found to have SMP, it would support a provisional licence based on either rolling forward the Q5 settlement for one year, or on including different price controls if used for a longer period. STAL suggested that this approach would have benefits as it would allow the CAA time to develop appropriate regulatory options after concluding the MPT, while providing effective protection for users and avoiding significant and potentially nugatory costs.

3.66 Given the CAA's findings from its market power assessment that STAL's prices are either at, or above, the competitive level, a price cap set at constant real prices may not provide adequate protection to users. This could be overcome if it was based on no nominal increase, though a nominal freeze could expose the Stansted to significant cost pressures, if inflation increased significantly above its current, relatively low, levels.

3.67 The CAA has considered STAL's proposals for a one-year licence. However, this is a relatively short period and the CAA questions whether a period of just 12 months would be sufficient for some of the uncertainties to be resolved.

3.68 The CAA has also considered the potential for a longer-term licence, for two or three years, based on constant real or nominal prices. To test the reasonableness of this, the CAA could take into account, as context, calculations of a RAB-based or LRIC based price cap. It could also take into account an index of comparator airports.

3.69 Such an approach does have potential downsides. It is by definition simple and to an extent arbitrary (though it may recognise the spurious precision of other methods of calculation). There is also a risk that a short-term price cap would not fully reflect the market power assessment if this turns more on the expectation of future SMP owing to tightening capacity constraints in the London area.

3.70 Overall, the CAA considers that a pragmatic short-term price control should remain a plausible option given the range of uncertainty for STAL in Q6.

3.71 A summary of the CAA's evaluation against its criteria is given in figure 3.8 along with an assessment of whether this option compares more favourably (+), less favourably (-) or broadly the same (=) as the RAB counterfactual discussed earlier.

Figure 3.8: Evaluation of a short-term price cap for STAL Q6

Criteria	Assessment	Relative to RAB?
Price protection	It protects users with a simple design of a price cap. It also avoids the uncertainties faced with a RAB or LRIC calculation.	+
Service quality protection	Service quality protection would be dependent on the provisions included in the regime, although both STAL and the airlines agreed that the Q5 SQR scheme remained fit for purpose.	=
Promote competition	As the CAA has not seen evidence that the current price cap has distorted competition, capping prices in real or nominal terms should not distort the market. It is likely to have benefits over a RAB or LRIC approach as these are subject to wide uncertainty and volatility in their calculation.	=
Allows efficient business to finance its activities	It is unclear whether capping prices in nominal terms would be sufficient to allow STAL to finance its activities. There is less concern with capping prices at current levels in real terms as STAL has shown it can finance its activities at the current level of charges and does not envisage a substantial increase in the investment programme over Q6.	=
Efficient and effective investment	The removal of the RAB would delink prices from investment. This could disincentivise investment, although given that much of the investment envisaged for Q6 is for renewing existing assets, this is unlikely to have a significant impact.	-/=
Operational efficiency	If the price cap is set at an appropriate level, there should be incentives to outperform	=

Criteria	Assessment	Relative to RAB?
	efficiency assumptions.	
Allow environmental measures	There is no reason why environmental measures could not be introduced.	=
Transparent, accountable, proportionate, consistent and targeted	It is not clear that a short-term price cap including similar controls as included in Q5 would be proportionate to the degree of market power held by STAL if this is based more on SMP becoming stronger over time. On the other hand, it provides a chance to review the market situation after two or three years.	=
Practical implementation and stakeholder confidence	It is easy to implement. Stakeholders' confidence is likely to be dependent on the terms of the price cap.	=

Source: CAA

Voluntary undertakings

3.72 Voluntary undertakings can involve binding commitments from the airport operator regarding its future behaviour. These can include the future price path, service quality and other elements that might be found within a regulatory settlement. STAL has stated that undertakings could provide an effective and proportionate way of addressing the risk of an airport operator abusing its market power. STAL has suggested that undertakings could be provided to either the CAA or airlines and could involve:

- the level of service quality;
- the maximum and minimum size of the investment programme;
- consultation obligations;
- transparency and reporting obligations;
- dispute resolution;
- the future level of prices; and
- charges for non aeronautical services.

3.73 In appropriate market circumstances, airport operator undertakings can, in principle, be an effective way of addressing a risk of the abuse of SMP while reducing the costs and burdens of more formal regulation. As undertakings are proposed by the airport operator, it will be important to ensure that they are reasonable and effective and provide the required level of protection for both airlines and users.

3.74 Given the level of market power held by STAL, the CAA considers that voluntary undertakings could, in principle, be part of an appropriate form of regulation, but notes that STAL has yet to put forward firm proposals in this area. Any proposals would need to be consulted on before implementation and therefore, given the limited time now available, it may only be possible to include voluntary undertakings during, rather at the start, of the next control period.

3.75 Any assessment of voluntary undertakings would have to be carried out within the framework of the Act and in particular take account of the fact that where an airport operator is found to have met the MPT, a licence will be required. There may be scope to consider an offer of voluntary undertakings as to future conduct by the airport operator in question as an implicit part of the balancing exercise required by Test C of the MPT. However, CAA considers that considerable caution should be exercised in doing so given that undertakings are given no explicit place in the legislative scheme for economic regulation set out in the Act. In particular, the exercise of the CAA's discretion under Test C will be subject to compliance with the statutory duties in section 1 of the Act.

3.76 The CAA also notes that voluntary undertakings can only be taken into account while the CAA is considering a decision on the MPT (Test C and appropriateness) not afterwards. If undertakings are offered after the CAA has made an affirmative market power determination (MPD), the CAA does not have the ability to avert the regulatory consequences which follow from that determination[43].

3.77 Given the circumstances of Stansted, with two LCCs comprising about 90% of passenger traffic, it may be more commercially desirable for MAG to seek to conclude long-term agreements rather than voluntary agreements with these airlines or the CAA. Should this happen, the

[43] This is because the Act provides that once the CAA concludes that an operator has met the market power tests set out in section 6 of the Act, the section 3 prohibition automatically applies: no exception is provided in section 3 for airport operators that have provided voluntary undertakings.

CAA would expect to take this into account in finalising its view on the MPT and in its assessment of any regulation that is required after April 2014.

Default price cap

3.78 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 some form of calculation, either a RAB-based calculation, LRIC or an alternative approach and so it would be subject to many of the same considerations as these measures.

3.79 A default settlement would provide additional advantages of greater flexibility across airports, however, as there is a relatively homogenous airline customer base at Stansted, these potential additional benefits may be limited.

The CAA's initial proposals

3.80 The CAA's evaluation of the regulatory options against the evaluation criteria drawn from its statutory duties, and taking into account the market developments and users interests at Stansted, points to price monitoring being the preferred candidate for the markets for passengers and owners of cargo (figure 3.9). A short-term price cap may provide a useful fall back option if a price monitoring regime cannot be designed to work.

Figure 3.9: Summary of alternative options to RAB for STAL Q6

Evaluation criteria	LRIC	Comparator Index	Short-term price cap	Price monitoring
Price protection	=	+	+	+
Service quality protection	=	-/=	=	=
Promote competition	=	+	=	+
Allows efficient business to finance its activities	-	-	=	=/+
Efficient and effective investment	-/=	-	-/=	=

Evaluation criteria	LRIC	Comparator Index	Short-term price cap	Price monitoring
Operational efficiency	=	+	=	=
Allow environmental measures	=	-/=	=	=
Transparent, accountable, proportionate, consistent and targeted	-/=	=	=	=
Practical implementation and stakeholder confidence	-/=	=	=	=

Source: CAA

3.81 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 users.

3.82 The CAA's January 2013 'minded to' views in the market power assessment found that, in the passenger (LCC and Charter) market, STAL holds a degree of market power that may be substantial and is likely to become substantial over the period 2014 to 2019. The CAA found that STAL did have SMP in the cargo market. The risks of abuse, for passengers, may therefore be relatively low compared to the other regulated airports. While there is uncertainty in projections, the acquisition by MAG provides a fresh start to relationships with airlines, with an opportunity to increase traffic. There is also not a large capital programme to be funded, where investors would need greater surety around future pricing and funding.

3.83 Were the CAA to make a final decision that the MPT is met in relation to Stansted, STAL would require a licence to recover charges for airport operation services it provides at that airport. The CAA would be minded to conclude that it is appropriate to grant that licence and has the power under section 18 of the Act to impose such licence conditions as it considers necessary or expedient having regard to two matters:

- the risk that STAL may engage in conduct that amounts to abuse of its SMP in a market for airport operation services (or for services that include airport operation services); and
- the CAA's duties under section 1 of the Act.

3.84 This latter element of the CAA's discretion requires it to look at what will further interests of the users of air transport services regarding the range, availability, continuity, cost and quality of airport operation services. It also places a duty on the CAA, where appropriate, to carry out its functions in a manner which it considers will promote competition in the provision of airport operation services. These two obligations require the consideration of a number of other matters such as the need to promote economy and efficiency on the part of licence holders and to have regard to the better regulation principles of transparency, accountability, proportionality, consistency and targeting.

3.85 In this context, the CAA considers that price monitoring is likely to be the most appropriate form of regulation. It provides greater flexibility to deal with uncertainty going forward and reduced regulatory specification, which would be more appropriate to the degree of SMP held by STAL.

3.86 Monitoring would involve the expectation that it would support STAL self-disciplining its pricing behaviour and ensure that it does not abuse its market power within a framework where there is a credible regulatory backstop. The CAA's role comprises regulatory monitoring of STAL's performance across a range of measures together with the 'threat' of more onerous regulatory intervention if STAL did not behave as if it faced effective competition or if it was seen to be operating in a way that was against the CAA's statutory duties. It is this 'threat' (with the consequential unfavourable reputational and financial outcomes associated with tighter regulation), which operates as the incentive for STAL to act as if it faced effective competition.

3.87 While taking forward proposals for price monitoring for STAL, the CAA will also undertake calculations using a RAB, LRIC and comparator based approaches, to use these as reference ponts to assist with its judgement of the appropriateness of future price levels.

3.88 The options discussed in this Chapter have been presented at a relatively stylised, high level. The CAA recognises that it needs to develop a detailed explanation for what a price monitoring regime may mean in practice for STAL in Q6. This is the subject of Chapter 4.

CHAPTER 4

A Price Monitoring Regime for STAL

4.1 This chapter explains in more detail how the CAA's initial proposals for a price monitoring regime could work for STAL in Q6. This section sets out:

- examples of price monitoring regimes used in the UK and other countries;
- how such a regime can build on the basic requirements in the ACR;
- reporting obligations on STAL under price monitoring;
- the CAA's role to enhance transparency and provide a credible 'backstop';
- the threshold above which STAL's pricing will need to be justified and which could lead to tighter regulation;
- the proposed review of the operation of this regime;
- special arrangements for the cargo market at Stansted; and
- views of the CAA Consumer Panel.

