Civil Aviation Authority

Economic regulation at Gatwick from April 2014: final proposals

CAP1102

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Executive Summary

Purpose of the document

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

2. Please note the **deadline for responses** to this consultation is **4 November 2013** and they should be sent to airportregulation@caa.co.uk. Parts of the responses that are confidential should be clearly marked as such. The CAA cannot commit to taking into account responses received after this date.

Delivering the CAA's statutory duties

3. These proposals are those the CAA considers are best calculated to further its relevant statutory duties, which are found in the Civil Aviation Act 2012 (The Act). The primary duty is to further the interests of users (passengers and owners of air freight) regarding the range, availability, continuity, cost and quality of air operation services; and a range of other matters that the CAA must have regard to.

4. In assessing users' interest, the CAA has taken account of airlines' views (among others), recognising that airline interests often align with those of users. However, this is not always the case, and the CAA has also reviewed a wide range of direct research about user views and preferences. The CAA has been advised by its Consumer Panel.

5. In assessing users' interests, the CAA must balance the interests of present users in lower airport charges with the interests of future

users in GAL’s ability to continue to be able to invest in modern infrastructure and services in a timely manner. (Of course, present and future users will often be the same people.) Under section 1(5) of the Act, if there is a potential conflict between the interests of different classes of users or between their interests in the various different parameters set out in section 1(1), the CAA is directed to carry out its functions in a way that will further such interests as it thinks best.

6. These final proposals are built around commitments offered by GAL. They will be backed by a licence, the main aim of which is to ensure that the commitments are in fact honoured and to ensure the CAA can continue to act where appropriate to protect users. The CAA will also monitor how the new commitments and licensing regime operates in practice. The CAA proposes that this is the best way to further its duties, particularly the primary duty to users, for several reasons.

- The price commitments provide a discount to what the CAA regards as the fair price for a five year Regulatory Asset Base (RAB) based control, and locks in lower future charges for longer, providing greater certainty to airlines and their passengers.
- The commitments will provide a better framework to diversify the service offering and to incentivise volume growth. This is because they encourage bilateral contracts which can allow service quality, capital investments, operational practice, volume commitments and price to be better tailored on an integrated basis to the needs of individual airlines and their passengers. RAB-based regulation allows for bilateral contracts only on a very limited basis, and cannot provide the same degree of tailoring.
- The commitments should promote competition by facilitating innovation and diversity of offer. These are necessary, although not sufficient, for competition between airports. Although capacity limits reduce competition between London airports, it is nevertheless an expansion of choice for at least some users if airports are enabled to diversify their offerings.
- Embedding the commitments within a licence provides a backstop protection of licence enforcement, for instance if there are reductions in service quality that are against users' interests.

- The commitments will encourage GAL to improve its efficiency as the price is below the five year RAB price. The longer time period of the commitments should provide GAL with greater incentives to reduce operating expenditure and outperform commercial revenue assumptions.
- The commitments will facilitate efficient investment as GAL would have flexibility to tailor investment to the needs of airlines, while the licence will provide users with backstop protection to ensure that investment is undertaken in users' interests.
- The commitments will prospectively ensure that GAL has adequate financial resources as GAL would not have proposed commitments that it could not finance.
- The final proposals will provide protection on financial and operational resilience through commitment and licence obligations and performance monitoring.

7. The CAA considers that its final proposals are consistent with the better regulation principles, to which the CAA has a statutory duty to have regard to, in that licence obligations have only been introduced where they are required and the monitoring regime should ensure transparency and accountability.

Process to date

8. In developing these final proposals the CAA has had extensive engagement with GAL, the airlines at Gatwick and other stakeholders.

- Publication of two early consultation documents setting the scene (July 2011) and Q6 policy update (May 2012) that consulted on the CAA's emerging thinking.
- A detailed Constructive Engagement process where GAL was required to develop and discuss an initial business plan (IBP) with the airlines. This recognised that airlines' commercial interests often align with the interests of their passengers, although not always. It also recognised that airlines are materially affected by the CAA's decisions. This led to a much better understanding of the issues as an input to the CAA's initial proposals.

- CAA workshops and formal and informal discussions with both GAL and the airlines.

9. As the commercial interests of the airlines may not always align with the interests of passengers[1], the CAA has undertaken considerable primary passenger research and surveys to inform its views as well as evaluating the stock of research it has access to from third parties such as the airport operators, airlines, and independent agencies. The CAA considers that the interests of cargo owners are broadly aligned with those of passengers given that over 99% of cargo traffic at Gatwick travels in the bellyhold of passenger aircraft. The CAA has also sought scrutiny from its Consumer Panel on its approach to understanding passengers' priorities.

10. As part of its January 2013 revised business plan (RBP) GAL put forward proposals for airport commitments to airlines, which GAL intended would replace more formal licence regulation. GAL proposed including in its Conditions of Use commitments on price, service quality and other matters normally covered by a regulatory settlement.

11. In April 2013, the CAA published its initial proposals. These recognised that commitments could be the preferred approach to Q6, but found that those offered at that time were insufficient, and so proposed to implement a traditional price cap. Subsequently GAL has revised these commitment proposals substantially in response to feedback from airlines and the CAA.

12. At the same time as the initial proposals the CAA published its ‘minded to’ assessment of whether GAL passes the market power test (MPT) in the Act. The CAA considered that, taking into account GAL's proposed commitments, it was minded to conclude that the MPT in the Act was met and there was a continuing need for the licence regulation of GAL beyond April 2014. These final proposals assume that GAL passes the MPT.

[1] Where this document refers to passengers interests it should also be taken to referring to the interests of those with risks in cargo and present and future users.

Fair price

13. The CAA has calculated what it sees as a fair price, reflecting the maximum average level of airport charges. This calculation was done both to enable assessment of GAL's proposals, and to enable a RAB-based control to be implemented if these proposals were not in users' interests. Such a calculation was indeed the basis of the CAA's initial proposals.

14. The methodology for calculation of the fair price is based on a single till RAB model – the same methodology that was used to calculate GAL’s present price cap. This approach is designed to balance the needs of passengers today and passengers in the future, in terms of airport charges being no more than the minimum needed to remunerate an efficient airport operator, whilst ensuring a fair return on investments. The CAA has considered a fair price over five years, consistent with the potential duration of a RAB-based price cap (which has been used to date in airport price settlements, was the proposed form of control in the initial proposals and is commonly seen in other regulated sectors); and also seven years, for consistency with the duration proposed by GAL in its commitments.

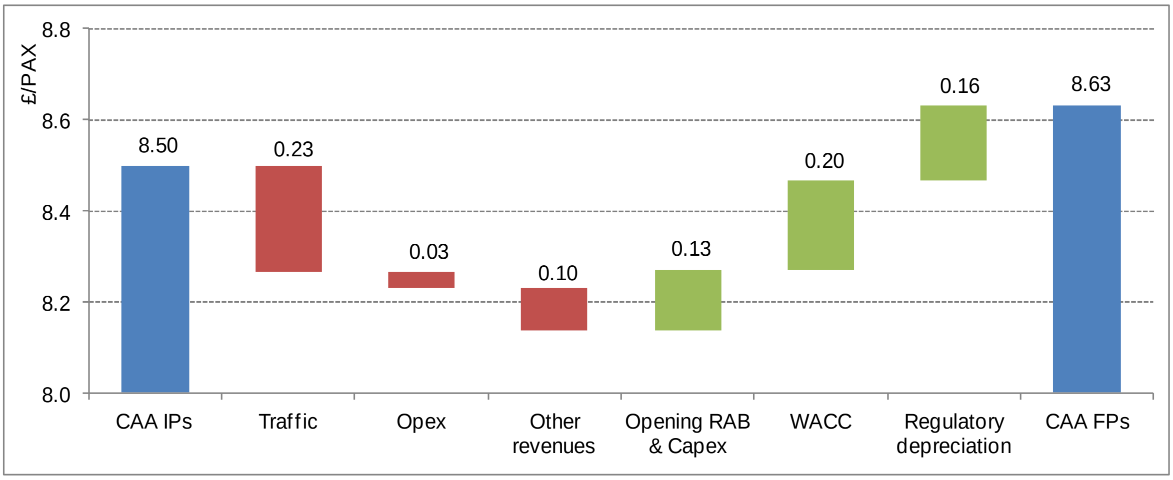
15. The CAA has calculated the fair price in these final proposals as the Retail Price Index (RPI) +1.6% per year over five years and RPI+0.3% per year over seven years. This is an increase in the fair price included in the initial proposals, which was RPI+1.0% per year over five years and RPI+0.0% per year over seven years.

16. The main differences in the fair price calculation between the initial and final proposals for a five year period are set out below.

- The Weighted Average Cost of Capital (WACC) has increased from 5.6% to 5.95%. This is due to the CAA’s revised assessment of the cost of debt. This partly reflects placing greater emphasis on longer-run data and averages, and partly technical changes in response to points raised by stakeholders. The gearing and tax assumptions remain unaltered, while the cost of equity has marginally increased to reflect a slightly riskier position of GAL since it was divested from BAA.

- Traffic forecasts have increased by 2.8% over five years resulting from more up to date traffic data and the likely use of larger aircraft from easyJet's purchase of Flybe's slots.
- The operating expenditure (opex) efficiency assumption has increased from 1.1% per year to 1.2% per year based on removing costs associated with GAL's ✂ wage growth assumption, offset by an allowance for the CAA's higher traffic forecasts.
- Forecast core capital expenditure (capex) has been reduced very slightly from £794 million to £791 million from a combination of:
  - including additional schemes in the core plan following additional proposals from GAL, airline support, further assessment of the technical and passenger justification (North Terminal coaching bays, stands 551 and 552, minor projects);
  - removing some schemes from the core plan: South Terminal International Departure Lounge (IDL) reconfiguration (now a renewals project), business systems transformation (now a development project); and
  - cost changes for individual schemes from both GAL and the CAA's consultants.
- Projected commercial revenues have increased by around 1% per passenger from higher outturn data car parking revenues per passenger slightly offset by lower per passenger retail and property revenues. Overall total commercial revenues increased by 3% to £1,015 million largely driven by the increase in traffic forecasts.
- Forecasts for other regulated charges (ORCs) have decreased, from £275 million to £259 million, or 6%, due to the inclusion of the CAA's projections for increased opex efficiency in the ORC projections.
- The opening RAB has increased by £105 million due to the inclusion of the pension commutation payment. The changes to the opening RAB and capital expenditure have increased regulatory depreciation by 4.2% to £751 million.

Figure E1: Fair price average yield per passenger – comparison of the CAA's initial and final proposals



Source: CAA

Form of regulation

17. The CAA considers that there are likely to be a number of potential benefits from commitments plus bilateral contracts. Firstly, while bilateral contracts would not be precluded under RAB-based licence regulation, the CAA considers that contracts would be more likely to occur with the commitments in place. For example, these would reduce the risk for GAL and the airlines concerned that the terms offered in a typical 10 year bilateral might not be consistent with regulation over more than one control period; they would provide a longer period for an early sacrifice of margin to be recouped; and they would enable a more flexible capital plan, which would support differentiated service. Second, given the diverse mix of airlines at Gatwick, it is unlikely that "one size would fit all" and the commitments may provide benefits over licence regulation in the form of additional flexibility, which would allow better tailoring to individual airlines and passenger needs. This would not only enhance choice and value to users, but would also facilitate airport competition at the margin. Third, the commitments would also provide greater certainty to airlines as they are for seven rather than five years, provide greater focus on the airport and airline relationship and avoid some of the distortions of RAB-based regulation in terms of management distraction and perverse incentives.

18. The commitments provide limits on the maximum average revenue yield over seven years based on published prices at RPI+1.5% per year and average prices (taking into account published prices and bilateral contracts) at RPI+0.5% per year. The latter price is also known as the ‘blended price’.

19. The CAA has reviewed the price in the commitments against the CAA's assessment of the fair price. The CAA considers that it should place most weight on the comparison between the blended price in the commitments and the five year RAB-based fair price. The five year RAB is the most likely counterfactual duration if the CAA were to introduce a RAB-based price cap. This is because of the uncertainties in forecasting beyond this period. Based on a comparison with the five year fair price the commitments would reduce average charges by 3% over the next five year period. They would also would lock in the benefits of lower charges in the first two years of the next control period, which have a risk of being eroded over time as new cost pressures emerge.

20. The commitment blended price is also comparable to the seven year fair price (RPI+0.5% per year compared to RPI+0.3% per year).