Price monitoring in the UK and other countries

4.2 Forms of price monitoring (also known as Information Disclosure) with a threat of re-regulation are used in a number of other regulatory regimes (as set out in FE's follow-on report[44]) including:

- regulation by the Australian Competition and Consumer Commission (ACCC) of Adelaide, Brisbane, Canberra, Darwin, Melbourne, Perth and Sydney airports in Australia;
- regulation by the New Zealand Commerce Commission (NZCC) of Wellington, Auckland and Christchurch airports in New Zealand;

[44] First Economics, March 2013, *Airport Price Monitoring: Further Insights*, available at: http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=14279.

- regulation by the NZCC of the electricity distribution networks in New Zealand; and
- regulation by Ofcom of the Royal Mail in the UK.

4.3 Other examples of price monitoring require the regulated company to provide information annually (and in some cases provide some information quarterly) across a number of dimensions of performance. As set out in the FE report:

- Australian airports are required to report on volumes, prices, revenues, costs, profits, asset values, rates of return, quality of service and car parking;
- New Zealand airports are required to report on prices, profits, innovation and investment, efficiency and quality;
- New Zealand electricity distribution networks are required to report on: profit and return on investment, RAB, cost information, comparisons of forecast to actual expenditure, prices and pricing methodology, revenues and volumes, network integrity and asset management plans; and
- Royal Mail is required to report on financial performance, operational performance including performance against efficiency targets and quality of service targets, universal service prices and competition (access prices, transfer charging, headroom and cost allocation). It is also required to provide detailed costing information.

4.4 These regimes have developed over time (the Australian regime has been in place since 2002 and has been reviewed by the Productivity Commission (PC) in its 2006, 2008/9 and 2011 reports). The PC has been generally positive in its assessment of airport regulation:

- investment outcomes continue to be strong;
- pricing outcomes appear to have been within reasonable limits;
- quality outcomes are 'satisfactory'; and
- commercial negotiation continues to develop.

Price monitoring and the Airport Charges Regulations

4.5 STAL will remain subject to the ACR. The ACR provide airlines (but not directly passengers) with a number of protections, which include the following requirements:

- airport operators must consult annually with airlines on airport charges and service quality;
- airport operators have to provide airlines with information about the overall cost structure and revenues relevant to charges;
- airport operators have to provide four months' notice of changes to the system or level of airport charges or to the quality of service associated with an airport charge;
- airport charges must not discriminate between airlines but they can differentiate between airlines for reasons that are relevant, objective and transparent and this can include cost and the quality and scope of services;
- airport charges can also vary between categories of airport users for reasons relating to the public and general interest where the criteria used for varying charges are relevant, objective, and transparent; and
- airport operators must consult airlines on major infrastructure projects.

4.6 As set out in the CAA's January 2013 'minded to' MPT assessment,[45] there are a number of reasons why the ACR on their own may not provide sufficient protection for passengers and cargo users at Stansted in Q6:

- the ACR does not require charges to be cost reflective - while charges should vary according to transparent criteria, this does not have to include costs or quality of service. Also the ACR does not control the overall level of charges and so is unlikely to provide protection against the risk of excessive prices;

[45] CAA, Stansted Market Power Assessment: developing our 'minded to' position, January 2013.

- the ACR is likely to provide limited incentives for the airport operator to be efficient - the airport operator is required to provide details of the overall cost structure associated with different charges. However, this is unlikely to be sufficiently detailed to allow airlines to challenge robustly the efficiency of airport costs;
- the ACR imposes limited incentives for the airport operator to provide an efficient level of service quality - the airport operator has to consult on the level of charges and where appropriate service quality, but this may not lead to efficient levels of service quality; and
- compliance with the ACR may not lead to efficient investment. The airport operator has to consult on investment, but there is no requirement to consider the results of that consultation in deciding on its capex programme, or to undertake an appropriate level of investment.

4.7 The aim of price monitoring is to supplement (rather than duplicate) the protection provided by the ACR. In particular, the aim is to provide greater protection around the overall level of charges set by STAL, and to supplement the incentives for cost efficiency, service quality and for STAL to provide an efficient level of investment.

4.8 Price monitoring by itself does not directly restrict STAL from increasing prices or from lowering service standards to exploit its SMP. Price monitoring could increase the level of transparency about STAL's performance which may help airlines to hold STAL more firmly to account and support them in negotiating longer-term bilateral contracts and deals.

4.9 However, price monitoring is limited in its scope to identifying possible problems with STAL's behaviour based on the data submitted. Further investigation would be required to establish whether there actually is a problem and the extent of the concerns. It is the threat of regulatory action and, in particular, the threat of more stringent regulation, together with the adverse reputational and financial consequences for STAL that such regulation would entail, that provides the incentive for STAL to avoid abusing its SMP and to behave as if it was in an effectively competitive market.

4.10 Therefore, price monitoring aims to enhance the requirements in the

ACR and involves three ways of moderating STAL's behaviour:

- reporting obligations - which include the threat of re-regulation;
- greater transparency - which empowers airlines; and
- publication/reporting by the CAA - which empowers airlines and impacts on STAL's reputational incentives.

4.11 If the price monitoring regime works well, it should encourage STAL to exercise self-discipline and to self-regulate so as to bring acceptable prices and performance to customers without the need for price controls or other direct regulatory intervention.

4.12 Given the changes involved, and to reflect the CAA's 'minded to' finding that STAL's market power in the passenger market (LCC and Charter) is likely to increase over the period 2014 to 2019, the CAA would expect to allow stakeholders some time to understand and adjust to the new regime. The CAA would therefore not expect to re-impose tighter regulation in the first two years of the regime, unless there was clear evidence that STAL was taking advantage of the situation to the detriment of passengers and cargo owners or otherwise distorting the structure of competition in the relevant market.

STAL's Reporting Obligations under Price Monitoring

4.13 Under price monitoring, STAL would be required to provide the CAA with information about its prices, cost, efficiency, service quality and investment performance. This would allow the CAA to monitor STAL's performance and report and comment on it.

4.14 The reporting obligations (set out in STAL's licence) might include the following.

- Pricing: The ACR will require airport operators to publish prices. However, this does not cover bilateral contracts. Reporting average yields from its aeronautical/airport charges will alert the CAA to the possibility of STAL exercising its SMP. Also, reporting income from the standard tariff rate will indicate the prices paid by parties who may be in a weaker competitive position and are not able to negotiate bilateral contracts with STAL.

- Profitability: this gives an indication of whether STAL is making excessive profits considering the risk that it faces. This may suggest that prices are higher than they would be in an effectively competitive market.
- Operating costs and efficiency: this gives an indication of improvements in STAL's efficiency and of whether prices are reasonably reflective of costs. The CAA would want costs to be broken down by key areas to understand trends over time and to determine whether there are particular areas of STAL's operations where efficiency is declining or not increasing as fast as other areas. Cost allocation principles could be established in regulatory accounting guidelines.
- Investment: it will be important to ensure that STAL undertakes investment efficiently (particularly where it is paid for up-front and there is a long gap before the asset is used) and that the investment delivers the outputs required by users. This could be at an aggregate level or a more granular level.
- Service quality: this is a key aspect of performance, as a decline in service quality reduces the overall price service package. The Q5 rebate regime (discussed in Chapter 2) was agreed between STAL and airlines. It comprises 15 measures of service quality[46] (both passenger and airline facing) that indicate efficient and reliable services to users. This would form the basis for assessing service quality under price monitoring, but if STAL and the airlines chose to agree a different service quality performance regime, the CAA would consider adjusting the requirements.
- The CAA is also considering including a measure of overall passenger satisfaction in the reporting requirements. The CAA recognises that passenger responses in the airport QSM survey may take account of factors outside the airport operator's control (e.g. service at check-in desks). However, the CAA believes that it still provides useful information on the overall performance of the airport operator, of which the CAA could take account when considering STAL's performance under price monitoring.

[46] Economic Regulation of Stansted Airport 2009-2014, CAA Decision, Annex E, March 2009.

- Other charges and revenues[47]: these tend to be airport operation services where STAL could potentially exercise SMP and hence should be included within the reporting metrics required under price monitoring. In Q5, these services were subject to transparency (and cost reflectivity) requirements. In the CAA's view, the Q5 transparency condition has worked well; reassuring users that these charges are based on appropriate criteria and do not impose an unnecessary burden on STAL. Given this and the lack of complaints from users during Q5, the CAA proposes reflecting the Q5 transparency condition in a licence obligation on STAL. The CAA, however, proposes to make two changes:
    - to remove check-in desks, baggage facilities and hydrant refuelling from the list, as charges for these services are already required to be transparent under the Airports (Ground Handling) Regulations 1997;[48, 49, 50] and
    - to remove the requirement to explain why any variations from the profit centre reports provided to the CAA, as this may create an unnecessary additional burden and the CAA may seek further information if necessary.

4.15 STAL would also be required to provide financial information on profits and investment and also a 'shadow RAB'. This would facilitate the reintroduction of RAB-based regulation if the CAA decided that the price monitoring framework was not promoting the desired outcomes and that reintroduction of a RAB-based price cap was the most appropriate form of regulation. In order to ensure consistency between data sets, the data would (as now) be required on a financial

[47] These include revenues derived from the following services: check in and baggage services, staff car parking at the airport, staff ID cards, fixed electrical ground power, hydrant refuelling, airside parking, airside licences, other desk licences, cable routing, maintenance, heating and utility services and facilities for bus and coach operators.

[48] The CAA is not proposing transparency under Price Monitoring of charges on airlines for persons with reduced mobility, as this is already required by Regulation (EC) 11-7/2006.

[49] Regulation 16(d) requires that any fee charged for airport installations necessary for suppliers of groundhandling services has to be determined according to ‘relevant, objective, transparent and non-discriminatory criteria’.

[50] Additional transparency would therefore be required for charges for: staff car parking, staff ID cards, fixed electrical ground power, airside parking, airside licences, other desk licences, cable routing, facilities for bus and coach services, maintenance, heating and utility services.

(April to March) year basis.

4.16 A set of proposed reporting metrics is outlined in figure 4.1. The CAA proposes to develop more detailed definitions for these requirements over the next few months.