21. The CAA considered whether the benefits of GAL’s commitments are such that a licence-based framework is not required at all. This question is primarily addressed in the minded to market power assessment with regard to GAL. The CAA has concluded that it cannot be confident about fulfilling its statutory duties by relying on commitments without a licence. This is because of the relatively weaker enforcement regime (which because it will be enforced by airlines rather than the CAA is likely to operate in the interests of airlines more reliably than in those of users); because the lack of a licence would limit the CAA's ability to respond to future events (for example, non compliance with CAA policy on issues like future second runway costs); and because the commitments that have been offered by GAL do not provide transparency around a shadow RAB, or effective protection around financial resilience.

22. Accordingly, the CAA has considered what form of regulation should be implemented under a licence. The licence would include provisions that enable the CAA to enforce the commitments and prevent GAL from altering or withdrawing its commitments. This would address the CAA’s enforceability concerns with GAL’s

commitments. The CAA also considers that financial resilience obligations will be required in the licence, given the potential passenger detriment if shortcomings arise.

23. The CAA considers that while there are risks in other areas, for example on capital expenditure (where GAL has committed to minimum capex of £100 million per year around half that proposed by GAL and assumed in the fair price calculations) and service quality, its concerns are best addressed through monitoring GAL's performance. If issues do arise, the CAA can consider the introduction of new licence conditions on a case by case basis.

24. The CAA considers that the commitments, licensing and monitoring regime would be consistent with the better regulation principle that regulation should be targeted only in cases where action is required, while allowing the CAA to increase regulation if GAL cannot develop the good relationships with airlines that would be important for an effective regime.

25. On balance, the CAA considers that a commitments plus limited licensing framework and effective monitoring would best further passengers' interests.

The CAA will introduce a new regulatory approach for GAL based on the airport's commitments to airlines and underpinned by a CAA licence

26. The licence will include the following terms (in addition to conditions on fees and licence revocation):

- a condition that makes the commitments a licence condition (subject to carve-outs on airline standards and GAL's pricing principles, which the CAA does not consider appropriate to include in a licence);
- a condition that GAL shall comply with the commitments in a manner designed to further the interests of present and future passengers; and

- a condition that prevents GAL from unilaterally varying its commitments and prevents modification outside the instances set out in the commitments.

27. In the light of responses to the CAA's initial proposals, the CAA does not consider it needs licence conditions to: modify the commitments in response to a dispute as this could be done through the licence modification provisions under section 22 of the Act; or to impose a short-term price freeze in the event of a dispute, given the potential for the CAA to use an urgent enforcement order to protect passengers' interests under section 35 of the Act.

28. To address financial resilience concerns the CAA considers that it requires licence obligations on adequacy of financial resources, holding company undertakings and restrictions on business activities.

29. The CAA will also ask GAL to continue to undertake a shadow RAB calculation should this be required as the basis for any future price control.

30. To avoid increasing complexity and cutting across the flexibilities that are a benefit of the commitments, the CAA considers that its concerns in other areas are best addressed through it monitoring GAL’s performance under its commitments to ensure that they are operating in the passengers' interest. Consequently in the second half of 2016 the CAA will ask stakeholders for views and undertake an assessment of the performance of the commitments and publish its findings.

31. The CAA would expect the monitoring regime and to some extent the licensing regime to evolve over time. If GAL has good relationships with airlines and the flexibilities within the regime are operating in the passengers' interest then the CAA considers that this could lead to a scaling back in the CAA's monitoring of the commitments. Conversely if the commitments are not operating in the passengers' interest and relationships with airlines are poor then the CAA can impose additional licence requirements through the modification process as set out in the Act. This should address the risks that the flexibilities within the proposed regime are not working in the passengers' interest.

Next steps

32. Between now and the implementation of this regime on 1 April 2014, there are a number of steps.

- 4 November 2013: responses to the final proposals consultation must be submitted to the CAA.
- December 2013: the CAA Board will make a decision on whether the MPT is met for GAL;
- January 2014: The CAA will publish its decision on the MPT for GAL. Assuming that the MPT for GAL is met, the CAA decision on economic regulation and the final notice of the proposed licence and its conditions under section 15(1) of the Act will be published.
- February 2014: licence and final conditions under section 15(5) of the Act issued, to come into force on 1 April 2014. GAL and any other person with a relevant interest (e.g. airlines) will then have six weeks to decide whether or not to lodge an appeal with the Competition and Markets Authority (CMA).
- 1 April 2014: the Q6 price control will come into force. If an appeal is lodged then there is no automatic suspension of the licence pending the CMA's decision.
- The CMA will have ten weeks from the date of the publication of the final conditions (not from the receipt of the stakeholder's decision to lodge an appeal) to decide whether to give the stakeholder leave to present an appeal. The CMA will then have 24 weeks (again, from the date of publication) to determine the appeal. The CMA may request an eight-week extension to its deadline.
- Interested parties can also appeal the CAA's determination on whether the MPT is met to the Competition Appeals Tribunal (CAT) within 60 days of the publication of the CAA's reasons for the determination. The CMA may extend the period for considering an appeal on licence conditions if there is an appeal to the CAT which it considers relevant to the appeal on the licence.

PART A - INTRODUCTION

CHAPTER 1
Introduction

Purpose of the document

1.1 The document sets out the CAA's final proposals for the economic regulation of GAL from 1 April 2014 (Q6). The CAA is making these final proposals pursuant to its powers and duties in the Act. Part 1 of the Act came into force on 6 April 2013 and replaces the framework for airport economic regulation under the Airports Act 1986 (AA86) that has governed all previous quinquennial reviews.

1.2 The CAA welcomes views on its final proposals contained within this document by no later than 4 November 2013. The CAA cannot commit to take into account representations after this date. The CAA reserves the right not to take into account information, or place less weight on information that is provided after 4 November 2013 that could have been provided earlier.

1.3 The CAA has published a number of relevant documents alongside these final proposals. These include the CAA's views on the appropriate cost of capital for GAL. The CAA has also published a number of independent consultant reports that it commissioned. All these reports can be obtained from the CAA's website.[2]

1.4 The CAA has reflected views from stakeholders based on their submissions to the CAA. The CAA has endeavoured to check the accuracy of all these attributed statements. Should any stakeholder consider that the attributed statement does not reflect their previous submissions to the CAA, it is open to the stakeholder to raise this in their response to this document.

1.5 References in this document to 'the airlines' mean views submitted to the CAA by the representative body for airlines for the purposes of Constructive Engagement (CE). In the case of Gatwick, it means the Airline Consultative Committee (ACC). The CAA acknowledges that the views of individual airlines may differ on particular issues.

[2] www.caa.co.uk

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

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

Questions for stakeholders

1.8 Given the relatively late stage of the process and the CAA's extensive consultation process to date, it would particularly welcome views on the following three key issues:

- the CAA's view of a fair price (see chapters 2 to 9);
- the appropriate form of price regulation for GAL from April 2014 and the CAA's evaluation of the various options (see chapter 10); and
- the appropriate licence conditions that would be associated with GAL's proposed commitments (see chapters 11 to 12).

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, please contact Tim Griffiths (tim.griffiths@caa.co.uk).

1.10 Responses must be received by no later than 4 November 2013.

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

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

Next steps

1.13 Between now and the implementation of the Q6 price control on 1 April 2014, there are a number of steps.

- 4 November 2013: responses to the final proposals consultation must be submitted to the CAA.
- December 2013: the CAA Board will make a decision on whether the MPT is met for GAL.
- January 2014: Assuming that the MPT for GAL is met, the CAA decision on economic regulation and the final notice of the proposed licence and its conditions under section 15(1) of the Act will be published. At the same time the CAA will publish its decision on the MPT for Gatwick.
- February 2014: licence and final conditions under section 15(5) of the Act issued, to come into force on 1 April 2014. GAL and any other person with a relevant interest (e.g. airlines) will then have six weeks to decide whether or not to lodge an appeal with the Competition and Markets Authority (CMA).
- 1 April 2014: the Q6 price control will come into force. If an appeal is lodged then there is no automatic suspension of the licence pending the CMA's decision.
- The CMA has ten weeks from the date of the publication of the final conditions (not from the receipt of the stakeholder's decision to lodge an appeal) to decide whether to give the stakeholder leave to present an appeal. The CMA then has 24 weeks (again, from the date of publication) to determine the appeal. The CMA may request an eight-week extension to its deadline.
- Interested parties can also appeal the CAA's determination on whether the MPT is met to the Competition Appeals Tribunal (CAT) within 60 days of the publication of the CAA's reasons for the determination. The CMA may extend the period for considering an

appeal on licence conditions if there is an appeal to the CAT which it considers relevant to the appeal on the licence.

The process that has shaped the CAA's final proposals

1.14 The CAA's final 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.[3]
- A process of CE between April 2012 and December 2012, overseen by the CAA, whereby GAL and the airlines discussed the main building blocks that could be used to calculate future charges. This process culminated in a report to the CAA approved by the Joint Steering Group (JSG).
- An IBP (April 2012) and RBP (January 2013) from GAL setting out its view on the main building blocks that could be used to calculate future charges in the period April 2014 to March 2019. The RBP included GAL's proposals for airport commitments as an alternative to licence regulation.
- The CAA's initial proposals for GAL published in April 2013 which were based on a RAB-based price control but stated that GAL's commitments together with a basic licence could be the preferred form of regulation if issues associated with the terms of the commitments could be addressed.[4]
- Written representations from stakeholders to the CAA's initial proposals, which included revised commitment proposals from GAL, which sought to address issues highlighted by the CAA in the initial proposals.[5] Some stakeholders have shared with the CAA

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

4 CAA, April 2013, CAP 1029: Economic Regulation at Gatwick from April 2014: Initial Proposals, http://www.caa.co.uk/docs/33/CAP%201029%20Economic%20regulation%20at%20Gatwick%20from%20April%202014%20initial%20proposals.pdf.

5 The responses to the initial proposals are published at:

consultancy studies they have commissioned.[6]

- Further submissions from the airlines and GAL in response to a CAA request to reach agreement on key issues on the service quality and capital expenditure regimes.
- A stakeholder session with the CAA Board in July 2013 at which both GAL and representatives from the Gatwick airline community explained their respective positions on the regulation at Gatwick.[7]
- A consultation in July 2013 on a draft licence that could be associated with GAL's revised commitment proposals, if the CAA considered that this was the preferred form of regulation.[8]
- GAL's final commitment proposals received on 20 August,[9] which responded to issues raised by stakeholders in the CAA's consultation on the draft licence which could be associated with GAL's revised commitment proposals.[10]
- Several independent studies commissioned by the CAA on the efficiency and appropriateness of GAL's business plan projections and the form of regulation (see figure 1.1). In a number of cases the CAA has commissioned updates to these reports to address the points raised by stakeholders in their responses to the initial proposals.
- Advice from the CAA Consumer Panel.[11]

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http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=14902.

6 These reports are published at: http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=14279.

7 CAA, July 2013, Minutes from Board stakeholder sessions for Gatwick, http://www.caa.co.uk/docs/78/CAA%20Board%20&%20Gatwick%20Meeting17072013.pdf.

8 CAA, July 2013, GAL – proposed licence conditions in relation to price commitments, http://www.caa.co.uk/docs/78/GALProposedLicenceCondition.pdf.

9 GAL, August 2013, London Gatwick's final Contracts and Commitments proposal, http://www.caa.co.uk/docs/78/GALCommitmentsLetter.pdf.

10 Responses to these commitments are at: http://www.caa.co.uk/default.aspx?catid=78&pagtype=90&pageid=67.

11 The minutes of the CAA Consumer Panel meetings are published at: http://www.caa.co.uk/default.aspx?catid=2488&pagetype=90&pageid=14123.

Figure 1.1: Independent consultancy studies commissioned by the CAA

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

Source: CAA

Note: These consultancy studies have been published on the CAA's website.

Statutory context to the CAA's review

1.15 The Act creates a new framework to govern the application of economic regulation to the airport sector. In essence it modernises the previous arrangements and brings the CAA's duties and powers into line with modern regulatory best practice. This includes the CAA having a single primary duty focused on the interests of passengers and those with rights in cargo. The scope of this duty concerns the range, availability, continuity, cost and quality of airport operation services[12] and the CAA must carry out its functions, where

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

appropriate, in a manner that will promote competition in the provision of airport operation services. The CAA must also have regard to a range of matters (figure 1.2). The Act also enables the CAA to regulate through a flexible licensing approach.