Figure 4.1: Proposed reporting metrics for reporting obligations

Type of information	Required disclosure for previous financial year
Prices	Average airport charges/aeronautical yield, income from published charges
Profitability	Percentage rate of return on total airport assets
	Percentage rate of return on STAL's aeronautical assets
	Percentage rate of return on shareholder's equity investments
Volumes	Passenger numbers, Air Traffic Movements (ATMs) split by passenger and non-passenger flights
	Cargo tonnage
Operating costs	Total airport operating costs
	Costs of key cost lines e.g. security
	Productivity metrics including operating costs per passenger and operating costs per aircraft
Investment	Total outturn investment
	Delivery of investment against business plan by project
Service Quality	Performance against service quality metrics reported on as part of the Q5 SQR scheme
	Overall measure of passenger satisfaction from the QSM survey
Non-aeronautical revenues	Individual revenues from other currently specified activities
	Non-aeronautical revenues by main line item (retail, car parking, property, other)
Customer Satisfaction	Customer satisfaction with consultation process
Regulatory accounts	Audited Profit and Loss, splitting costs and revenues between aeronautical and non-aeronautical
	The most recent Strategic Business and Investment Plan and Five Year Financial Forecasts

Type of information	Required disclosure for previous financial year
	Detailed statement of accounting policy, explanation of changes over time and reconciliation with previous year's regulated accounts
RAB	Outturn capex, acquisitions, disposals, estimated depreciation, opening RAB, closing RAB

Source: CAA

4.17 These data requirements would be set out in a Regulatory Reporting Notice (RRN). The CAA proposes that it will issue this in January each year and that it would list the information requirements for the forthcoming financial year. STAL would be required to provide to the CAA the information in the RRN together with a brief explanation and commentary of movements and trends by 31 July each year for data relating to the previous financial year. The CAA notes that Australian airports subject to price monitoring are required to provide more extensive information disclosure reports within 90 days of their year-end.

4.18 While the expectation is that the reporting requirement will remain unchanged until the regime is reviewed, were the CAA to seek any changes to the requirements, it would inform stakeholders on such changes in advance of issuing the RRN.

4.19 The CAA envisages that a subset of the information it receives would be available to users, for example through the annual monitoring report. However, there is a question as to the appropriate level of detail for such disclosure. It would of course be open to STAL to share this and any other relevant information directly with its customers as would generally be the case under a normal commercial arrangement.

The CAA's role under price monitoring

An annual report on STAL's performance

4.20 A key part of the price monitoring framework is the regulator's annual report on the regulated company's performance.[51] This allows the

[51] The ACCC report on prices, financial performance and quality of service monitoring at

regulator to highlight areas of the company's performance that may be causing concern, gain stakeholder feedback on the company's performance and create expectations about the outcome of the following review and regulatory consequences if poor performance continues.

4.21 The requirement to monitor STAL's performance and produce an annual report does have implications for the resources required by the CAA to fulfil its regulatory functions. However, this is an integral feature of this type of regulatory approach. Were the reports to be produced less frequently (say every 2 to 3 years), there could be a concern that this would not provide an effective constraint on STAL exercising its market power and could lead to customers facing a long period of adverse impacts before the CAA was able to re-introduce tighter regulation. It would also make raising concerns in one report and considering STAL's progress in addressing those concerns and delivering on commitments to improve performance in subsequent reports a much less effective part of the regime.

4.22 In essence, the absence of an annual report by the CAA would be closer to Option C in the FE report (see Chapter 3), which FE argued was more likely to be appropriate for an airport operator:

- which only just passed the MPT test and faced meaningful competitive constraints across a significant proportion of its revenue base; and
- which the CAA was convinced was committed to working with its customers in a normal commercial manner and to reaching agreements with them without regulatory intervention.

4.23 The CAA therefore proposes to publish by the end of each calendar year a report on STAL's performance related to the previous financial year. The CAA would expect the annual report to cover the information STAL is required to produce in the RRN (subject to any redactions the CAA considers necessary on the basis of commercial confidentiality).

Australian airports is at http://transition.accc.gov.au/content/index.phtml/itemId/347781. The New Zealand Commerce Commission report summarising and analysing the information that is publicly disclosed by regulated electricity lines businesses is at http://www.comcom.govt.nz/electricity-information-disclosure-summary-and-analysis/.

4.24 The report would also include the CAA's commentary and assessment of STAL's performance and areas for improvement or concern. The report may also contain data and commentary on overall market developments and other relevant information such as price comparisons with other comparator airports and complaints by STAL's airline customers and final passenger and cargo customers.

4.25 The commentary in the report would allow the CAA to draw attention to areas of STAL's performance that had deteriorated or otherwise raise concerns and either provide a 'warning' to STAL that it needed to improve its performance in order to avoid a more intrusive investigation (with the possibility of licence modifications to address such concerns) or highlight the need for further investigation that could ultimately lead to tighter regulation.

4.26 The annual report should help provide airlines with information to hold STAL more accountable and give them confidence to develop longer term bilateral deals with STAL if this is in their interest. The CAA would expect that, where concerns over STAL's behaviour fell within the scope of the ACR (for example price or non-price discrimination), airlines would use this mechanism to address their concerns in the first instance.

'Show cause' trigger

4.27 Price monitoring relies on the ex-post monitoring of outcomes. Users have no guarantee over the potential behaviour of the regulated company, only that the CAA has the ability to investigate and ‘step in’ if outcomes raise significant concerns. Given this, and the potential risk of STAL exercising its SMP, the CAA considers that, at least initially, it should pre-determine the level of airport charges where STAL would be required by the CAA to 'show cause' (i.e. explain and justify its actions).[52]

4.28 If the level of airport charges breached this threshold, STAL would be required to demonstrate to the CAA why such pricing is what would be expected from a company operating in an effectively competitive

[52] In this respect the position of STAL is different from that of Royal Mail in that the CAA believes that STAL's prices could be above the competitive level and therefore is concerned about future price rises, while Ofcom considered that Royal Mail's prices were below the competitive level and therefore offered more commercial freedom with regular reporting to allow price rises, but still keep a focus on achieving cost efficiency objectives.

market. The CAA may accept STAL's explanation as there may be good reasons such as a rise in underlying efficient costs or investment, but the burden of proof would rest on STAL to justify its actions.

4.29 The CAA would not expect to 'pre-approve' or otherwise give STAL comfort in advance that price rises above the trigger would be acceptable. The CAA reserves the right to undertake a detailed investigation and reintroduce tighter regulation if it is not satisfied with STAL's justification. The CAA intends this to be a credible incentive on STAL to ensure that it does not abuse its SMP.

4.30 The CAA recognises that an increase in airport charges is not the only manner in which STAL could exercise SMP. However, price increases can have a significant impact on users and have been a subject of much debate between users and STAL over recent years. Price is also an important context for Q6 highlighted by research into passenger interests at STAL (see Chapter 2). Service quality has been subject to much less debate and controversy. Other indicators such as cost efficiency and investment are essentially leading indicators and the CAA considers that these would be better dealt with through annual reporting. The CAA, however, will monitor developments and if concerns in these areas arise, the CAA would consider introducing additional 'show cause' thresholds or other measures where appropriate.

The threshold for the CAA's 'show cause' trigger

4.31 Having decided on the principle of a 'show cause' trigger, the CAA needs to set a threshold level for this to help manage stakeholder expectations. The CAA has considered a wide range of alternatives for this with the aim of using a reasonable proxy for a competitive benchmark.

4.32 The CAA notes that the OFT's approach to dealing with excessive pricing "would usually look for evidence that prices are substantially higher than would be expected in a competitive market, and that there is no effective competitive pressure to bring them down to competitive levels, nor is there likely to be".[53]

The regulated price

4.33 There was a dual rationale for the price caps set by the CAA for Stansted for Q5: that the caps were the product of a 'building block' methodology; and that the CAA considered that the resulting price control profile was consistent with the development of more effective competition between airport operators over time.[54] The regulated price cap is currently around £7.11 (2011/12 prices). STAL has been pricing up to the regulatory cap (although it may not price up to the full cap in 2013/14). As discussed in Chapter 3, the CAA considers there are a number of reasons why this regulated price may not be consistent with a competitive benchmark.

LRIC

4.34 The advantages and disadvantages of using a LRIC approach to set price caps are set out in Chapter 3. Despite its reservations about employing this methodology, the CAA commissioned consultants EE to undertake LRIC calculations for Stansted (and Gatwick).

4.35 EE indicated that a MEAV approach was likely to be the best estimate of the competitive price. This gives a LRIC estimate of around a £1/passenger below the current regulated price cap (2011/12 prices), although there is significant variation between the different LRIC measures (see figure 4.2) and the choice of any one approach is to a certain extent arbitrary. EE emphasised that its LRIC estimates are sensitive to the assumptions underpinning them, with estimates changing by +/- 10% to 15% with relatively small changes in assumptions.

[53] OFT414a, Assessment of conduct: Draft competition law guideline for consultation, paragraph 2.6 http://www.oft.gov.uk/shared_oft/business_leaflets/competition_law/oft414a.pdf.

[54] In reaching a view on the appropriate price level, the CAA placed some weight on the LRIC estimate of £7 per passenger and took into account the price paid by Ryanair and easyJet across the airports that they used and the average aeronautical revenue per passenger across a range of UK airports. The CAA also took the competitive price into account when deciding on the profiling of the price cap during the price control so that the price cap increased during Q5 and was closer to the competitive price at the end of the control period, although the CAA, at the time consider that the LRIC estimate would still be above the price cap in 2013/14.

Figure 4.2: LRIC calculations for Stansted - £/pax, 2011/12 prices

Increment	LRIC
Max use single runway (35 mppa) - SG1 plans (capacity schemes only)	1.8
Max use single runway - SG1 (all schemes	6.1
Second runway	8.5
Max use single runway - STAL Strategic Business Plan 2011	0.8
Modern equivalent replacement cost	6.3

Source: EE. Note: The EE analysis used the Q5 cost of capital of 7.1%.

Price benchmarking

4.36 One the key factors that the CAA considered when assessing the competitive price level was benchmarking a comparator peer group for Stansted (see Chapter 3). The research the CAA commissioned from LF indicated that STAL's aeronautical revenue per passenger is approximately up to £1.00 above the average of comparable airport operators and about £1.50 above the subset of airport operators that are subject to lighter regulation. LF estimated that the margin of error of this analysis was +/- 10% to 15% (equivalent to £0.60 to £0.90).

4.37 The CAA cross-checked the validity of these results by examining the actual prices charged at comparator airports to its main airlines under long term contracts. The CAA found that these prices were lower than the prices currently charged by STAL.

RAB-based comparator

4.38 The CAA has calculated an indicative RAB-based price cap for STAL. A summary of the CAA's analysis is set out in Appendix A.

4.39 Due to concerns over interfering with the sale process, the CAA agreed with STAL not to undertake detailed consultancy work reviewing individual RAB-based building blocks. STAL's business plan is consistent with the data in the Information Memorandum that was provided to potential buyers of the airport. Consequently, the CAA does not consider that the business plan would be subject to the same biases as normal regulatory submissions (i.e. to understate), but if anything could overstate revenues and profits.

4.40 The CAA has, however, undertaken a more detailed review of the three building blocks that are likely to be the most critical for the calculation of a RAB-based comparator: traffic, opex and the WACC.

4.41 The CAA considers that STAL's traffic forecasts appear reasonable, albeit there is a range of uncertainty as discussed in Chapters 2 and 3.

4.42 The CAA has assessed opex using a number of sources. These include its mid Q review of STAL’s opex undertaken by Steer, Davis and Gleave (SDG) and employment cost benchmarking undertaken by consultants IDS Thomson Reuters (IDS). The CAA has also had regard to ‘top-down’ benchmarking undertaken by its consultants Cambridge Economic Policy Associates (CEPA).