Figure 1.2: The CAA's duties under the Act

S1	**CAA's general duty**
(1)	The CAA must carry out its functions...in a manner which it considers will further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of airport operation services.
(2)	The CAA must do so, where appropriate, by carrying out the functions in a manner which it considers will promote competition in the provision of airport operation services
(3)	In performing its duties under subsections (1) and (2) the CAA must have regard to: (a) the need to secure that each holder of a licence...is able to finance its provision of airport operation services in the area for which the licence is granted, (b) the need to secure that all reasonable demands for airport operation services are met, (c) the need to promote economy and efficiency on the part of each holder of a licence...in its provision of airport operation services at the airport to which the licence relates, (d) the need to secure that each holder of a licence...is able to take reasonable measures to reduce, control or mitigate the adverse environmental effects of the airport to which the licence relates, facilities used or intended to be used in connection with that airport…and aircraft using that airport, (e) any guidance issued to the CAA by the Secretary of State..., (f) any international obligation of the United Kingdom notified to the CAA by the Secretary of State..., and (g) the principles in subsection (4).
(4)	Those principles are that - (a) regulatory activities should be carried out in a way which is transparent, accountable, proportionate and consistent, and (b) regulatory activities should be targeted only at cases in which action is needed.
S104	Regulatory burdens
	The CAA also has a duty not to impose or maintain unnecessary burdens while performing its regulatory functions under Chapter 1 of Part 1 of the Act.

Source: The Act

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

Who should be regulated?

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

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

1.17 The CAA published its 'minded to' position in relation to the MPT in May 2013.[13] The CAA considered that the MPT was likely to be met by GAL in relation to, at least, the core area of Gatwick and this was likely to endure over the period 2014 to 2019. If the CAA's 'minded to' position that the MPT was met is confirmed, GAL will require a licence from April 2014 to lift the prohibition on levying charges. These final proposals assume that GAL passes the MPT.

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

[13] CAA, May 2013, Consultation on Gatwick market power assessment, http://www.caa.co.uk/docs/33/CAP%201052%20Consultation%20on%20Gatwick%20market%20power%20assessment%20(p).pdf.

summarised in chapter 10 of this document.

Licence regulation

1.19 Should the CAA's 'minded to' position that the MPT is met be sustained, the CAA may include in a licence such conditions that it thinks are needed to prevent the risk of abuse of market power as well as any other condition that it thinks are necessary and expedient[14] to secure its statutory duties under section 1 of the Act, including those which further the interests of users of air transport services or (where appropriate) promotes competition in the provision of airport operation services.

1.20 A licence must specify the airport area and the airport for which it is granted and it must include any price control conditions that the CAA decides are required, as well as provisions for revoking the licence.[15] In addition, the licence may include obligations requiring payment of fees to the CAA.[16] Licence conditions can also include provisions relating to activities carried on outside the airport area for which the licence is granted.

1.21 In January 2012, and at the request of the Secretary of State/Department for Transport 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 final proposals for the licence conditions that the CAA considers are required in the GAL licence are set out in Appendix B.

1.22 GAL and airlines have rights to appeal the CAA’s final decision on the inclusion, or absence, of licence conditions to the CMA subject to certain qualifying criteria being met.[17] In the event an appeal is made that meets the qualifying criteria the CAA’s decision will stand until the CMA determines the appeal – unless it has granted interim relief or the appeal relates to specific financial arrangements. While CMA

[14] Section 18 of the Act.

[15] Section 17 and 19 of the Act.

[16] Section 20 of the Act.

[17] Section 24 of the Act. The appeal body is currently the Competition Commission but will be the Competition and Markets Authority from April 2014.

appeals should normally be determined within 24 weeks, this can be extended if a relevant appeal to the Competition Appeal Tribunal (CAT) is ongoing.[18]

GAL's commitment proposals

1.23 GAL put forward proposals for airport commitments as an alternative to licence-based regulation. These commitments, that GAL is proposing to include in its Conditions of Use, set out limits on airport charges, a service quality regime and commitments on consultation, investment, and operational and financial resilience.

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

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

Structure of the rest of this document

1.25 This document is structured as follows:

- Part A: Introduction:
  - Chapter 1;
- Part B: Calculation of a fair price:
  - Chapters 2 - 9: based on individual RAB-based building blocks;
- Part C: Form of regulation:
  - Chapter 10: discusses GAL's commitments and the most appropriate forms of licence regulation;
- Part D: CAA's final proposals for a licence:
  - Chapters 11 and 12: discuss the CAA's final proposals for a licence and monitoring regime to be associated with GAL's commitments;
- Appendix A: glossary
- Appendix B: licence
- Appendix C: Rolling forward the RAB

PART B – CALCULATION OF A FAIR PRICE

CHAPTER 2

Introduction to the fair price

Initial proposals

2.1 The initial proposals calculated a fair price for the maximum average level of GAL's airport charges, using a single till RAB calculation. The CAA intended that this would act as a counterfactual for the assessment of alternative forms of regulation including GAL's commitments to airlines. In the absence of acceptable commitments, the CAA intended that this calculation could be used as the basis for setting a price cap for Q6.

Responses to the initial proposals

2.2 In its response to the initial proposals GAL raised a number of concerns with the concept of a fair price:

- there was no concept of a fair price in the CAA's statutory duties and price is only one of five parameters mentioned in the CAA general duty;
- the concept of a fair price, which is based on considering airport charges in relation to cost, would benefit incumbent airlines and the CAA had not demonstrated that any restriction in airport charges would benefit current passengers in terms of reduced air fares;
- the CAA should not use a single till concept in calculating a fair price; and
- the concept of a fair price did not benefit future passengers as it would keep prices below market clearing levels and so entrench the position of incumbent airlines and make it difficult for new airlines to enter the market.

2.3 Other stakeholders did not respond directly on the issue of a fair price.

Key issues

A fair price and the CAA's statutory duties

2.4 The CAA does not accept GAL's argument that calculating a fair price is somehow out of line or only partially in line with the CAA's general duty.

2.5 The CAA's general duty is to further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of airport operation services. Users of air transport services are defined as current and future passengers and those with a right in cargo. The CAA must do this, where appropriate, in a manner that will promote competition in airport operation services.

2.6 The CAA has considered the concept of the fair price as the CAA considers that excessive pricing is the greatest risk to passengers from GAL's abusing its SMP.

2.7 The concept of calculating a fair price to act as a price cap and counterfactual for assessing alternatives is wholly consistent with key parameters of the CAA's general duty.

- Cost - the concept of a fair price ensures that the average maximum price that airlines pay for airport operation services is consistent with the average cost of those services. Airport charges are not paid directly by users, and there is no guarantee that the amount passed through to an individual user matches the charges paid by the airline with respect to that user's journey. However, in the aggregate and other things being equal, higher airport charges will either be passed through (affecting users as regards cost); or are likely to affect airline route profitability and therefore affect the willingness of airlines to run certain routes. If routes are lost, this is harmful to users. Lower airline profitability can also be expected, in the aggregate and other things being equal, to make airlines less likely to invest in fleet renewals and this may mean fewer users can travel, or that ticket prices are higher, or that the quality of the travelling experience is reduced. Thus, higher costs of airport operation services have knock-on effects that matter to users, whether or not the user pays the extra costs directly.

- Quality - the calculation of the fair price is based on broadly maintaining existing levels of service quality, while funding investments that are in future passengers' interest. Survey evidence demonstrates that passengers are broadly satisfied with existing service quality at the airport.[19]
- Availability and continuity - the calculation of a fair price takes into account the need for GAL to finance its provision of airport operation services. It is also consistent with the enhanced provisions for operational resilience set out in the initial proposals.
- Range - the fair price is based on the same concept used for Q5, where the price is based on a set of core airport operation services with airlines able to buy additional services if demanded by their passengers. This ensures that these services, such as departure lounges, are provided on a market basis, while ensuring that passengers have adequate protection in the provision of core services.

2.8 The concept of a fair price allows GAL to recover its efficient costs for meeting the needs of passengers and so is consistent with other parts of matters the CAA has to have regard to, in particular:

- the need to secure that each holder of a licence is able to finance its provision of airport operation services;
- the need to secure that all reasonable demands for airport operation services are met;
- the need to promote economy and efficiency in its provision of airport operation services; and
- 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.

2.9 The fair price calculation uses a RAB approach as this provides a price that is: simple, well understood, based on regulatory precedent (for example the Q5 price cap for Gatwick was RAB-based), based on efficient costs, and is supported by airlines (but not GAL).[20]

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19 See figure 3.2 of the initial proposals.

20 The CAA notes that historic investment does not appear to be out of line with the needs of

A fair price to passengers

The need to regulate airport charges

2.10 GAL stated that in a competitive market with capacity constraints, airfares will rise and so any benefit from constraining airport charges would not be passed on to users. GAL stated that in the presence of price regulation airlines will retain most, or all, of any difference between the CAA's fair price and a market price as evidenced by the slots market at Heathrow and (increasingly) at Gatwick. Further GAL stated that this is not the outcome that would be delivered in a competitive market as periods of relatively high or low returns can be observed as firms innovate, invest in new facilities and capacity, design prices that reflect the differential value that different customer groups bring to the value chain and seek to attract new customers and grow the market. GAL considered that a tariff regime that restricts prices to a RAB-based price would not deliver this.

2.11 The main thrust of GAL's argument appears to be that the CAA should allow prices at Gatwick to rise to market clearing levels. In a properly functioning market, prices can rise during periods of scarcity. This provides a signal for new investment or entry to take place, with prices falling after the provision of additional capacity as supply constraints are reduced. As GAL pointed out the CAA recognised this in its assessment of Test B for the Stansted market power assessment.[21] However, the airport market within the South East of England does not appear to have the characteristics of a properly functioning market. In particular, government control over the supply of additional capacity, in particular new runways at the main airports of Heathrow, Gatwick and Stansted, places a severe limit on the ability of the market to react to any shortfall in capacity. This in essence has created the current situation where both Heathrow and Gatwick are full for large parts of the day.[22] In this type of market, any removal of price controls on airport charges is likely to lead to increased profits to the airport operator, with no discernible benefit to end users. This is a situation that could pertain for some time rather than be a short-term

airlines and passengers and there is less uncertainty over individual building blocks, in particular traffic.

[21] Paragraph 8.46.

[22] This was also recognised in the CAA's discussion of Test B for Stansted in paragraphs 8.57 to 8.60.

phenomena only.

2.12 In considering airport charges in relation to efficient costs the CAA is trying to mimic what would happen in a fully functioning competitive market where there were no constraints on new capacity. This produces lower airport charges for airlines, which through competition in the airline market would to some extent be passed on to users in terms of lower airfares.[23] GAL's proposed approach would ensure that it retained all the benefits from continuing capacity constraints which resulted from government policy. The CAA's approach ensures that it is more likely that a substantial part of the benefit will flow through to passengers. The CAA considers this approach is more consistent with its general duty.

The Competition Commission's final report on the market review into BAA

2.13 The CAA notes that its approach is consistent with the Competition Commission's (CC's) final report on the market review into BAA, 2009, which stated that:

2.14 "Even under separate ownership, moreover, as a result of capacity constraints, competition in the short term may focus on particular types of traffic, for example in off-peak periods, and therefore be unlikely to be sufficiently effective to substitute for regulation. Separate ownership would also give rise to competition to invest in new capacity; but there would be a period of time before there could be confidence that competition between separately-owned airports was sufficiently effective to substitute for regulation. Heathrow, however, may retain a strong market position as the main UK hub airport, requiring effective regulation for longer." (paragraph 6.87)

2.15 "We also believe that competition would in any case deliver quality and modest pricing benefits in the period immediately following divestiture, i.e. while capacity constraints and price control regulation persist." (paragraph 10.66)

2.16 "In the South-East, the situation is more complex because of the current system of regulation, planning and aspects of government policy. Against this background, we expect competition between Heathrow, Gatwick and Stansted to result in more efficient investment

23 SLG Economics, September 2013. Q6 review of the distribution of economic rent between airport, airlines and passengers and cargo users at Heathrow and Gatwick.

in response to customers' needs, improved levels of service and lower prices. ..., some of the benefits resulting from the process of rivalry can be expected to arise shortly after divestiture and we are confident that over time, the scale of benefits accruing to passengers and freight companies will grow, driven by the momentum of developing competition. However, the benefits resulting from anticipated improvements in the design, cost, timing and allocation of new capacity will largely accrue to customers when the new capacity comes into operation. In the case of new runway capacity, we recognise that this is highly unlikely to occur before 2017 at the earliest." (paragraph 10.115)

2.17 "We reiterate our view that we expect competition between London airports to develop such that we would no longer expect Stansted and Gatwick to hold substantial market power. Clearly a decision on whether or not to lift price caps as new capacity comes on stream will require the balancing of risks based on the consideration of a number of factors, including the nature and intensity of competition that develops in the period following divestiture of Gatwick and Stansted. It is therefore not possible for us now to recommend the promulgation of a clear-cut rule that the price caps at Gatwick and Stansted be lifted at a particular date (such as the end of Q5) or at the point when the existing situation of capacity shortage has been eased to a particular extent (such as through certain projects or specified quantities of new capacity coming on stream). However, we strongly support the reduction and in due course, the removal of regulation, as competition develops." (paragraph 10.344)

2.18 The CAA notes that at the time of the CC's final market inquiry report government policy was for additional runways at both Stansted and Heathrow airports. Government policy has since changed and the Airports Commission has not indicated whether and where it would support new runways in the South East of England although new runway capacity may not be available until 2025.[24,25]

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[24] See Gatwick proposals for a second runway, which state that this could be open by 2025. http://www.mediacentre.gatwickairport.com/News/A-second-runway-at-London-Gatwick-is-the-affordable-sustainable-and-deliverable-solution-80b.aspx.

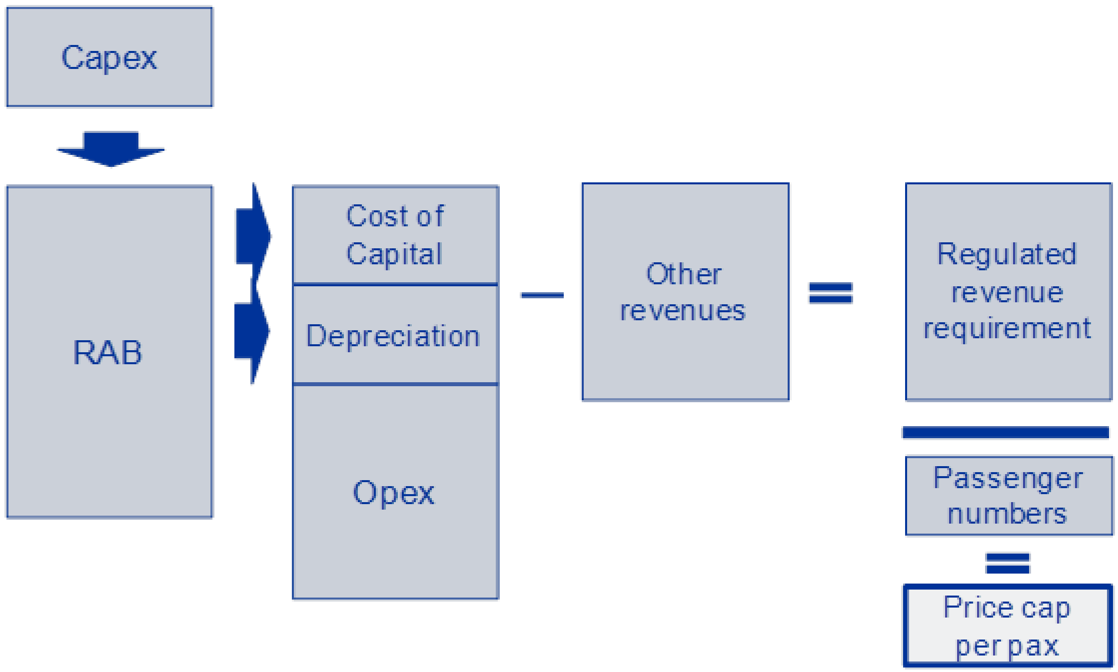
[25] Heathrow's proposals for a third runway are forecast to deliver extra capacity between 2025 and 2029, with a statement that a new hub at Stansted or in the Thames estuary would not be delivered until at least 2032. http://mediacentre.heathrowairport.com/Press-releases/Heathrow-

The use of a single till RAB approach

2.19 The CAA does not accept GAL's challenge that the CAA should not use a single till RAB-based approach for calculating the fair price.

2.20 A RAB approach is commonly used across many regulated sectors to set price caps and sets price equal to the efficient costs of operating the airport. The calculation of the price cap is based on a number of regulatory 'building blocks', as shown in figure 2.1. Under a single till approach other revenues are netted off costs to calculate the net revenue requirement to be recovered from airport charges.

Figure 2.1: Price cap building blocks



Source: CAA

2.21 As stated above a RAB-based approach in general provides a cost based price, which the CAA considers mimics what would normally happen in a fully functioning competitive market. A single till approach to RAB-based calculations has merits based on 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. It also has merits for policy consistency and is readily understood and accepted by a wide range

unveils-a-new-approach-to-third-runway-5e2.aspx.

of stakeholders. Using a dual till would have significant impacts on costs for passengers, as airport charges and consequently air fares would rise and hence would not be consistent with the CAA's general duty in this context.

2.22 The CAA has undertaken a 'minded to' assessment of the market power that GAL holds for airport operation services[26] 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, taking off, manoeuvring, parking, and servicing of aircraft at the airport, the passenger terminals and the cargo processing areas".[27] This includes facilities that are remunerated by airport charges and other aeronautical services the detail of which is set out in the product bundle of the GAL market power assessment.[28] If an airport operator has SMP over the core airport area, it would therefore have SMP over airport charges and other aeronautical services, the detail of which is set out in the product bundle of the GAL market power assessment. The CAA is not required to cover all airport operation services in its assessment. However, using a single till approach, the CAA would seek to take account of revenues from other services in setting regulatory controls on airport charges as it does at present.

2.23 The CAA considers its views on a single till approach to be fully consistent with the views of the CC's report on the BAA market inquiry:

2.24 "Another option that we would not expect to see involves basing price caps on aeronautical costs and assets (dual till) instead of all airport assets (single till). This was fully discussed in our 2002 regulatory report and it remains our view that the dual till has significant disadvantages, including higher fares to the detriment of consumers (since higher airport charges would to some extent be passed through in higher fares)." (paragraph 10.335)

The concept of a fair price and future passengers

2.25 GAL stated that setting a fair price based on its costs would be

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

[27] Section 5(4).

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

detrimental to the interests of future passengers as it would keep prices below market clearing levels and so new airline entrants would not operate more profitable routes, use sub-optimal slots, or pay an upfront cost to acquire their required slots.

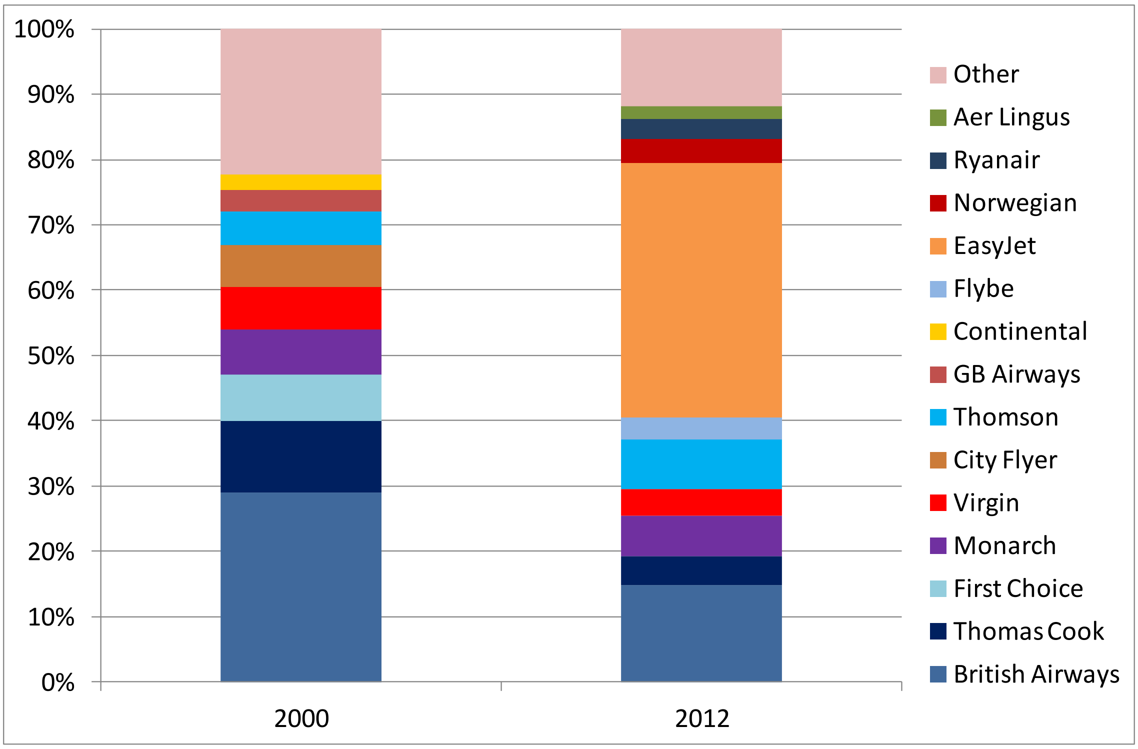
2.26 The CAA does not consider that its approach to a fair price would be detrimental to future passengers. To a large extent the interests of future passengers over the period of Q6 are likely to be the same as current passengers, as most future passengers will be people that already fly. Ensuring charges are cost based will ensure that a substantial part of any scarcity rents passes through to passengers now and in the future. Over time the needs of passengers may change and, in a competitive market, airlines, whether existing or new ones, would need to respond to these needs to maximise their profits.

2.27 The tightness of capacity constraints at Gatwick and the setting of a RAB-based price cap do not seem to have prevented new airline entry and a significant change in the airline mix at Gatwick (see figure 2.2). Consequently the CAA considers that calculating a RAB-based price is in the interests of both current and future passengers.

2.28 The CAA's approach is strongly linked to the fact that price signals cannot make new capacity appear over the next quinquennium (or much longer). If this changes, the CAA's approach could be subject to review.

2.29 Finally, although GAL challenges the use of a RAB-based single till approach it has not put forward a credible alternative that would command stakeholder confidence.

Figure 2.2: Change in airline mix at Gatwick between 2000 and 2012 (% of total passengers)



Source: CAA passenger statistics

Conclusions on a fair price and the CAA statutory duties

2.30 The CAA has carefully considered GAL's comments against its statutory duties. For the reasons set out above, the CAA concludes that calculating a fair price based on a single till RAB approach is the best discharge of its duties in particular to further the interests of passengers and where appropriate promoting competition in airport operation services.

Fair price calculations

2.31 Estimates of a fair price, using a single till RAB-based approach, have been provided over five years, consistent with a typical duration of a regulatory price control used in previous airport reviews, the proposed duration of a RAB-based price control in the initial proposals (given the uncertainties in forecasting for a longer duration)[29] and is commonly used in other regulated sectors) and seven years, for comparison with GAL's seven year commitment proposals. Part B does not include proposals for a price control, but provides a basis for assessment of alternative forms of regulation (Part C) and also for the CAA's final proposals (Part D).

[29] The CAA did not receive responses to the initial proposals that asked the CAA to consider a RAB-based price control of longer than five years.

CHAPTER 3

Traffic forecasts

3.1 This chapter sets out the CAA's final projections for the traffic forecasts that will be used to derive the fair price. Traffic forecasts are important to a RAB-based calculation. They define the denominator in the price cap calculation, which sets a maximum average revenue yield. They also influence other building blocks dependent on passenger numbers, such as opex, commercial revenues and service quality. This chapter consists of the following sections:

- approach to forecasting;
- issues between GAL and airlines;
- responses to CAA's initial proposals; and
- CAA final projections.

Approach to forecasting

3.2 GAL's forecasting methodology is based on a ‘bottom-up’ short-term capacity forecast for the first three years and a ‘top-down’ econometric forecast over the medium and longer term.

3.3 The capacity model forecasts passenger numbers as a function of supply decisions such as airlines' capacity plans, average aircraft size and passenger load factor (based on historical performance and market trends), network plans and flight frequency. The model considers long haul and short haul services separately, and therefore requires an assumption about the future proportion of such services at the airport.