4.43 The key observations the CAA draws from its review of this evidence are as follows.

- The mid-Q review identified that there could be potential efficiencies in rostering, staff and intragroup and electricity distribution costs.
- The employment cost benchmarking identified that the staff paybill could be cut by 16 to 18% if reduced in line with benchmarks. The report identified further potential efficiencies from removing grade shift, reducing absence and reducing pension costs.
- There is further potential for improving the efficiency of rosters and passenger flow rates at security.
- The top-down benchmarking has identified annual efficiency improvements of 0.9% to 1.0% per year may be possible due to ongoing improvements in efficiency that take place across the economy, with some further scope for additional catch-up efficiency, as STAL catches up with previous underperformance.

4.44 STAL has included efficiencies to staffing levels in the business plan but has not addressed issues such as pay rates and pension costs (staff costs are 38% of opex), or included a top-down efficiency trajectory. The CAA's initial view is that a reasonable opex efficiency reduction would be -1% to -2.5% per year in real terms (this compares to a 0.4% real increase in opex in the BP).

4.45 The CAA commissioned consultants PricewaterhouseCoopers (PwC) to provide estimates of the WACC. PwC calculated that the WACC is lower than the 7.1% estimate used in Q5 due to a reduction in corporate tax and the cost of debt. Based on a review of the PwC report the CAA considers a reasonable range for the WACC may be around 6.0% to 6.5%.

4.46 Figure 4.3 shows the forecast RAB-based price cap with CAA low and high scenarios based on different assumptions on the WACC and opex. All other assumptions are as in the STAL BP. Based on this analysis, it appears that a RAB-based approach could produce a price cap of between RPI -2.5% and RPI -5.4% per year, although the precise level is subject to considerable uncertainty. For example, if the impact of discounts is removed from STAL's traffic forecasts then this would reduce traffic by around 13% in 2018/19. STAL has emphasised the inherent uncertainty in their traffic forecasts which impact on their suitability for use in the RAB-based framework. If the impact of the discount is removed from STAL's traffic forecasts then this would increase the RAB-based price cap by 2.9% per year. This would move the CAA high and low range to RPI +0.4% and RPI -2.5% per year.

Figure 4.3: RAB-based comparator price caps

	STAL business plan	CAA Low	CAA High
Cost of capital	7.1% (Q5[55])	6.0%	6.5%
Opex (compared to BP)	STAL Business Plan (RPI+0.4% per year)	RPI -2.5% per year	RPI -1.0% per year
Potential price cap	RPI -1.1%	RPI -5.4%	RPI -2.5%
Without discount led growth			
Potential price cap		RPI -2.5%	RPI +0.4%

Source: CAA

Note: The STAL business plan did not include a WACC assumption. The Q5 assumption has been used for comparison purposes. STAL stated that that it expected the WACC to be higher than Q5.

Level of the 'show cause' trigger

4.47 The CAA recognises that a reasonable approximation for a competitive benchmark for the 'show cause' trigger requires judgement and that there is no simple way to derive it. The CAA has

[55] The Q5 headline rate was 7.1%. However, in Q5 this was adjusted downwards to 6.86% to reflect the timing of cash flows and it was 6.86% which was applied to the Q5 RAB to calculate the price cap.

therefore looked at a range of alternatives above, recognising that each one has a range of uncertainty associated with it.

4.48 The CAA notes that some information (such as the comparator index and LRIC calculations) points to a competitive price below the current regulated price. However, the CAA does not consider that it is reasonable to reduce the maximum average airport charge in nominal terms for two reasons. First, it may take some time for STAL to generate the opex efficiencies that may allow it to reduce prices. Second, the uncertainty in the competitive price analysis makes it difficult to be certain at what level the price reduction should be set and how this price should change over time. The CAA notes that even keeping prices constant in nominal terms would imply a significant improvement in real cost efficiency (particularly if underlying inflation rose significantly). Nevertheless, it is open to MAG to offer such reductions if it can reach mutually beneficial deals with the airlines.

4.49 This implies that it might be better to set the 'show cause' trigger between flat nominal and flat real prices to encourage prices to move towards the competitive level over time, but allow STAL time to generate cost efficiencies. The CAA therefore proposes to set the trigger at half the rate of inflation (RPI/2). In this context, it is important to emphasise that the 'show cause' trigger does not prevent STAL from charging prices above this level, but that it would need to provide robust justification for such price increases.

CAA's response to a breach of the 'show cause' trigger or other poor performance

Investigation

4.50 If STAL's performance breached the 'show cause' trigger, or if other aspects of its performance were not what the CAA would expect from an operator facing effective competition[56] then the CAA would expect the airport to:

[56] For example sustained excessive profits, a poor record on service quality or cost efficiency, a failure to address concerns raised in previous CAA reports or credible and legitimate complaints from airlines and final customers

- explain its performance and how it has gained consent from the airlines or sought to gain their consent;
- propose corrective measures to improve its performance; and
- explain why the CAA should not introduce stricter regulation.

4.51 If the CAA was not satisfied with STAL's explanation and/or proposals, it could propose a detailed investigation and following this could seek a re-introduction of more stringent price controls by modifying the licence conditions for STAL.

Short-term price freeze

4.52 In order for the prospect of tighter regulation to impose an effective discipline on STAL's behaviour, it should contain appropriate incentives to deliver the aims of price monitoring. A concern in this regard is that it could take considerable time for the CAA to complete the licence modification processing order to decide on an appropriate remedy and there is therefore a risk that STAL could exercise or abuse its SMP during this period.

4.53 The FE report recommends that "for the prospect of re-intervention to impose the maximum possible discipline on an airport … there may be merit in the CAA programming a short-term price cap into an airport's licence. This default price cap would automatically switch on in the event that the CAA finds that self-regulation isn't working and there is a need to re-regulate."

4.54 The CAA considers that it is appropriate for the licence to make provision for the triggering of a short-term price cap that would come into effect if the CAA had found material concerns with STAL's behaviour under the price monitoring regime and was proposing to take the necessary steps to consider an appropriate remedy.

4.55 There is provision under Section 21(1)(a) of the Act for licence conditions to have effect at times or in circumstances specified in the condition. The circumstances in the context of STAL's licence would therefore be specified by reference to the presence of 'show cause' triggers, failure to provide satisfactory explanation and/or proposals to address the CAA's concerns regarding STAL's performance as outlined above. Where these specified circumstances are present, an appropriate price freeze of a defined duration would take effect.

Tighter regulation of STAL

4.56 If the CAA has identified material concerns with STAL's behaviour under the price monitoring regime, the CAA would initiate the process to impose an alternative tighter regulatory approach. It should not be presumed that this will lead to RAB-based price cap regulation, or that if it does that it would be based on the value of the shadow RAB calculated by STAL rather than some other measure such as MEAV. The CAA would expect to consider a range of options and choose the most appropriate approach given the circumstances and situation at the time. Such a modification would be subject to the right of appeal set out in the Act for licence modifications.

Review of price monitoring regime

4.57 It would be appropriate for the CAA to review the operation and workings of the price monitoring regime once it has had a chance to 'bed-down' and to understand how STAL reacts to the regime. The CAA therefore proposes that the regime is reviewed before the end of the third year of its operation. This review could lead to a number of options such as changes to the 'show cause' trigger. Of course if the CAA had in the interim initiated the process to impose tighter regulation because it had identified material concerns with STAL's behaviour then this would supersede the review.

Views of the CAA Consumer Panel

4.58 The CAA sought the views of its Consumer Panel on the form of regulation and, in particular, price monitoring. The Consumer Panel:

- supported monitoring of service quality within a price monitoring regime (if considered appropriate for an airport operator with less market power);
- emphasised, within service quality monitoring, the importance of ensuring transparency (and potentially data availability) and that users' concerns and not just those of airlines are considered; and
- would expect an annual review of STAL's performance by the CAA with the threat of re-regulation.

Cargo

4.59 The CAA's 'minded to' market power assessment identified that STAL had a position of SMP in the cargo market. Consequently, the CAA proposes to continue with the arrangements under Q5, that the charges applied to non-passenger flights (e.g. for landing) should be no higher than those applied to an equivalent passenger aircraft.

4.60 The CAA also proposes to continue to implement the public interest finding of the CC with respect to the structure of charges for cargo. The CC concluded that the current structure of landing charges at Stansted, which failed to give off-peak discounts to aircraft in excess of 250 metric tonnes, had no basis and had been operating against the public interest.

4.61 The CAA therefore required that STAL fix its airport charges for the landing of aircraft so that the charge levied for landing an aircraft in excess of 50 metric tonnes but below 250 metric tonnes during a peak period is higher than the charge levied for landing at other times. Where this condition continues to apply, the charges levied for landing aircraft in excess of 250 metric tonnes shall, at all times, bear the same relationship to the equivalent charges levied on aircraft in excess of 50 metric tonnes but below 250 metric tonnes.

CAA's initial proposals

4.62 The CAA's initial proposals are that a price monitoring regime for STAL for Q6 should have the following key characteristics:

- a removal of the fixed regulatory price cap on STAL's maximum average airport charges when the present arrangements expire in April 2014;
- STAL will be required to report information to the CAA to enable it to produce an annual report on STAL's performance, which will highlight any areas of regulatory concern;
- the CAA will specify a 'show cause' trigger on price increases of half RPI (RPI/2);

- if STAL breached the 'show cause' trigger or if other aspects of its performance were not what the CAA would expect from an operator facing effective competition, then STAL would need to justify itsperformance to the CAA’s satisfaction or, in the case that it is not, it will invite the CAA to consider more intrusive and tighter regulatory options;
- if the CAA conducts a full investigation and is not satisfied with STAL's explanation or proposals, there is an automatic price freeze during the process for introducing a licence change to the regulatory regime;
- the arrangements to be established for a five-year period starting from April 2014, but subject to a review of their operation (including on the level of the 'show cause' trigger) by the CAA before the end of the third year;
- special requirements to reflect the nature of the cargo market at Stansted; and
- the arrangements to be included in a licence condition for STAL.

CHAPTER 5

A Licence for STAL

5.1 Should the CAA confirm later this year its 'minded to' view that STAL passes the MPT in the Act, it would expect to issue STAL with a licence. This Chapter discusses the structure of the licence, what must be in the licence granted to STAL and what it might be desirable to include the licence. It discusses the issue of financial resilience in detail and examines whether there are any other issues, which at this stage, ought to be the considered for the STAL licence.

5.2 The licence was 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 draft conditions that the CAA considered would be necessary. Since then, the CAA has discussed the conditions with STAL and other stakeholders.

5.3 A draft of a licence for STAL is contained in Appendix B.

Structure of the STAL licence

5.4 The draft licence has been prepared by considering approaches to licensing in other economic regulated sectors in the UK. It is currently structured as follows.

- Part I: Scope and interpretation of the licence. These terms define the airport operator, airport area and certain points of interpretation.
- Part II: Conditions on fees and revocation. These conditions enable the licence to be operational and govern the arrangements for payment of fees to the CAA and licence revocation.
- Part III: Price control conditions. These conditions will give legal effect to the CAA's final decisions on this issue. Should the CAA confirm that it wishes to pursue a price monitoring regime, these conditions will be contained in this part of the licence.

- Part IV: Service quality conditions. This condition will set out STAL's operational resilience obligations. Although research indicates that passengers are generally satisfied with the experience at Stansted, this research does not take into account passengers' experiences during times of service disruption and nor do the current SQR arrangements. However, it is during these occasions that passengers can experience significant anxiety and detriment. The CAA therefore intends to use STAL's licence to strengthen its approach to planning for service disruption and its response to passengers in the event of such disruption.
- Part V: Financial conditions. These conditions relate to STAL's obligations to improve its financial resilience, such as maintaining a continuity service plan.

5.5 The requirements in Part I and Part II are either required by the Act for any licence or necessary to make the licence work. The conditions for STAL are the same as in the draft licence prepared for HAL and GAL save for certain issues that are airport specific such as the name of the airport operator and the area to which the licence relates. More detail on the description of these requirements is set out in the CAA's initial proposals for HAL and GAL.

5.6 Part III contains the draft licence requirements with respect to the price monitoring and information disclosure regime. As such, it will be different from any HAL and GAL licences and tailored to the situation for Stansted. This is not surprising as this part of the licence is the key area where arrangements should be tailored to the specific circumstances of the airport.

5.7 The requirements in Part IV with regards to operational resilience are the same as for Heathrow and Gatwick, reflecting the fact that the principles of mitigating passenger harm in the event of service disruption should apply to all regulated airports. The approach to assessing compliance will, however, take account of the circumstances at the particular airport: for example, the severity of the risk of poor operational resilience and the degree of likely detriment to passengers and cargo owners. For more detail on the description of these requirements, please refer to the CAA's initial proposals for HAL and GAL.

5.8 The requirements in Part V for strengthening STAL's financial resilience, could be different from Heathrow and Gatwick as discussed below.

Financial resilience

5.9 In performing its duty to further the interests of users of air transport services, the CAA must do so in a manner that will promote competition in the provision of airport operation services. Furthermore, 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.

5.10 Most other regulated companies have ‘ring fence’ provisions in their licences which restrict the types of activities they can undertake and how they set up their financial arrangements. These provisions seek to minimise the risk of financial distress which could have adverse impact on consumers. The Act allows the CAA to include such provisions in the airport operator licences, subject to the CAA's duties.

5.11 The Act does not require the CAA to introduce financial resilience ring fencing conditions nor does it require any such conditions to be consistent with existing financial arrangements. However, 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 derogations or activation of 'dormant' conditions in respect of financial resilience.[57]

[57] An alternative approach could be to introduce a full ring fence into the licence but to derogate those aspects that cut across 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 STAL’s future financial arrangements.

However, it is not clear how long these conditions would remain dormant, or indeed if they would ever be used. 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. To provide clarity and greater certainty, the CAA will issue

Requirements proposed for STAL

5.12 The CAA’s initial proposals for HAL and GAL include elements of the standard utility style ring fence. They include conditions similar to those found in regulated utilities where they are consistent with but do not merely duplicate, protections found in existing financial arrangements; and the benefits outweigh the costs (figure 5.1).

Figure 5.1: Summary of HAL and GAL initial proposals

Included in financial resilience conditions in initial proposals	Excluded from financial resilience conditions in initial proposals
Restriction on business activities Parent company undertakings Certificate of adequacy of resources Continuity of service plan Need to inform the CAA of changes to ring fence type conditions in financial arrangements	Prohibition on the granting of security Prohibition on the disposal of assets without CAA approval Prohibition on granting of cross default guarantees Credit rating requirement

Source: CAA's Initial proposals for Heathrow and Gatwick (April 2013)

5.13 The CAA is mindful that it must carry out its functions in a manner that it considers will promote competition in the provision of airport operation services. To introduce a suite of financial ring fence conditions for STAL that is more extensive than HAL and GAL would appear to jeopardise competition in the long-term with either those airport operators or with the operators of other non-regulated airports such as Luton and Southend.

5.14 Given the CAA's views on the degree of SMP STAL has, it is not axiomatic that the introduction of any financial resilience conditions would discourage competition with Southend and Luton. The CAA considers that its options for financial resilience conditions are bound by on the one hand those it proposes for HAL and GAL and on the other hand by the absence of such conditions at other airports (for

a policy statement setting out the circumstances in which it would use that mechanism and how, to provide certainty and clarity for the future.

example, Luton and Southend).

5.15 The CAA's initial proposals are that STAL should be subject to the same requirements as those on HAL and GAL. However, the CAA will continue to work closely with STAL on this issue and it does not rule out adopting a slightly different approach from the other airports upon further consideration (see below).

Costs and benefits of the CAA's initial proposals for STAL

5.16 The CAA has considered whether benefits of introducing financial resilience conditions similar to those it proposes at HAL and GAL outweigh the costs of this approach. The CAA is mindful of introducing and administrating such a package of measures in a cost effective manner.

5.17 There are good reasons concerning the interests of users for the CAA to include some conditions on financial resilience in STAL's licence. For example, financial distress could cause detriments to passengers' interests in both the short and the longer term. The economics of an airport whose operator has SMP may suggest, however, that even in time of financial distress, the airport is likely to remain open because it is likely to generate cash. Nevertheless, there could be a temporary closure[58], for example, while an administrator resolves legal and operational issues. Financial distress may also lead to reduced expenditure at the airport with implications for service quality. Furthermore, investors might re-assess their views on the riskiness of airports in general which could lead to a higher WACC or a difficulty raising capital.

5.18 The CAA considers that the proposed licence conditions concerning 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.

5.19 The annual certificate of adequate resources will incur some costs for the airport, although these can be reduced if the timing is aligned with the airport's annual reporting. The CAA considers that these costs will

[58] 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.

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.

5.20 The continuity of service plan, both in its preparation and review, is likely to create costs for the airport. 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 cost to users of service disruption, the benefits of a plan are expected to be significantly higher than the cost of producing the plan.

5.21 The CAA considers that the current, relatively benign circumstances might be the most appropriate time to introduce financial resilience conditions.

5.22 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. For example, the CAA is interested in exploring with stakeholders whether all of the financial resilience conditions are appropriate in the context of a price monitoring regime rather than a RAB based regime.

Potential other licence conditions

5.23 The CAA considers that there may be merit in considering other licence conditions for STAL. 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.

5.24 The issues that the CAA will consider further are listed in the next paragraphs. It should be noted that this list is not exhaustive and that the CAA may decide not to pursue certain issues upon further consideration.

5.25 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 these other legal requirements.

5.26 Consultation protocol. The CAA will need to consider whether the licence should contain a condition akin to the present 'Annex G' of the CAA's price control determination for Q5 that set out its expectations on how STAL will consult airlines on various matters.

5.27 Complaints handling. The CAA would like to understand whether the licence should contain clear requirements on STAL in relation to how it deals with passenger complaints.

5.28 Revocation. In addition to the reasons for licence revocation set out in the draft licence (Appendix B), 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 common in licences for other regulated companies.

5.29 Non-discrimination conditions. The CAA may need to consider whether the licence should contain any competition type conditions. In doing so, the CAA will need to avoid duplicating or cutting across existing obligations such as the ACR or the Competition Act 1998.

The CAA initial proposals

5.30 The CAA proposes a licence for STAL in the form described above if it confirms its view that it passes the MPT in the Act. The STAL licence will have some requirements that are necessary, either because the Act prescribes them or because they are necessary to make the licence operational. Aside from some STAL specific clauses, such as the airport operator name and airport area, these requirements are the same for all regulated airports with a licence.

5.31 The CAA proposes that the STAL licence should contain conditions that are aimed at strengthening its operational and financial resilience. The CAA considers that the benefits to users could outweigh the costs of these conditions.

5.32 The main area of the licence that will be completely different from HAL and GAL is the price control section, because the CAA is proposing a new price monitoring and information disclosure regime.

APPENDIX A

Indicative RAB-Based Price Cap Calculations

A1 This Appendix provides a RAB-based price cap calculation for STAL for Q6. It discusses the main building blocks including:

- traffic forecasts;
- opex;
- non-regulated aeronautical revenues;
- commercial revenues and other income;
- capex;
- the opening and closing RAB;
- WACC; and
- indicative Q6 price cap.

A2 STAL's BP is consistent with the data in the Information Memorandum that was provided to potential buyers of the airport. Consequently, the CAA does not consider that the BP would be subject to the same biases as normal regulatory submissions (i.e. to understate), but if anything could overstate revenues and profits. The CAA has therefore focused its review on the three building blocks that are likely to be the most critical for the calculation of a RAB-based comparator: traffic, opex and the WACC. It should be emphasised that the BP reflects the views of the previous owners, BAA, and does not necessarily represent the views of the new owners, MAG. All views attributed to STAL in this appendix refer to STAL when it was under previous ownership unless otherwise stated.

A3 The assessment draws on the output of CE, where the SACC tended to represent the views of the airlines.

A4 All figures are in 2011/12 prices unless otherwise stated.

A5 The RAB-based calculation is based on a single till approach. This has merits based on policy consistency and consistency 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. 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[59].

Traffic forecasts

A6 As an input to CE, STAL provided a forecast of passengers and ATMs based on bottom-up forecasts of short term airline plans and a top-down model which reflected the impact of different traffic drivers, for example economic growth. Each of the High, Central and Low Case forecasts was based on a defined set of probabilities of occurrence of the key input variables[60].

A7 There is no major disagreement between the airlines and STAL on the principle of using a blend of bottom-up and top-down approach to forecasting traffic at Stansted, whilst taking into account capacity constraints at the London airports. However, there has been no specific agreement on the assumptions and traffic forecasts for Q6.[61] Whilst not accepting STAL's traffic forecasts, the airlines did agree to use them as the basis for further CE discussions.

A8 The CAA considers that STAL's approach is a reasonable forecasting methodology despite the inherent uncertainties in traffic forecasting for Stansted. The CAA notes that: the Q5 forecasts were significantly different from outturns due in part to the effect on traffic of the unpredicted economic downturn and volcanic ash.

A9 There may be reasons for considering that the Central Case forecast by STAL as part of CE is likely to underestimate for two reasons.

[59] More detail for this is given in the Heathrow initial proposals document

[60] The CE forecasts were based on a key initial assumption, for the purposes of CE, that the level of charges remained flat in real terms over the Q6 period.

[61] In May 2012 Ryanair provided STAL with its traffic forecasts for Stansted based on various levels of airport charges. According to Ryanair's proposals, Stansted could restore growth to 24m passengers per year within a six-year period under the "right" conditions.