3.4 The top down econometric model forecasts total unconstrained London traffic (segmented by long haul, short haul and domestic) based on a regression analysis of London passenger traffic for the period 1990 to 2012, against economic, oil price and average airline fare variables. This forecast applies different market maturity assumptions to each market segment. The constrained forecast for

Gatwick, which takes into account capacity constraints in the London airport system, is then derived based on the allocation of traffic across the London and the reallocation of passengers that cannot be accommodated at airports that become full.[30]

3.5 In GAL's January 2013 RBP (which used forecasts made by GAL's consultants SH&E[31] in September 2012), the first three years of forecast up to 2014/15 were based on the capacity model while the forecast for the following years was based on the econometric model.

3.6 In GAL's May 2013 forecasts, which were provided in response to the initial proposals, the same forecasting methodology was used, with an adjustment in that forecast traffic up to 2015/16 was based on the capacity model.

Issues between GAL and airlines

3.7 The four key issues raised by stakeholders in response to the CAA's initial proposals were:

- the Gross Domestic Product (economic growth) assumptions used by GAL were at the low end of a range of independent forecasts;
- the short-term bottom-up assessment of traffic by GAL appeared to understate future demand;
- GAL's forecasts appeared to overemphasise the potential increase in long haul traffic and underplay the potential for short haul demand growth; and
- the inclusion of adverse demand shocks.

3.8 Both GAL and the ACC provided revised traffic forecasts in response to the initial proposals.

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

31 GAL's forecasts are provided by the consultants ICF SH&E.

GDP assumptions

Issue

3.9 The ACC regarded the use by GAL's consultants SH&E of a particular GDP forecast (by the Economist Intelligence Unit (EIU)) instead of an average of a range of independent forecasts used by SH&E previously was unjustified, particularly as the EIU forecast was at the low end of those collected by SH&E.

CAA initial proposals

3.10 The CAA agreed with the ACC that the conservative economic assumptions used by SH&E were unwarranted and cited other independent forecasts by Consensus Forecasts (CF) and the Office of Budget Responsibility (OBR) which had a more robust medium and longer-term economic outlook than that suggested by the EIU forecast.

Stakeholder views

3.11 The ACC stated that there was a case for the traffic forecast to be based on a (slightly) higher rate of forecast economic growth in the medium term, as measured by the HM Treasury independent average, than the CAA allowed for in its initial proposals. This would lead to an upward adjustment of 0.2 million passengers per year from 2016/17 onwards.

3.12 In its revised forecasts provided in response to the initial proposals GAL has now incorporated a wider range of GDP inputs, blending the latest Treasury growth forecasts, the EIU's long term forecasts and the International Monetary Fund's (IMF) UK forecasts. GAL also stated that it was not minded to use the OBR forecast as an alternative, as it was considerably above the consensus forecast from 2015 onwards.

CAA final projections

3.13 The CAA considers that the upwardly revised GDP assumptions used by GAL are now more aligned with the average of a range of latest independent and consensus forecasts, although they still appear to be lower than the industry average as shown in figure 3.1. More recent economic data also indicates a marked improvement in business and consumer sentiment and the prospect for a sustainable recovery has also improved.[32] The CAA has therefore continued to include an uplift on GAL's September 2012 base forecasts to reflect higher GDP growth, which ranges from around 0.7 million in 2015/16 to around 1.7 million in 2018/19.[33]

Figure 3.1: Forecast of GDP growth

Year	GAL	GAL	Consensus Forecast	HM Treasury	OBR	ACC
	May-13	Sep-12	Apr-13	Aug-13	Mar-13	Dec-12
2013	0.8%	0.5%	1.3%	1.1%	0.6%	–
2014	1.6%	1.6%	2.1%	1.8%	1.8%	–
2015	1.9%	1.2%	1.6%	2.0%	2.3%	2.0%
2016	2.1%	1.0%	2.1%	2.1%	2.7%	2.1%
2017	1.8%	1.3%	2.2%	2.1%	2.8%	2.1%
2018	1.7%	1.6%	2.1%	–	–	2.2%
2019	1.9%	1.9%	2.2%	–	–	2.3%
2020	2.2%	2.1%	2.2%	–	–	2.2%
2021	2.3%	2.3%	2.2%	–	–	2.3%

Source: GAL, ACC, CF, HM Treasury and OBR

Note: 2013-14 forecast by CF is obtained from the September 2013 issue of Consensus Forecast while the longer term forecasts from 2015 to 2021 are from the April 2013 issue.

Short-term forecast

Issue

3.14 The ACC was concerned about the lack of transparency of the short-term assumptions and the medium term adjustments made by the consultant SH&E for GAL's RBP forecasts.

[32] According to the Bank of England (Inflation Report, August 2013), the "outlook for growth (in the UK) is stronger than in May" and that "a sustained recovery in both demand and supply appears likely." On 3 September, 2013, the OECD economic agency also sharply increased its growth forecast for the UK economy this year to 1.5% - up from a forecast of 0.8% issued in May.

[33] The amount of uplift is broadly similar to those embedded in the ACC's December 2012 traffic forecast which the ACC asked GAL to recalculate at the time to reflect their higher GDP assumptions as shown in figure 3.1.

CAA initial proposals

3.15 The CAA had sought further information from SH&E on its input assumptions and verified their validity with the most up-to-date capacity plans and traffic projections submitted in confidence to the CAA by the major airlines.

3.16 Information available to the CAA at the time suggested that GAL's base case forecast was likely to understate the short-term traffic outlook at Gatwick.

Stakeholder views

3.17 The ACC welcomed the CAA's bottom up assessment of short-term traffic growth at Gatwick and noted that since submitting its previous forecasts at the end of 2012, updated traffic data showed higher growth than the forecast and that easyJet had also announced the purchase of 25 slot pairs from Flybe at Gatwick from summer 2014. The ACC estimated that the higher traffic outturn in 2012/13 would have a step impact of 0.2 million passengers per year over the Q6 period whilst the slot purchase by easyJet would result in another net increase of 1.6 million passengers per annum over and above that carried by Flybe due to the use of larger aircraft. This was based on the assumption that easyJet's current average load of 149 passengers per flight would apply to all traffic on these purchased slots.

3.18 GAL accepted that the information received by the CAA from airlines accounting for 70% of Gatwick traffic as compared to less than 40% received by SH&E could have a material impact on the short-term forecast. However, GAL cautioned that there was a natural optimism bias in the commercial forecasts from airlines individually and collectively.

3.19 GAL's latest forecast incorporated the impact from Norwegian Air Shuttle establishing a base at Gatwick which was reflected in the higher traffic numbers in the early years of the forecast. However, GAL's forecast took no account of the impact of easyJet's recent purchase of Flybe's slots.

3.20 Subsequent to their response, GAL estimated that there would only be a 350,000 to 550,000 per year increase in passengers as a result of switching Flybe’s slots to easyJet. GAL considered that the impact would be lower than forecast by the ACC as the Flybe slot times were not a perfect fit for the traditional easyJet three wave based business model and that the application of the average easyJet load factor at Gatwick did not take into account seasonality ratios or route specific intelligence or declining Flybe volumes.[34] The ACC responded by stating that: given the expense of the slots it would be strange if easyJet could not operate all the slots; the ACC has been transparent over its calculations; average easyJet loads are much higher than those from Flybe and declining Flybe passenger volumes could lead to the ACC's forecasts being understated.

CAA final projections

3.21 The CAA notes that the first three years of GAL's revised forecast (up to 2016/17) now matches the CAA's forecasts in the initial proposals (figure 3.2). This forecast did not account for the impact of easyJet's recent purchase of Flybe's slots. For the rest of the Q6 GAL's forecast of traffic growth slows from 1.7% in 2016/17 to 1.1% in 2018/19 even though GAL has assumed a higher potential for traffic migration from Heathrow[35] and a more robust economic outlook than in the RBP forecasts.

[34] GAL's email to the CAA on 10 September, 2013.

[35] GAL noted that Heathrow has lowered their predicted growth in aircraft sizes resulting in more spilt traffic to other London airports. This resulted in Heathrow reaching its capacity constraint much earlier at 2016/17 than previously assumed in GAL's RBP.

Figure 3.2: Forecast of passengers (in millions and year-on-year growth)

	GAL		GAL RBP		ACC		CAA IPs	
	May-13	Yoy growth*	Sep-12	Yoy growth*	Jun-13	Yoy growth*	Apr-13	Yoy growth*
2012/13	34.2	–	33.8	–	34.3	–	34.2	–
2013/14	34.4	0.6%	34.0	0.6%	34.8	1.5%	34.6	1.2%
2014/15	35.0	1.7%	34.5	1.5%	36.8	5.7%	35.0	1.0%
2015/16	35.5	1.4%	34.7	0.6%	37.3	1.4%	35.5	1.4%
2016/17	36.1	1.7%	35.0	0.9%	38.1	2.1%	36.1	1.8%
2017/18	36.6	1.4%	35.4	1.1%	38.8	1.8%	36.8	2.0%
2018/19	37.0	1.1%	35.9	1.4%	39.6	2.1%	37.6	2.2%
2019/20	37.6	1.6%	36.6	1.9%	–	–	38.5	2.2%
2020/21	38.2	1.6%	37.2	1.6%	–	–	39.3	2.1%
2014/15 – 2018/19	180.2	1.4%**	175.5	1.0%**	190.6	1.9%**	180.9	1.9%**
2014/15 – 2020/21	256.0	1.5%**	249.3	1.3%**	–	–	258.6	1.9%**

* year-on-year growth rate, ** compound annual growth rates (CAGR)
Source: GAL, ACC and CAA.

3.22 The more recent short-term capacity plan and traffic forecast supplied to the CAA by the airlines on a confidential basis suggest that GAL's base forecast is likely to understate the short-term traffic outlook at Gatwick[36], although the presence of individual and collective optimism bias cannot be ruled out from these airline submissions.

3.23 The CAA considers that the recent purchase of 25 slot pairs by easyJet from Flybe, which had not been factored into GAL's revised forecast, could also have a significant impact on the output volume and competitive dynamics at the airport from 2014. However, given that easyJet plans to continue to serve some of Flybe's existing domestic and Channel Islands routes out of the airport[37] which have

[36] To date, the airlines that have submitted confidential information to the CAA constitute around 75% of the total passengers carried at Gatwick in 2012/13. These most updated traffic forecasts collectively suggest growth rates of 4.8% and 5.2% respectively in 2013/14 and 2014/15.

[37] easyJet has announced plans to increase its capacity on the Gatwick-Inverness route by

relatively high proportion of business passengers who tend to value flight frequency more than price alone[38], it is not inconceivable that easyJet may find it difficult, at least in the initial years, to achieve its average load on these routes.

3.24 It is also the CAA's view that part of the expected increase in traffic arising from these 25 slot pairs would have to come from competition from other airlines which serve the same or competitive routes as easyJet. Nevertheless, given that Gatwick is already easyJet's largest base[39] with 13.7 million passengers carried in 2012/13 to more than a hundred destinations, the CAA considers that the fairly well-distributed Flybe's slot pairs would be a useful complement to easyJet's existing slot portfolio. This would allow easyJet considerable flexibility in adding frequencies on popular existing routes as well as new destinations to its extensive network at the airport.[40]

3.25 Taking into account these factors would suggest that a net step increase of 1.6 million passengers per annum to Gatwick's total passenger volume from the slots sale as predicted by the ACC would not be readily attainable (at least over the short term). Consequently, the CAA has adjusted GAL's forecasts accordingly such that the net increase to Gatwick's traffic as a result of the change in slot ownership only would be on average around 1 million per annum over the Q6.

Traffic mix

Issue

3.26 The ACC considered that GAL's forecasts overemphasised the potential increase in long haul traffic while underplaying the potential for short haul traffic growth at the airport especially given its success

almost 30% and introduce a thrice-daily service between Jersey and Gatwick from March 2014.

38 See 'Flying on Business; a Study of the UK Business Air Travel Market', CAA CAP796, November 2011. http://www.caa.co.uk/application.aspx?catid=33&pagetype=65&appid=11&mode=detail&id=4769.

39 The Flybe deal will increase easyJet's current slot share at Gatwick from c. 41% to c. 47% during a summer season.

40 According to the Financial Times (23 May 2013), easyJet plans to use some of the slots to provide additional frequency on some of its popular routes (such as Alicante, Faro and Malaga) out of Gatwick as well as adding new routes.

in gaining short haul traffic.

CAA initial proposals

3.27 In the initial proposals the CAA considered that there was scope for higher short haul and domestic traffic growth at Gatwick than forecast by GAL, in particular given development plans by Norwegian Air Shuttle and others at the airport. Also, the CAA considered that given Gatwick's market position and attractiveness within the London system, any planned reduction in capacity by some airlines was likely to be backfilled relatively quickly by other existing carriers or new entrants.

Stakeholder views

3.28 GAL noted that the timescale for any expected backfilling, which in its opinion, could extend to several months or more and therefore, depending on the scale of the reduction, could have a material effect on annual traffic levels.

3.29 GAL also considered that the constraints on traffic movements at Heathrow and Gatwick meant that long haul movements would grow disproportionately quickly at Gatwick compared to the rest of the London market since long haul flights typically carry a higher number of passengers and cargo volumes per movement.

3.30 BA pointed out that GAL's forecasts showed that GAL anticipates the airport remaining a predominantly short haul point-to-point airport in the future. BA also stated that its previous analysis on the London short haul market also lent support to this view as it showed that Gatwick had outperformed the other London airports consistently in the short haul market in the previous ten years.

CAA final projections

3.31 Having considered the responses received, the CAA remains of the view that GAL's revised forecast (see figure 3.3) understates the growth potential for the short haul and domestic traffic, particularly in light of the purchase of slots by easyJet which will result in a substantial injection of new short haul capacity into the market. Long haul traffic is forecast by GAL to fall by 6.1% initially in 2013/14 but rebound thereafter to the level of 5.7 million by 2020/21 as in its previous RBP forecast. However, while information supplied to the CAA by the airlines suggests a much smaller reduction in long-haul traffic in 2013/14, the average growth of 3.7% per year forecast by GAL between 2018/19 and 2020/21 appears to be unsubstantiated when contrasted with its previous corresponding long haul traffic forecast of 1.8% per year. The CAA has produced its own forecasts of traffic by segment shown in figure 3.6.

Figure 3.3: GAL's forecast of passengers by segment

	Passengers in millions				Year-on-year growth rate			
	LH	SH	Dom	Total	LH	SH	Dom	Total
2012/13	4.9	25.4	3.9	34.2	–	–	–	–
2013/14	4.6	26.0	3.7	34.4	-6.1%	2.4%	-5.1%	0.6%
2014/15	4.8	26.4	3.8	35.0	4.3%	1.5%	2.7%	1.7%
2015/16	4.9	26.8	3.8	35.5	2.1%	1.5%	0.0%	1.4%
2016/17	5.1	27.1	3.9	36.1	4.1%	1.1%	2.6%	1.7%
2017/18	5.2	27.4	3.9	36.6	2.0%	1.1%	0.0%	1.4%
2018/19	5.3	27.7	4.0	37.0	1.9%	1.1%	2.6%	1.1%
2019/20	5.5	28.1	4.0	37.6	3.8%	1.4%	0.0%	1.6%
2020/21	5.7	28.5	4.1	38.2	3.6%	1.4%	2.5%	1.6%
2014/15 – 2018/19	25.3	135.4	19.4	180.2	2.5%**	1.2%**	1.3%**	1.4%**
2014/15 – 2020/21	36.5	192.0	27.5	256.0	2.9%**	1.3%**	1.3%**	1.5%**

LH = Long haul, SH = short haul, Dom = Domestic, ** compound annual growth rates (CAGR)
Source: GAL

Treatment of traffic shocks

Issue

3.32 The ACC noted the specific allowance for adverse shocks (such as Desert Storm, 9/11, SARS and ash cloud) included by Heathrow Airport Ltd (HAL) in its traffic forecasting model. Although a specific allowance for adverse shocks had not been proposed by GAL, the ACC strongly rejected any proposed inclusion as it considers that this would potentially double count traffic risk in the traffic forecasts and the WACC.

CAA final projections

3.33 The CAA considers that the impact of demand shocks on traffic could be accounted for by either:

- first removing the impact of shocks in the historic data and then reintroducing their expected impact back into the forecast later as in the case of HAL; or
- incorporating them in the regression model based on the historic data and therefore in the forecasting parameters as has been the case for GAL. As such, the average impact of shocks has already been taken into account in GAL's underlying demand forecast.

3.34 It is the CAA's view that the allowance for demand shocks in the traffic forecasts and in the cost of capital are two different concepts. While the expected impact of demand shocks can be accounted for in the forecast level of traffic (based on either GAL's or HAL's approach), the variation around this expected level is considered in the cost of capital. The CAA therefore considers that the forecasts properly account for traffic shocks and there is no double counting with the cost of capital allowance.

CAA final projections

3.35 In summary, the CAA proposes to use the traffic forecasts in figure 3.4 for its calculation of the fair price. The CAA's final projections represent a total of 186.0 million passengers over the five years of Q6 which are 2.8% or 5.1 million above its initial projections of 180.9 million. This is 3.2% higher than GAL's forecast but 2.4% lower than the ACC's forecast.

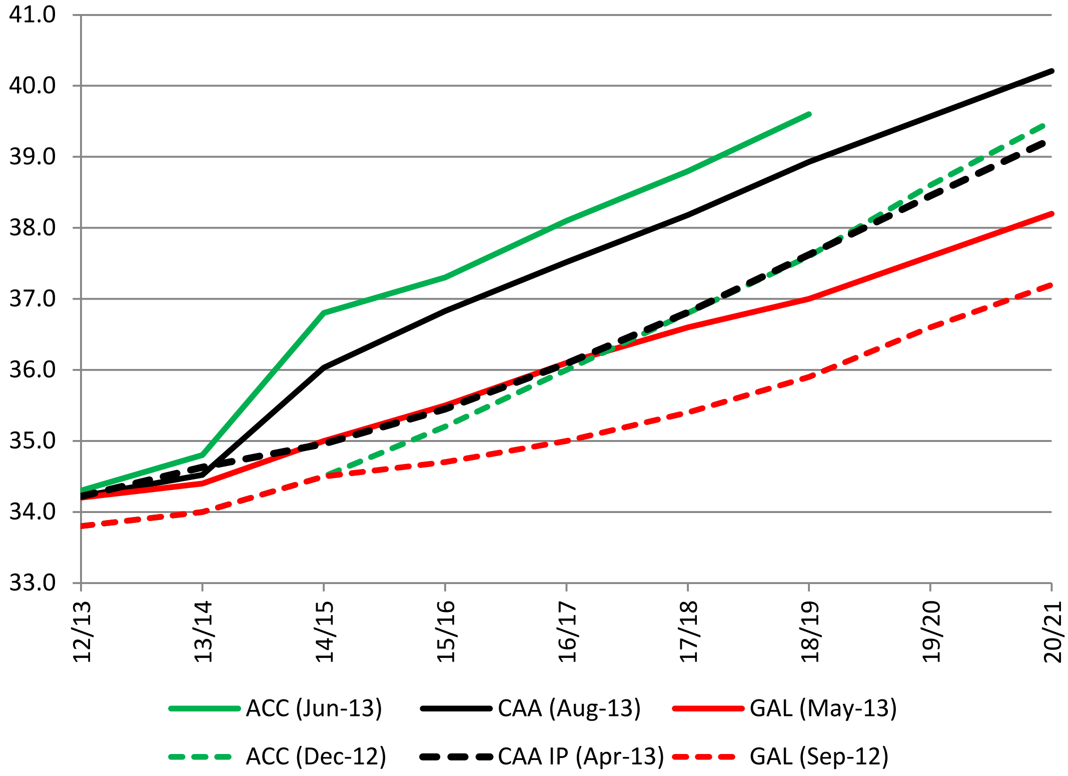
Figure 3.4: Comparison of traffic forecasts by the CAA, GAL and ACC

	CAA		GAL		ACC	
	Pax (m)	Yoy growth*	Pax (m)	Yoy growth*	Pax (m)	Yoy growth*
2012/13	34.2		34.2		34.3	
2013/14	34.7	1.5%	34.4	0.6%	34.8	1.5%
2014/15	35.8	3.0%	35.0	1.7%	36.8	5.7%
2015/16	36.6	2.2%	35.5	1.4%	37.3	1.4%
2016/17	37.2	1.8%	36.1	1.7%	38.1	2.1%
2017/18	37.9	1.8%	36.6	1.4%	38.8	1.8%
2018/19	38.5	1.7%	37.0	1.1%	39.6	2.1%
2019/20	39.2	1.7%	37.6	1.6%	–	–
2020/21	39.8	1.4%	38.2	1.6%	–	–
2014/15 – 2018/19	186.0	1.9%**	180.2	1.4%**	190.6	1.9%**
2014/15 – 2020/21	265.0	1.8%**	256.0	1.5%**	–	–

* year-on-year growth rate, ** compound annual growth rates (CAGR)
Source: CAA, GAL and ACC

3.36 Figure 3.5 shows the CAA forecasts alongside those of GAL and the ACC.

Figure 3.5: Comparison of Gatwick passenger forecast (million)



Source: CAA, GAL and ACC.

3.37 Figure 3.6 provides an indicative forecast of passengers by segment to assist with the consideration of capex requirements. This forecast is based on the CAA's view of airlines' capacity plans and fleet mix, average load, aviation trends, market intelligence, capacity constraints in the London system and Gatwick's historic success in attracting and retaining various types of traffic.

Figure 3.6: CAA forecast of passengers by segment (million)

	Long haul	Short haul	Domestic	TOTAL	Yoy growth*
2012/13	4.9	25.4	3.9	34.2	
2013/14	4.7	26.3	3.7	34.7	1.5%
2014/15	4.9	27.0	3.9	35.8	3.0%
2015/16	5.0	27.6	4.0	36.6	2.2%
2016/17	5.1	28.1	4.0	37.2	1.8%
2017/18	5.2	28.6	4.1	37.9	1.8%
2018/19	5.3	29.1	4.2	38.5	1.7%
2019/20	5.4	29.6	4.2	39.2	1.7%
2020/21	5.5	30.0	4.2	39.8	1.4%
Compound annual growth rates (CAGR)					
2014/15 – 2018/19	2.0%	1.9%	1.6%	186.0	1.9%
2014/15 – 2020/21	2.1%	1.8%	1.4%	265.0	1.8%

* year-on-year growth rate

Source: CAA.

CHAPTER 4

Capital expenditure

4.1 This chapter considers the appropriate level of capex to be taken into account in the fair price calculation. It consists of the following sections:

- capital expenditure process to date: this section outlines the process which has led to the CAA's final projections, including the CAA's initial proposals and the responses to the consultation;
- issues: this section summarises the major issues discussed in the CAA's initial proposals. It sets out the CAA's initial proposals, the responses received, the independent review carried out by consultants for the CAA and the CAA's final projections; and
- CAA's final projections: this section sets out the CAA's capex projections.

4.2 It should be noted that the capex will not be fully paid for during the price control period. Consistent with the RAB methodology, new capex will be added to the RAB. Each year, a contribution to prices is made from a capital charge (i.e. the WACC multiplied by the RAB) and a depreciation charge. Therefore, although Q6 capex will not have a significant effect on Q6 prices, it will need to be fully charged to prices over time.

Capital expenditure process to date

4.3 The capital programme has been subject to extensive discussions between GAL and the airlines as part of the formal CE and subsequently. This has led to a number of projects being dropped or refined.

4.4 Following formal CE, GAL's January 2013 RBP set out a capital programme of £911 million for Q6 split between asset stewardship, Q5 carry over and development projects. Airlines supported £414 million of this expenditure but did not support commercial projects which increased prices in Q6 and projects which airlines considered did not provide value for money enhancements to the passenger experience.

CAA's initial proposals

4.5 The initial proposals reviewed GAL's RBP in terms of:

- the inclusion of individual schemes, in particular whether schemes were in the passengers' interest; and
- the efficient costs of those schemes.

4.6 The CAA's review of the inclusion of individual schemes for the initial proposals drew on the outputs from CE; the agreements reached between the airport and airlines; independent consultancy work commissioned by the CAA from Davis Langdon (DL)[41] which examined technical justification of schemes; and research into whether schemes were in passengers' interests.

4.7 The CAA found that the majority of schemes proposed by GAL were in passengers' interests. The CAA found that the scope of some schemes was not fully justified and should be reduced, in particular North Terminal Border Zone, North Terminal arrivals and North Terminal early bag store schemes. Furthermore the costs of maintaining 95% pier service, based on Pier 6 South, would need to be reduced substantially to be in passengers' interests. The CAA also removed the costs of three schemes: North Terminal baggage reclaim, where the costs had been duplicated; runway two costs, where the inclusion of the scheme did not appear to be consistent with previous regulatory treatment of these costs; and North Terminal coaching bays, where there was not sufficient evidence to include the costs of the scheme.