First, the outturn traffic of 17.5 million in 2012 was higher than the 17.1 million forecast. Second, a comparison with the latest forecast published by DfT in 2013[62] indicates that STAL's central forecasts for Stansted are 13% to 15% lower than DfT's, although similar assumptions were used for oil prices and economic growth. The CAA therefore considers that STAL's central forecasts could under estimate the potential for traffic growth at the airport.

A10 Towards the end of CE, STAL updated its forecasts to take account of an additional uplift to reflect discount led growth. These forecasts reflect higher growth than that included in the earlier STAL forecasts. The BP included these revised forecasts. In light of the above discussions and information available to date, the CAA considers that these updated forecasts appear reasonable. The CAA therefore proposes to use the traffic forecasts in figure A1 below, which are in line with STAL's revised forecast.

Figure A1: CAA's Q6 passenger assumptions

	2014/15	2015/16	2016/17	2017/18	2018/19	Q6 Total
Passengers (m)	18.3	19.6	20.9	22.0	23.3	104.1

Source: STAL Business Plan, January 2013

A11 Likewise, the CAA proposes to use the cargo tonnage forecasts in figure A2 below, which are in line with STAL's forecast.

Figure A2: CAA's Q6 cargo assumptions

	2014/15	2015/16	2016/17	2017/18	2018/19	Q6 Total
Cargo tonnage (000s)	252	264	277	290	304	1,387

Source: STAL Business Plan, January 2013

Capital expenditure

A12 There was no agreement between STAL and airlines on the Q6 capex programme, although both parties agreed that further engagement on key projects would be beneficial. STAL and airlines agreed that the CAA should only reflect the cost of strategic and capacity-related investments in the price cap when they are undertaken, given the

[62] DfT, UK Aviation Forecasts, January 2013

uncertainty over timings. The BP Q6 capital plan is £142.1 million (figure A3), the vast majority of which (86%) is on asset renewals and mandatory schemes. The capital plan represents around only 2% of the RAB value. For the purposes of calculating an indicative price cap, the CAA has used the forecasts in figure A3.

Figure A3: BP Q6 capex assumptions

£m 2011/12 prices	2014/15	2015/16	2016/17	2017/18	2018/19	Total
Asset renewals	20.1	17.0	18.3	19.4	21.8	96.5
Mandatory	0.5	10.0	12.0	3.7	0.0	26.2
Strategic	6.3	1.7	1.6	1.8	0.8	12.2
Capacity	0.0	0.0	0.0	2.0	5.3	7.2
Total	**26.8**	**28.7**	**31.9**	**26.9**	**27.8**	**142.1**

Source: STAL Business Plan, January 2013 and STAL

A13 The SACC provided feedback on the capex plans. Key areas of concern highlighted by the SACC were:

- baggage system replacement - while the SACC agreed the importance of the effective operation of the baggage system, it asked STAL to review the scope of the project to ensure that remained fit for purpose given the decline in traffic volumes;
- tracked transit system rehabilitation or redevelopment - airlines did not consider that either option was cost effective and asked the airport to develop a lower cost walkway to satellites 1 and 2; and
- International Departure Lounge (IDL) reconfiguration - where airlines supported the reconfiguration of the IDL, provided that this avoided negative operational impacts and was done in the most efficient way.

A14 STAL responded to the SACC's comments, stating that it was undertaking further work on the development schemes and would shortly be providing further details to airlines. Following the change of ownership, STAL has subsequently instigated full consultation on the terminal scheme.

A15 A further airline concern related to the allowances for risks, where estimates can reach 30% for individual projects, when the airlines argued that many asset replacements were risk free. STAL replied that risk allowances were required to cover unforeseen scope and cost risks. STAL stated that allowances of 20 to 30% for Q6 were consistent with the early stage of development of most schemes and benchmark to other airport schemes.

A16 The CAA notes that the capex plan will undoubtedly change in particular with the change of ownership of the airport, with new owners likely to have new ideas and proposals for schemes.

A17 For the purposes of the RAB-based comparator the CAA has used the BP capital plan forecasts.

Operating expenditure

A18 Due to the planned sale of Stansted, STAL stated that it was not able to participate in CE opex discussions. The parties were therefore not able to reach any agreement over opex projections.

STAL's January 2013 Business Plan

A19 As part of the CE process, STAL published a BBP in May 2012, which provided two opex scenarios. Subsequently, STAL published a (final) BP in January 2013 providing an updated central opex forecast.

A20 Over Q6, the BP forecasted opex to increase from £146 million in 2013/14 to £149 million in 2018/19, a rate of 0.4% per year. Passenger numbers were expected to increase so that opex per passenger would fall from £8.31 to £6.41, a reduction of 5.1% per year. Overall reductions in cost per passenger were expected to be driven primarily by a return to higher levels of passenger growth leading to increased security staff utilisation. This would also drive higher energy consumption. Rates costs were expected to increase as a result of the revaluation in 2015.[63]

A21 The airlines expressed concerns over levels of STAL's opex efficiency, especially in relation to security costs. The SACC commissioned an analysis from ATM Accounting Services of security roster information provided by STAL to estimate the potential for opex

[63] The CAA understands that the rates revaluation will be delayed to 2017. We return to this point in the discussion of rates cost below.

savings. This indicated that there was significant inefficiency in STAL's security operations arising from inefficient rostering, excessive reliance on over-time payments and 'hours paid but not worked'. Overall this study estimates that there was potential for efficiency of around £14 million per year from 2011.

Discussion of Key Issues

A22 The CAA has undertaken several pieces of analysis to inform its initial proposals. It has assessed STAL’s performance in Q5 against the forecast used to set the price control; commissioned several independent studies of various aspects of STAL’s opex performance and developed a comparison of airport and airline cost performance. These analyses are described in the following paragraphs.

Airport Opex Benchmarking Evidence

A23 The CAA has reviewed several pieces of opex benchmarking evidence. In each of these studies, opex per passenger has been used to assess the relative performance of different airports adjusting for factors such as depreciation and irregular costs. Opex per passenger at Stansted was between £6.92 and £7.73 compared to comparator averages of between £7.16 and £8.94. This would tend to suggest that Stansted is relatively efficient; however, Stansted is a relatively small airport in comparison with the samples used in these studies. Its traffic is also dominated by LCCs (such as Ryanair), which means that its costs will tend to be lower than the average of the sample. Within these studies, opex per passenger is shown to be higher at Stansted than at some more specific comparators such as Birmingham, Edinburgh and Glasgow suggesting STAL is not at the efficient frontier.

A24 Building on the evidence described above, the CAA has undertaken additional comparative analysis of the relative performance of STAL, in terms of adjusted opex per passenger, based on the latest data.[64] Based on its analysis of financial accounting data, the CAA has estimated adjusted opex per passenger for a range of airports, taking account of differences in exchange rates and general price levels

[64] Adjusted opex excludes depreciation, retail, ANS, rail and losses on asset disposals. The metric is intended to provide an estimate of the core costs of airport operation. In some cases these costs have been estimated based on airport averages.

using Purchasing Power Parity (PPP) indices for international comparators.[65]

A25 The analysis indicates that adjusted opex per passenger at Stansted declined very rapidly in 2003 then remained relatively stable until 2007. Since then, costs per passenger have increased more rapidly than the group average. This coincides with the recession and the decline in passenger numbers at the airport and suggests that there is likely to be scope for opex reductions in line with historical performance if the airport was able to increase passenger numbers and utilisation in line with historical levels.

A26 Overall, the CAA's analysis suggests that STAL's opex per passenger is relatively low in comparison with the average, but higher than several comparable airports and its own historical performance, suggesting that STAL has scope to improve opex efficiency in Q6.

Consultancy Studies Commissioned by the CAA

A27 In preparation for Q6, the CAA commissioned several consultancy studies related to opex. The key findings of each of these studies are summarised in the following sections.

Mid Q Review of Stansted (undertaken by SDG)

A28 This study[66] reviewed the principle drivers of operating costs at Stansted and benchmarked levels of cost against other airports. The study estimated that there was a potential 10% efficiency saving (for security costs) based on the introduction of a daily, rather than a weekly, roster and greater hourly flexibility to cope with fluctuations in passenger throughput. Benchmarking of electricity costs against other airports indicates that unit costs were the second highest of the sample at £0.090 per kWh against a range of between £0.074 and £0.104. The report noted that electricity rates are high in comparison with other airports (benchmarks between 7.4p and 7.8p).

A29 The report noted that "recent experience from the sale of Gatwick suggest that there are reasonable expectations of a reduction in the

[65] Purchasing Power Parity indices indicate the relative price level in different countries and are often used to compare costs in different countries taking account of price levels. International comparisons are sensitive to different exchange rates and PPP indices.

[66] SDG, May 2012, *Review of operating expenditure and investment consultation (Annex D),, Mid-term Q5*, available at: http://www.caa.co.uk/docs/5/SDGStanstedReport.pdf

cost categories currently allocated intra-group by BAA". The study did not make a direct assessment of the potential for efficiency savings at the airport, however based on the 10% roster efficiency target described above, the CAA estimates that costs could potentially be reduced by around £2 million per year. Since this study was undertaken STAL has undertaken some changes to staff rostering described in a later section.

Employee reward benchmarking study (undertaken by IDS)

A30 This study[67] examined levels of pay and historical and forecast rates of increase at Stansted in comparison with the wider economy and benchmarks within the aviation industry. Overall, the IDS study concluded that if rates of total cash reward (basic salary, shift, overtime and bonus pay) at Stansted were brought into line with the benchmark comparisons, staff costs could be reduced by between 16% and 18%.[68] The CAA estimates that such savings would be between £8 million and £9 million per year. The IDS study also benchmarked STAL's pension costs. Based on this analysis, the CAA estimates that if STAL were able to bring its pension costs into line with benchmarks, costs could be reduced by up to £2 million per year.

Pension Scenario Analysis Study (undertaken by Hymans)

A31 In order to assess the ability of STAL to achieve the reductions in pension costs described above, IDS and Hymans undertook four scenario tests based on common changes to DB pension schemes. This study[69] suggested that pension costs could be reduced by between £1 million and £3 million per year.

Potential for Future Efficiency Study (undertaken by CEPA)

A32 This study[70] sought to examine the potential for efficiency gains at Heathrow, Gatwick and Stansted over Q6. It concluded that, based

[67] IDS, January 2013, *Benchmarking employment costs, Stansted*, available at: http://www.caa.co.uk/docs/1350/Benchmarking%20employment%20costs%20-%20A%20research%20report%20for%20the%20CAA%20-%20nonconfidential%20version.pdf

[68] On a total reward basis (including pension costs) staff costs at STAL are even further from benchmarks. The CAA estimates that total reward costs are between 37% and 42% higher than benchmarks on average.