4.8 The CAA's review of the efficient scheme costs drew on two independent consultancy studies commissioned by the CAA: Steer Davies Gleave (SDG) who reviewed GAL's capex on asset stewardship[42] and the DL study mentioned above that reviewed GAL's

41 Davis Langdon, March 2013, Gatwick Airport: Q6 Capex review for the CAA: Phase two report - final, http://www.caa.co.uk/docs/78/Q6DLangdonCapex.pdf.

42 Steer Davies Gleave, March 2013, Review of Maintenance, Renewals and Other Operating

enhancement/development capex projects. SDG identified efficiencies to asset stewardship costs from the removal of double counting in project risk allowances and a reduction of on-costs to be in line with benchmarks. DL identified efficiencies to project costs from a reduction in unit costs, a reduction in on-costs in line with benchmarks and the removal of double counting in risk allowances.

4.9 Based on the inclusion of schemes and the assessment of efficient costs the CAA included a capex allowance of £0.8 billion for Q6.

Responses to the initial proposals

GAL's responses

4.10 In its response to the initial proposals, GAL increased its capex proposals for Q6 from £0.9 billion in the RBP to £1.1 billion. Figure 4.1 sets out the key changes, the most important of which is the inclusion of hold baggage screening (HBS) at a cost of £151 million to comply with DfT requirements for HBS to be introduced by 2018. GAL also included some scope reductions which reflected the further development of individual projects and ongoing consultation with airlines. Figure 4.2 shows GAL's full capex programme for Q6.

Expenditure at Gatwick Airport: Final Report, http://www.caa.co.uk/docs/78/Gatwick%20Maintenance%20%20Renewals%20Final%20Report%20Issue%203%20v05%20-%20Public.pdf.

Figure 4.1: Main changes in GAL's revised capex proposals for Q6

Category	Main changes	Cost (£m)
Additional asset replacement	Stand and ST IDL retail enhancement	15.3
Additional carry over	Consolidated security gate and higher Pier 5 cost	3.6
Reduced scope/expenditure brought forward to Q5	Border zones, NT arrivals, coaching bays, NT IDL reconfiguration, NT security, ST IDL capacity	-27.0
Removal of ST IDL reconfiguration	Replaced by retail enhancements via churn	-12.7
Additional core projects	Stands 551/552/553, hangar facilities and minor projects	23.3
Additional development projects	HBS replacement and liquid explosive detection	150.9
Total		153.4

Source: CAA analysis of GAL's response to the initial proposals

Figure 4.2: GAL's revised capex proposals for Q6

Scheme	Total (£m)
Airfield Asset Replacement Programme	80.0
Facilities Asset Replacement Programme	154.4
Commercial & Property Asset Replacement	42.6
Compliance & Risk	37.5
IT Asset Stewardship	32.3
Total asset stewardship	**346.7**
South Terminal Baggage & Pier 1	83.6
Pier 5	2.7
Other carry over projects	1.6
Total carry over	**88.0**
Delivery of 95% Pier Service in NT (Pier 6 South)	165.6
North Terminal Security Reconfiguration	23.8
Early Bag Store	22.7

Scheme	Total (£m)
Upgrade Check-in & Bag Drop	39.3
NT Border Zone	12.5
North Terminal IDL Capacity Expansion	82.9
Runway 2	9.4
Business Systems Transformation	14.9
Stand Reconfiguration	9.4
Product Development Car Parking	4.7
Digital Media	5.0
CIP Departures	2.2
NT Baggage Reclaim	2.6
NT arrivals transformation	11.2
ST IDL Capacity	28.3
CIP Arrivals	2.0
Additional NT Coaching Bay	2.3
ST Public Transport and DDA Access	8.7
Consolidated Car rental and MT facility	7.6
Stands 551/ 552/553	8.8
Hanger Facilities	5.1
Minor Projects	9.4
Total core enhancement capex	**478.4**
HBS replacement	149.4
Liquid Explosives Detection	1.6
Total development projects	**150.9**
Total capex plan	**1064.0**

Source: GAL's response to the initial proposals converted to 2011/12 prices

4.11 GAL has responded to the initial proposals, stating in particular that:

- on-costs are assessed on a case by case basis and reflect the difficulty of delivering projects within a 24 hour 365 day public facing operational environment, takes account of recent project delivery and the changing requirements of customers and therefore GAL cannot be compared directly to other airport and non-airport projects;

- project risk allowances are based on GAL standard procedures, although each project is assessed individually; and
- the proposed unit cost efficiencies are not aligned to the preliminary design of the project and the advice from GAL's designers, although if the project continues to be developed GAL will be challenging the proposed specification to reduce costs where appropriate.

4.12 GAL stated that the Pier 6 South project is required to deliver 95% pier service in the north terminal and the cost per unit of pier service compared favourably with other GAL projects such as Pier 2 and Pier 5, particularly if the £50 million cost of the remote stands and asset replacement is excluded from the cost of the project. GAL indicated that at least one airline has confirmed its support for the project. GAL also raised a number of issues on the appropriateness of the assessments made by the independent consultancy studies commissioned by the CAA from SDG and DL.

4.13 GAL's response was based on easyJet being split across terminals although it noted that it supported airline consolidation into one terminal where possible and noted that the latest discussions had focused on consolidation in the North Terminal as following the purchase of the Flybe slots it may not be possible to accommodate all easyJet's operations in the South Terminal.

Other stakeholder views

4.14 The ACC continued to support a capex plan of around £0.4 billion. The supported plan was amended from the airlines' January 2013 position in that the supported expenditure on asset stewardship was reduced from £283 million to £277 million (due to greater efficiency assumptions) and the airlines now supported a number of additional schemes (upgrade check-in (part only), NT coaching bays, ST IDL reconfiguration (phase 1), ST public access and DDA, and stand reconfiguration).

4.15 The ACC did not have a common view on the following schemes:

- Pier 6 South where in general airlines considered that pier service could be maintained through increased towing (although one airline supported the scheme);

- North Terminal IDL (where BA did not support this as it considered GAL did not require the scheme to maximise commercial revenue);
- Early Bag Store (where an operational solution was considered feasible); and
- NT check-in ceilings and floors (where only one airline was supportive).

4.16 The ACC did not support other projects as they did not provide commercial returns within the Q6 period, were not required, or did not offer sufficient passenger benefits (see figure 4.3).

4.17 On HBS, given the early stage of the project the ACC considered that this project should be held outside the price cap. GAL and the ACC stated that they were going to make representations to the DfT on timing of the introduction of HBS in the UK.

4.18 In their individual responses easyJet, BA, Virgin, Thomson and TUI all expressed support for the ACC position. In addition easyJet stated that it supported North Terminal IDL project as it provided a commercial return over Q6, the North Terminal Early Bag Store given the passenger benefits but it did not support Pier 6 South as the costs of the project outweighed the benefits.

4.19 BA did not support the North Terminal IDL as it considered that the same level of passenger benefit could be achieved with GAL's current estate and GAL should do more to maximise revenue from existing operations before expanding facilities. BA supported the provision of self bag drop machines but did not support the upgrades to floors and ceilings as these related to ambience improvements where concerns were not identified through the passenger research undertaken by airlines, GAL or the CAA. BA did not support Pier 6 South as it considered GAL's modelling was flawed and 95% pier service could be maintained without the additional investment (with stand reconfigurations and increased towing).

4.20 Virgin supported investment in self-service bag drop technology at Zone A check-in, to improve passenger experience and the efficient utilisation of airport infrastructure. Virgin did not support the introduction of common user bag drop facilities at this time, as Virgin considered that this would diminish passenger experience and lead to additional costs from a split check-in operation. Virgin also supported the completion of the Pier 1/ST Baggage project.

4.21 Gatwick Airport Consultative Committee (GATCOM) and the States of Guernsey did not comment on GAL's capex proposals.

Figure 4.3: Schemes not fully supported by airlines

Category	Cost (£m)	ACC position
Asset stewardship	346.7	ACC supported expenditure of £276.6m based on the work by their consultants Atkins
Other carry over projects	1.6	No view as was not included in earlier GAL submissions
Delivery of 95% Pier Service in NT (Pier 6 South)	165.6	ACC had no agreed view with only Emirates supporting the scheme as it was attracted to the additional A380 stands and the facility to board premium passengers from a lounge directly onto the aircraft.
Early Bag Store	22.7	The ACC did not consider that this was an efficient use of capital expenditure as the data justifying the scheme was inconclusive. The ACC considered that if demand exceeded supply then operational solutions could be employed to avoid passenger detriment. easyJet supported the scheme.
Upgrade Check-in & Bag Drop	39.3	The ACC supported the provision of self bag drop facilities but did not support reconfiguration of check-in. Thomson supported the refurbishment of NT ceilings and floors.
NT Border Zone	12.5	The ACC did not support the scheme as the automated gates would be replaced by UKBF, the area has sufficient capacity and the other areas of enhancement are related to ambience improvements.
North Terminal IDL Capacity Expansion	82.9	The ACC had no agreed view with only BA not supporting the scheme as it considered that GAL had failed to maximise commercial revenue from the existing estate and the same level of passenger benefits could be achieved without the need for an extension
Runway 2	9.4	Not supported as the costs should not be treated as a capital project.
Business Systems Transformation	14.9	Not supported as part of core capex plan. While the ACC accepted that GAL should invest in IT projects no operating cost benefits were shown in the business case and further

Category	Cost (£m)	ACC position
		development was required.
NT Baggage Reclaim	2.6	Not supported as there was already one A380 capable belt and ACC analysis had shown that further enhancement was not required.
NT arrivals transformation	11.2	Not supported as the project was essentially ambience and did not deliver other passenger benefits.
ST IDL Capacity	28.3	Not supported as GAL already has more space per passenger than comparator airports and the project increases prices in Q6.
Stands 551,, 552 and 553	8.8	While supportive of a project to reconfigure stands 551 to 553, the ACC was concerned over the cost of the project and did not consider there was a requirement to increase gate room size as this would reduce the usable aircraft positions from 3 to 2. The ACC supported the further development of the project but considered it should be held outside the core capex plan.
Hangar Facilities	5.1	Not supported as while the ACC saw merit in the provision of extra hangar facilities at the airport GAL was unable to identify any airlines or maintenance operators who would like extra facilities at the airport and the business case increased prices for passengers within the period.
Minor Projects	9.4	Not supported as the ACC did not consider that there was a requirement for a separate project to cover these eventualities as they were already covered within the Asset Stewardship line and change control processes.
HBS replacement	149.4	The ACC agreed with GAL that the project was insufficiently developed to form part of the core capex plan.
Liquid explosives detection	1.6	Not supported as the ACC considered that this project was highly speculative and predicated on an assumption that the DfT would make changes to the screening process in Q6. Furthermore if this project was required in Q6 then it would be covered under the Asset Stewardship budget

Note: Costs are based on GAL estimates rather than those included in the ACC response

Source: CAA summary of ACC response

Discussion of key issues

Independent review

4.22 In developing its final proposals the CAA has commissioned SDG and DL to consider and address as appropriate the issues raised by GAL and other stakeholders in the responses to the initial proposals.

Steer Davies Gleave review of renewals schemes

4.23 SDG's March 2013 report reviewed GAL's RBP proposals for renewals (asset stewardship) expenditure. SDG's review focused on a top-down assessment of project risks, overheads and project specifics. SDG took into account the review of renewals costs undertaken by Atkins on behalf of the airlines.[43] The key findings from the SDG review were:

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

4.24 Based on this assessment SDG identified: core stretch savings of £18 to £32 million over Q6 based on a reduction to on-costs and project risk allowances; and super stretch savings of £39 to £73 million over

[43] Atkins, January 2013, Review of GAL Asset Stewardship Projects.

Q6 which included a 10 to 20% reduction to base costs to remove the allowance for unscoped work.