[69] This study is included in IDS benchmarking employment costs study

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

on a comparison of historical changes in Real Unit Operating Expenditure (RUOE) across comparator airports and STAL's own deviation from its historical peak, STAL is likely to have scope for further catch-up efficiency. It also estimated that an efficient organisation with a cost structure similar to STAL should expect to see net frontier efficiency shift of between 0.9% and 1.0% per year. The BP does not appear to include any frontier shift or 'stretch target'. On this basis, this study suggests that additional efficiency savings of around £4 million per year should be included in the BP.

Rates Costs

A33 The BP estimates that rate costs are expected to increase by 15% between 2014/15 and 2016/17 based on a 25% uplift in rateable values following the planned revaluation in 2015. The CAA understands that the revaluation has been rescheduled to 2017, meaning that this increase should occur two years later than stated in the BP. This would reduce opex by around £4 million over Q6. In addition the CAA considers that, whilst there is some uncertainty over the impact of the revaluation, the 25% uplift is likely to be too high.

Security Efficiency

A34 The consultancy studies and airline consultation have raised several points regarding security efficiency. Specifically, the significant reductions in peak processing flow rates, apparently low levels of rostering efficiency, and the potential for security outsourcing to reduce costs at the airport. Each of these points and the CAA's initial assessment is described below.

A35 The SDG Mid Q Review report states that peak security processing flow rates have declined from 211 passengers per hour per lane in 2007 to 143 in 2011, increasing the number of security staff required to deal with peak periods. This has increased cost per passenger at STAL by around 40%.Average flow rates of 143 passengers per lane per hour are relatively low compared with some other airports.

A36 The decrease in flow rates has been attributed to increasing security checks, and changing passenger behaviour, for example the increase in the level of passengers carrying electronic items which require additional x-ray images to be taken, increasing the workload of security staff. The CAA has been provided with some evidence which suggests that this is an important factor driving the decline of passenger flow rates. However, the CAA understands that other airports have been able to maintain or improve flow rates despite these same pressures. This suggests that STAL may be able to improve its flow rates over Q6.

A37 The Mid Q Review undertaken by SDG indicated that there is the potential for a 10% reduction in security costs if STAL were able to increase its rostering efficiency through moving to more flexible shift patterns. STAL has considered plans to improve security rostering efficiency, which could reduce security costs by around £2.4 million per year. STAL states that it has included 3/4 of this potential efficiency within its BP.

A38 Based on the analysis above, the CAA considers that STAL may be able to make further efficiencies in security over Q6 of around £0.6 million per year.

Summary of Opex Efficiency Analysis

A39 In combination, the evidence from the efficiency analysis described above indicates that STAL should be able to reduce opex further relative to the BP. Based on the upper and lower efficiency estimates described above, and before the consideration of risk and rate of change, such efficiencies are likely to be equivalent to a reduction of between £10 million and £20 million per year by the end of Q6 relative to the BP. This is equivalent to an average reduction of 1.0% to 2.5% per year from 2013/14. In comparison, the BP implies cost growth of 0.4% per year from 2013/14 over Q6.

A40 The CAA recognises that every method for benchmarking STAL's opex projections has some imperfections. The planned sale of the airport has also limited the extent to which the CAA has been able to examine specific costs lines. Overall, the CAA considers that there is evidence that STAL could improve efficiency over Q6 relative to its BP, particularly with regard to wage and pension costs.

A41 Some factors point to a fairly assertive stance on the scale of potential efficiencies. These include the relatively high growth in cost per passenger over the past three years and the high level of pension costs. On the other hand there are several factors that suggest that a lower point in the range may be more appropriate. For example, many of the benchmarks are derived from comparators that cannot completely take into account all aspects of STAL's operating environment. In addition, even an organisation at the 'frontier' of cost performance is unlikely to be efficient in every dimension. Finally, many of the savings may require time to be efficiently implemented.

A42 Given the uncertainties, the CAA has estimated a range for opex efficiency with a high and low scenario (figure A4).In the low opex scenario, the CAA considers that opex will fall from £146 million per year in 2013/14 to £129 million in 2018/19, a reduction of 2.5% per year. In the high opex scenario, the CAA considers that cost will fall from £146 million in 2013/14 to £139 million in 2018/19, a reduction of 1.0% per year.

Figure A4: CAA’s Q6 opex assumptions

£m 2011/12 prices	2014/5	2015/6	2016/7	2017/8	2018/9	Total
Opex – low	143	139	136	132	129	678
Opex – high	145	143	142	141	139	710

Source: CAA

Commercial revenues and other income

A43 Commercial revenues comprise retail revenues, such as those from duty and tax-free airside shops, bureau de change, catering and car parks, and property income through the rental of property space. Other income is mostly non-airport rents. Commercial revenues were not discussed as part of CE. The BP forecasts total commercial revenue of £112.5 million by the end of Q6. The CAA proposes to use the BP forecasts for the purposes of calculating an indicative price cap, as shown in figure A5.

Figure A5: CAA's commercial revenue and other income assumptions

	2014/15	2015/16	2016/17	2017/18	2018/19	Total
Commercial revenues	88.8	96.0	102.4	106.9	112.5	506.6

Source: STAL Business Plan, January 2013

Revenue from other charges

A44 The activities covered by these charges are: check-in desks, staff car parking passes, staff security passes, fixed electrical ground power, aviation fuel rents, PRM income and utilities and facilities for bus and coach stations. Under a single till approach this revenue is included in the calculation of a RAB-based price control. Other charges were not discussed during CE. The BP included forecasts of revenue from other charges, which the CAA proposes to use for the purposes of calculating an indicative price cap (figure A6).

Figure A6: CAA'sQ6 other charges revenues assumptions

	2014/5	2015/6	2016/7	2017/8	2018/9	Total
Other charges revenues	16.7	16.7	17.0	17.0	17.1	84.5

Source: STAL Business Plan, January 2013

RAB

A45 The forecast closing value of the RAB for Q5 is taken as the forecast opening value for Q6.STAL has continued to record the value of the RAB in its audited regulatory accounts. These accounts, audited by STAL's statutory auditors, set out the value spent on Q5 capex (and proceeds from disposals) for the first three years of Q5. STAL estimates the opening Q6 RAB to be £1,209 million.

A46 The depreciation charge deducted from the RAB during Q5 is the same as that which was included in the CC's recommendation, and therefore consistent with the CAA's Q5 decision. The CAA has verified STAL's indexation calculations. The CAA calculates an opening RAB of £1,195 million.[71]

[71] The CAA notes that while information provided by STAL was generally in 2011/12 prices, the RAB figure if £1,209 million is in fact in 31 March 2012 prices. This has led the CAA to use an opening Q6 RAB figure of £1,195 million which is approximately £14 million lower than STAL's calculation.

Figure A7: CAA's Q6 RAB assumptions

£m 2011/12 prices	2014/15	2015/16	2016/17	2017/18	2018/19	Total
Opening RAB	1,195	1,176	1,157	1,140	1,118	1,195
Net capex	27	29	32	27	28	142
Depreciation	(45)	(48)	(49)	(49)	(51)	(243)
Closing RAB	1,176	1,157	1,140	1,118	1,094	1,094
Average RAB	1,185	1,167	1,149	1,129	1,106	-

Source: CAA

Weighted average cost of capital

A47 The BBP assumed a WACC of 7.1% as required by the CE mandate, although STAL noted that its cost of capital was substantially higher than this due to relatively high degree of sensitivity in Stansted's traffic and financial performance to macroeconomic conditions, airport competition and other factors. The CAA received no other submissions from STAL or from other stakeholders in respect of the WACC. The CAA engaged PwC to advise on the estimation of the WACC.[72] Other than for beta and gearing (which PwC recommended should not change from Q5), PwC estimated the same value for the components of the WACC (the risk-free rate, the equity risk premium and the tax rate) for Stansted as it did for Heathrow and Gatwick. PwC estimated the same cost of debt for Stansted as it did for Gatwick.

A48 PwC recommended that the gearing assumption in the Stansted WACC should be the same as the Q5 decision at 50%. This compares to PwC's recommendation of 60% for Heathrow and 55% for Gatwick. The choice of gearing reflects the underlying business risk of the airport - the higher the business risk the lower gearing should be. Business risk includes both systematic risks (which are also factored into the estimation of the asset beta in the CAPM framework) and non-systematic risks.[73]

[72] PwC's reports can be found on the CAA website: http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=14279

[73] Systematic risk is the risk inherent to the entire market. It is also known as un-diversifiable risk

A49 PwC also recommended that the asset beta assumption should be the same as Q5 and in the range 0.55 to 0.67. This compares to PwC's recommendation of 0.42 to 0.52 for Heathrow and 0.46 to 0.58 for Gatwick.

A50 The CAA's review of credit rating reports, PwC's analysis and the CAA's analysis concludes that Stansted's returns are relatively riskier than Heathrow and Gatwick and hence, other things being equal, Stansted should attract a higher asset beta. The nature of Stansted's airline base means that it recovers more slowly from shocks than does Gatwick and Heathrow. Stansted relies on a small number of LCCs whose operations are more point-point than network in nature. Stansted may be considered the riskiest of the three airports, though it also serves London and South East England and operates in the same macro-economic environment.

A51 The corporate tax rate has declined from 28% at the time of the Q5 decision to 23% now, with the Chancellor signalling that it might be further reduced to 21% (from April 2013) and 20% (from April 2014). The reduction from 28% to 20.2% (the average for a 5 year Q6) alone would reduce the Q5 accounting rate of return of 6.86% (as derived from the WACC from 7.1%) to approximately 6.58%. Figure A8 shows the WACC calculation for Stansted.

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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.

Figure A8: STAL's WACC

	CAA/CC Q5	PwC - Current market rates	PwC - Long-term returns
Gearing	50%	50%	50%
Pre-tax cost of debt	3.4 - 3.7%	2.35 - 3.05%	2.7%
Risk-free rate	2.0%	0.25 - 0.75%	1.6%
Equity risk premium	3.0-5.0%	6.0%	5.0%
Asset beta (number)	0.55 – 0.67	0.55 – 0.67	0.61
Equity beta (number)	1.00 – 1.24	1.0 – 1.24	1.12
Post-tax cost of equity	5.0 – 8.2%	6.25 – 8.19%	7.20%
Tax rate	28%	20.2%	20.2%
Pre-tax cost of equity	6.94 – 11.39%	7.83 – 10.26%	9.02%
Pre-tax WACC range	5.20 – 7.54%	5.09 – 6.66%	5.86%
Pre-tax WACC point estimate	7.1% (6.86%)*		
Vanilla[74] WACC range	4.20 - 5.95%	4.3 - 5.62%	4.95%
Vanilla WACC point estimate	≈ 5.6 (5.46%)*		

* The headline WACC for Q5 was 7.1%. However, it was the accounting rate of return of 6.86% that was the rate applied to the RAB to the RAB. The 'vanilla' equivalents were a Q5 vanilla WACC of 5.6% and a Q5 vanilla ARR of 5.46%.

Source: CAA

A52 Though there is no significant planned capex in the RAB-based price cap, the CAA still has to be mindful of setting the allowed WACC too low. Most importantly, it is difficult for a regulator to reduce the risks of underinvestment within a regulatory period. However, if the WACC is set too high, the airport's shareholders will be over-rewarded and customers will pay more than they should. Taking these factors into account, the CAA concluded that the allowed WACC range should be set in the top half of the range. The CAA considers that an appropriate range for the WACC for Stansted is 6.0% to 6.5% and this has been used for the low and high scenarios respectively.

[74] The 'vanilla' WACC is the weighted average of the pre-tax cost of debt and the post-tax cost of equity. Because it excludes the effect of taxation it simplifies comparisons across sectors (which have different approaches to taxation) and across time (when the tax rate changes).

RAB-based price comparator

A53 This section brings together the 'building block' components discussed in the previous sections and calculates the potential price cap under a RAB-based approach under two scenarios: high and low, based on different assumptions on the WACC and opex (figure A9). The CAA has assumed that cargo income would vary with STAL traffic growth forecasts, and the resulting passenger airport charge profile. The calculations imply a cap on the yearly increase of airport charges of between RPI-5.4% and RPI-2.5%.

Figure A9: CAA's RAB-based price comparator (Low and High Scenarios)

2011/12 prices	Unit	2014/15	2015/16	2016/17	2017/18	2018/19
Opex (low)	£ million	143	139	136	132	129
Opex (high)	£ million	145	143	142	141	139
Depreciation	£ million	45	48	49	49	51
Cost of cap. (low)	£ million	71	70	69	68	66
Cost of cap. (high)	£ million	77	76	75	73	72
Total revenue (low)	£ million	259	257	254	249	247
Total revenue (high)	£ million	267	267	266	263	262
Commercial revenues	£ million	(89)	(96)	(102)	(107)	(113)
Other charges revenues	£ million	(17)	(17)	(17)	(17)	(17)
Other Income - Cargo (low)[75]	£ million	(8)	(8)	(8)	(8)	(7)
Other Income - Cargo (high)[75]	£ million	(8)	(8)	(9)	(9)	(9)
Net revenue (low)	£ million	145	136	126	118	110
Net revenue (high)	£ million	153	146	138	131	124
Passengers	Million	18.3	19.6	20.9	22.0	23.3
Yield per pax (unprofiled) (low)	£ per pax	7.95	6.94	6.04	5.36	4.70

[75] Because of an underlying pricing assumption for cargo, for consistency, the low cargo revenue is paired with the low total revenue and high cargo revenue is paired with the high total revenue.

2011/12 prices	Unit	2014/15	2015/16	2016/17	2017/18	2018/19
X (low) = -5.4%						
Year-on-year change (low)	%	-5.0%	-5.2%	-5.6%	-5.6%	-5.2%
Yield per pax (profiled) (low)	£ per pax	6.90	6.54	6.18	5.83	5.53
Yield per pax (unprofiled) (high)	£ per pax	8.38	7.43	6.59	5.95	5.33
X (high) = -2.5%						
Year-on-year change (high)	%	-2.2%	-2.4%	-2.8%	-2.8%	-2.4%
Yield per pax (profiled) (high)	£ per pax	7.10	6.93	6.73	6.54	6.38

Source: CAA calculations

A54 The CAA is proposing a price monitoring regime with a 'show cause' trigger (a threshold for airport charges above which the CAA would expect to carry out a full investigation). This approach does not, in itself, cap Stansted's prices, and therefore, the CAA considers that STAL is able to finance its provision of airport operation services. The CAA's view is that a financeability assessment is not required for this form of regulation given that the CAA is not setting a price cap but simply monitoring prices.

A55 The year-on-year change approximates, but is not strictly equal, to the X because of the form of the price cap formula (RPI+X) is not the same as the calculation of the year-on-year change (1+RPI)x(1+X)-1.

APPENDIX B

STAL licence conditions

Part I: Scope and interpretation of the licence

Licensed Operator

1. Licensed Operator means Stansted Airport Limited (the Licensee).

Airport Area

2. The Airport is Stansted 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 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 of the Act revoking 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 Monitoring

Regulatory reports

1. In every year that this Licence is in force, the Licensee shall provide to the CAA as soon as reasonable practicably, and in any event no later than [31 July], the information specified in the most recent Regulatory Reporting Notice published by the CAA before the start of the relevant year.

2. The Licensee shall provide such explanations as are necessary for CAA to understand the underlying the methodology used to calculate the reporting data referred to in Condition [3.]1 and provide a short summary of movements and trends in the data provided in Condition [3.]1.

Short Term Price Cap

3. Condition [3.]4 has effect if the CAA has issued a Temporary Price Control Notice.

4. The Licensee shall not thereafter raise any of its prices while the Temporary Price Control Notice remains in force.

5. A Temporary Price Control Notice shall remain in force until the earlier of the following:

   a) the issuing by the CAA of a notice terminating the Temporary Price Control Notice;

   b) the CAA modifies the Licence under section 22 of the Act to include a price control condition as defined by section 19 of the Act; or

   c) the period set out under the Act for making an application for permission to appeal against a licence modification has expired.

Regulatory Accounts

6. In every year that this Licence is in force, the licensee shall prepare and publish as soon as reasonably practical, and in any event not later than [3 months] after the end of the financial year to which they

relate, a set of regulatory accounts in a manner consistent with Regulatory Accounting Guidelines notified by the CAA.

7. If no Regulatory Accounting Guidelines are notified to the Licensee before 1 January in the relevant year, the Regulatory Accounting Guidelines from the previous relevant year shall be used.

8. The Licensee shall keep and, so far as it is able, procure that any connected person keeps the accounting records which it is 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.

9. The Licensee's regulatory accounts shall:

   a) be prepared in accordance with applicable law and except so far as the CAA reasonably considers necessary, International Financial Reporting Standards (IFRS) as adopted by the EU from time to time; and

   b) state the accounting policies to be adopted.

10. The Licensee shall procure, in respect of the regulatory accounts prepared in accordance with this condition a report by its Auditors addressed to the CAA stating whether in their opinion those accounts have been properly prepared in accordance with this Condition and the Regulatory Accounting Guidelines and on that basis fairly present the financial performance and financial position of the Licensee.

11. The Licensee shall deliver to the CAA and publish the Auditors' report referred to in Condition [3.]10 at the same time as the regulatory accounts as required by Condition [3.]6.

Definitions

12. In this Condition 3:

   a) Regulatory Reporting Notice means any notice issued by the CAA and identified as such, setting out the data that the Licensee is required to provide;

   b) Regulatory Accounting Guidelines means any guidelines issued by the CAA and identified as such, setting out the approach that the Licensee should use in preparing its regulatory accounts;

c) Temporary Price Control Notice means a notice issued by the CAA and identified as such, setting out that the CAA is concerned with the Licensee's performance by reference to the criteria set out in [ ] and proposing to take the necessary steps under section 22 of the Act to modify the Licence to address those concerns;

d) Relevant year means the period of 12 months ending with 31 March in each year;

Condition 4: Charges for cargo operators and large aircraft

1. In each of the five consecutive years beginning on [1 April 2014] the operator of Stansted airport shall not levy airport charges in respect of air services that do not fall within the definition of passenger air services that are higher than are levied in respect of equivalent air services falling within that definition.

2. Condition [4.]3 shall apply when and for so long as the Licensee fixes its airport charges for the landing of aircraft so that the charge levied for landing an aircraft in excess of 50 tonnes but below 250 metric tonnes during a peak period is higher than the charge levied for landing at other times.

3. Where this condition does apply, the charges levied for landing aircraft in excess of 250metric tonnes shall, at all times, bear the same relationship to the equivalent charges levied on aircraft in excess of 50 metric tonnes but below 250 metric tonnes.

4. This Condition 4 shall continue in force until [31 March 2019] unless, before that date, they are modified or withdrawn.

Definitions

5. In this Condition 4 passenger air services means air services carrying passengers that join or leave an aircraft at Stansted airport, including air services operated for the purpose of business or general aviation.

Condition 5: 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 5 shall continue in force until [31 March2019] unless, before that date, it is modified or withdrawn.

Definitions

7. In this Condition 5 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 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 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, information about their relevant rights under the denied boarding regulations during disruption.

Definitions

16. In this Condition 6

a) Conditions of Use means the Stansted Airport Conditions of Use including Airport Charges as reviewed and 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 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: 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 [7.]2(a) or (b).

4. The Licensee shall obtain and submit to the CAA with each certificate provided under Condition [7.]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:

a) any and all business undertaken by the Licensee and its subsidiary undertakings as at [1 April 2014];

b) to the extent that it falls outside condition [7.]6(a), 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

c) 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 Covenanter a legally enforceable undertaking in favour of the Licensee in the form specified by the CAA that that Covenanter will:

a) refrain from any action, and procure that every subsidiary of the Covenanter (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 a company or other person in question becoming a Covenanter and shall remain

in force for so long as the Licensee remains the holder of this Licence and the Covenanter remains a Covenanter.

9. The Licensee shall:

a) deliver to the CAA, within seven days of obtaining the undertaking required by Condition [7.]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 7 the Covenanter means a company or other person which is at any time an ultimate holding company of the Licensee

Condition 8: 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 [8.]1.

3. The continuity of service plan prepared under Condition [8.]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

AA86	the Airports Act 1986
ACCC	Australian Competition and Consumer Commission
ACR	Airport Charges Regulations 2011
ASQ	Airport service quality
ATMs	Air traffic movements
BBP	Baseline business plan
BP	Business plan
capex	Capital expenditure
CAT	Competition Appeal Tribunal
CC	Competition Commission
CE	Constructive engagement
CEPA	Cambridge Economic Policy Associates
CEWG	Stansted CE Working Group
DfT	Department for Transport
EE	Europe Economics
FE	First Economics
GAL	Gatwick Airport Limited
HAL	Heathrow Airport Limited
IDL	International Departure Lounge
IDS	IDS Thomson Reuters
IFRS	International Financial Reporting Standards

LCC	Low cost carrier
LF	Leigh Fisher
LRAIC	Long-run average incremental costs
LRIC	Long-run incremental costs
MAG	Manchester Airports Group
MEAV	Modern equivalent asset value / valuation
MPD	Market power determination
MPT	Market power test
NZCC	New Zealand Commerce Commission
opex	Operating expenditure
PC	Productivity Commission
PPP	Purchasing power parity
PRMs	Passengers with reduced mobility
PwC	PricewaterhouseCoopers
Q5	the fifth quinquennium
Q6	the sixth quinquennium
QSM	Quality survey measurement
RAB	Regulatory asset base
RRN	Regulatory Reporting Notice
SACC	Stansted Airport Consultative Committee
SDG	Steer Davis and Gleave
SG2	Second runway project
SMP	Substantial market power
SQR	Service Quality Rebate
STAL	Stansted Airport Limited

the Act	the Civil Aviation Act 2012
the airlines	the airlines operating at Stansted
WACC	Weighted average cost of capital