4.25 GAL raised a number of concerns with SDG's analysis. SDG responded to each in turn.

- Factual accuracy in particular in the statement that GAL had not kept abreast of the strategic implications of legislative requirements and should have reflected on them in GAL's long term strategy. SDG noted the comment and stated that it was meant to cover broader issues than simply HBS. On HBS SDG noted that GAL's RBP did not contain a proposal to upgrade the HBS equipment to Standard 3 machines in Q6, despite a mandatory requirement for this to be introduced by 1 September 2018, i.e. within Q6. SDG commented that this omission was surprising in the circumstances (and in comparison to Heathrow, where a project for this upgrade was in the programme). SDG also noted the ACC's statement that GAL had advised it had "mistakenly failed to develop to achieve Standard 3 Hold Baggage Screening capability within the capital plan [for Q6]" and GAL's statement that the HBS project should not go into the price cap due to insufficient time to develop the project ahead of the Q6 submission.
- GAL said that SDG's conclusions drawn on benchmarking lacked sufficient credible evidence and did not make sense in particular as SDG did not identify who the benchmarks are and so it was not possible to know if they were valid. SDG stated that as a prerequisite for obtaining the benchmarking data it was unable to publicly divulge the identity of the UK benchmarked airports, but it had taken every care to ensure that the comparisons made were in fact valid. The CAA considers that the UK airports used by SDG for benchmarks are valid for comparison with GAL. SDG accepted that no benchmarking exercise can be perfect, but did not consider that the exercise is invalid. SDG stated that it was careful to ensure that comparisons were as fair as possible given the information available and considered that the benchmarking exercise was worthwhile for the purpose of developing proposed cost savings.

- GAL said that SDG's comments on the opportunities to improve accuracy in GAL's procurement system were not based on demonstrable evidence. GAL did not elaborate on the general comment about the sufficiency of evidence for these opportunities. SDG stated that it had considered that as risk allowances for many projects were significantly above benchmarks as supporting evidence for its concern that there was a tendency for excessive contingency to be built into some cost estimates.
- GAL said that SDG's report contained contradictory and unbalanced statements, in particular around the balance between maintenance and renewals, which disregarded the PAS55 certified asset stewardship process. SDG acknowledged that GAL had achieved PAS55 and this demonstrated some robustness in its processes. Despite this, SDG did not find evidence that alternatives to the present capital renewals programme had been investigated, indicating that there was potential for savings to be achieved through, for example, identification of more cost effective solutions. SDG did not consider that the PAS55 certification, of itself, meant that no improvements to the renewals programme could be made.
- GAL said that SDG's comments on unscoped works were inconsistent with projects at a Tollgate 2 stage and consequently the super stretch savings were questionable as they relied on the argument that at this early stage of development all costs should be based on a greater level of detail which was not available so far in advance. GAL stated that its risk allowances were based on GAL's procedures which added a 20% risk allowance to class 5 estimates at Tollgate zero, unless a specific project warranted a risk reduction. The CAA notes that both the initial and the final proposals focus on the core stretch targets as they seem to be more appropriate than the super stretch targets. SDG acknowledged that not all aspects of some projects at an early stage of development would be fully scoped. However, SDG considered that the level of unscoped works as a proportion of the base construction costs is higher than would be expected and may be double counting the allowance for risk, as also noted by Atkins in its report undertaken for the ACC.
- GAL said its costs were reasonable and reflected the delivery of

projects within a 24 hour 365 day operational environment and cannot be compared to non-airport sectors. SDG stated that the GAL's on-cost allowance of 21.5% was much higher than its benchmark range of 13 to 15% and was only applied to non-airport specific assets. SDG pointed out that no reduction to airport-specific assets (i.e. all airfield assets, light masts and baggage systems) was applied. SDG also stated that DL had come to similar conclusions on GAL's on-cost allowances.

- GAL said that SDG failed to take into account relevant information provided by GAL in relation to some statements made in the earlier SDG report. GAL disagreed with the impression given by SDG's comment that information going back to 2005/06 was requested but not provided by GAL management, pointing out that GAL had provided all the information that they had and stated that management systems and asset stewardship maintenance tracking was not as robust under previous ownership and the availability of current processes underlines the progress made since the transfer of ownership. SDG noted the comment and stated that GAL's interpretation was not the intent in which the statement was made. GAL also considered that the areas mentioned by SDG where lower reactive maintenance could yield greater efficiency (electrical, building fabric and electronics) did not reflect GAL's explanation. SDG acknowledged that a rationale for higher reactive maintenance in some asset areas was discussed and may be appropriate in some cases. SDG however maintained that these areas could yield potential efficiencies.
- GAL additionally clarified that it had not double counted preliminaries within the benchmarks as these were included at facility/sub-facility level and had removed project specifics from the benchmark data.

4.26 SDG stated that it had carefully considered the comments made by GAL but had not found any new information to change its conclusions on on-costs and risk allowances or the savings identified in its final report.[44] SDG stated that the level of savings remained as proposed

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[44] Steer Davies Gleave, September 2013, Review of Maintenance, Renewals and Other Operating Expenditure at Gatwick Airport: Phase 3 Final Report, http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=14279.

in the earlier report, except for the following adjustments made to reflect the re-stated asset stewardship costs in GAL's response to the initial proposals:

- asset stewardship costs over Q6 re-stated as £367 million in 2013/14 prices (£347 million in 2011/12 prices) which resulted in an updated core stretch target in the range £20 to £36 million (previously £19 to £34 million); and
- re-stated asset stewardship costs resulted in an updated super stretch target in the range £44 to £82 million (previously £42 to £78 million).

Figure 4.4: SDG renewals cost allowances (£million, 2011/12 prices)

Basis	Cost	
GAL Q6 cost estimate	347	
	low	high
SDG core	313	328
SDG stretch	269	305

Source: SDG and CAA calculations

4.27 SDG also considered GAL's proposed costs of £149.4 million for HBS. This scheme involved the installation of standard 3 machines next to the baggage make-up facility in the south terminal and the creation of an entirely new baggage facility in the north terminal. SDG considered that GAL's solution appeared operationally robust although other options should be explored. SDG developed two options, both of which included some provision of standard 3 machines in the north terminal baggage hall. Based on these options and high level costings SDG identified that there may be an opportunity to reduce scheme costs by £34 to £45 million, or an average of £39.9 million, to give a total cost of £109.4 million.

Davis Langdon review of enhancement schemes

4.28 DL reviewed[45] GAL's revised proposals for enhancement schemes, in terms of:

[45] Davis Langdon, September 2013, Gatwick Airport: Q6 Capex review for the CAA: Phase three report - final, http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=14279.

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

4.29 DL's review built on their review of GAL's RBP which contributed to the CAA's initial proposals and took into account the responses of GAL and other stakeholders to the initial proposals.

4.30 In the review of scheme efficiency, DL identified a number of efficiencies based on: unit costs that exceeded those from DL's benchmark range, on-costs that were above DL's benchmark range (DL suggested on-costs should be an average of 17%), the removal of some double counting; and the removal of some elements of individual schemes that were not required. On this basis DL suggested the GAL's allowance for enhancement projects should be reduced from £478.4 million to £418.4 million.

4.31 In the review DL considered the two main issues raised by GAL in its response to the initial proposals:

- On-cost allowances which GAL considered should be based on the specifics of individual schemes and should reflect the delivery of schemes in a 24 hour 365 day environment and recent project delivery experience. GAL stated that a direct comparison could not be made between Gatwick and other airport or non-airport projects. DL recognised that on-costs varied across projects but considered that a 17% on-cost allowance reflected a reasonable overall target. DL considered that GAL's on-cost allowances of 14% to 22% were well above the typical external market, which ranged from 9.5% to 15%. Further a major part of on-costs was made up of the GAL charge, which was high compared to external market data and there were opportunities to reduce this.
- Pier 6 south where GAL considered its unit cost estimates were reasonable.
- GAL stated that the steelwork rates reflected recent competitively tendered rates. DL continued to consider that median market rates were appropriate and questioned whether GAL's rates had been properly adjusted.

- GAL considered that a kalzip roof was preferable to alternatives as it required less structure to support it and is more robust than a single polymer membrane which is more vulnerable to penetration during and after construction. DL continued to consider that cheaper alternatives were more appropriate and if a kalzip roof was used then this would reinforce DL's concerns on the overall weight of steel in the structure.
- GAL considered that the full allowance for handrails and walkways was required as the roof included photovoltaic panels and recessed plant space which required safe access. While DL understood GAL's comment to a degree, DL considered that the roof was a controlled environment and so the cost of safety devices appeared excessive.
- GAL considered that the curtain walling reflected the design of the extension which included significant glazing. DL considered that there continued to be considerable scope for design efficiencies.
- GAL considered that allowances for prelims and contractors overheads and profits was in line with other major projects at Gatwick and was comparable to Gatwick framework rates. DL considered that the allowances were high compared to recent projects at Gatwick and elsewhere and could be reduced.

4.32 DL's review of the justification for individual capex projects encompassed a technical review of the business case and a consideration of whether there was airline support for the schemes. DL did not consider whether schemes were justified specifically from a passenger viewpoint. On this basis DL identified six schemes where the business case appeared to be weak and there was little or no support from the airlines.

- Pier 6 south - while DL considered that Pier 6 south may be the most appropriate option if 95% pier service is to be delivered, increased towing could provide something close to 95% pier service by the end of Q6.
- North Terminal Border Zone - where DL agreed that the area required a refresh but queried the introduction of new technology without service commitments from United Kingdom Border Force (UKBF).

- Runway 2 - where DL suggested it was a matter for the CAA whether the costs, in particular those for providing material to the Airports (Davies) Commission, should be capitalised.
- North Terminal arrivals transformation - while accepting there might be a case for a less ambitious project, DL considered that based on simple arithmetic the scope of the existing project was difficult to justify.
- Hangar facilities - where DL considered that the business case did not appear to be that strong and the area could simply be leased to an entity to undertake all development costs.
- Minor development projects where GAL had not provided a business case.

Inclusion of individual schemes

4.33 The CAA considers that, where possible, it is appropriate in the context of Gatwick to review the cost and inclusion of individual schemes, in particular as there was not broad agreement on the programme with airlines. The CAA acknowledges that airlines' views on individual schemes can change as schemes develop, and that is one of the reasons behind the proposals for a core and development capex programme as set out in the initial proposals.

4.34 The CAA welcomes the work undertaken on capex by both GAL and the airlines through CE and subsequently. The CAA is pleased that GAL and the airlines have managed to reach greater agreement on schemes subsequent to its initial proposals. However, airlines do not support all of the schemes that GAL has included in its proposals.

4.35 On making a decision on which schemes to include in its projections the CAA has considered how best to further its statutory duties in particular to further the interests of existing and future passengers, and to do so, where appropriate, by promoting competition. The CAA considers that airlines have an important but not an exclusive role in helping it define how it furthers passengers’ interests for the purpose of development proposals for Q6. While airlines do not represent passengers, their interests are often broadly aligned. However this may not always be the case, for example in situations of airline market power, or where passengers' ability to act in the market is hampered (e.g. information issues). A passenger group that may have interests which are not articulated by airlines currently operating at the airport may be future passengers.

4.36 In addition GAL has stated that the ACC view tends to represent those airlines that are heavily engaged in the process and under-represents the views of current airlines that are not as heavily (or not at all) engaged in the process, as well as future airlines.[46] The current membership of the ACC covers eleven airlines and all the main business models currently operating from the airport.[47] Together these airlines represent 86% of passengers travelling through the airport.[48] While the CAA accepts GAL statement that easyJet, BA, Virgin and to a lesser extent Thomson have been most heavily involved in the process, these airlines represent 63% of passengers and a range of business models. The ACC has assured the CAA and GAL that their position has been discussed and agreed with members.

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

4.38 Where GAL and airlines have not reached agreement then the CAA has considered independent evidence on whether the proposed outputs are in passengers’ interests, or provide a commercial return over a reasonable time period.[49] In particular the CAA has drawn on the views of the Consumer Panel[50] and research undertaken by the CAA[51], GAL[52] and easyJet on passengers' willingness to pay (WTP)

46 Correspondence from GAL, 11 March 2013.

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

48 Figures based on CAA data for 2012.

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

50 The minutes of the Consumer Panel are published at: http://www.caa.co.uk/default.aspx?catid=2488&pagetype=90&pageid=14123.

51 Accent for the CAA, May 2011, 2131 consumer research, http://www.caa.co.uk/docs/2107/2131ConsumerResearch06122011.pdf.

52 LGW WTP research final report, December 2012, Accent, Figure 33.

for improvements. Where GAL and CAA research examined similar attributes, for example reducing security or check-in queues, the values identified were similar. This provided some confidence in the results. However the CAA is mindful that values can vary across passengers and while the GAL research indicated a willingness to pay of £11.94 for a given set of improvements, around 90% of passengers would only pay £1 or more extra.[53] The willingness to pay research has therefore been used to give an indication of the scale of potential passenger benefits rather than an indication of precise values. Where possible the CAA has cross checked the results from its own passenger research.[54]

4.39 **NT IDL reconfiguration** would provide increased circulation space; business, quiet, children's and teenagers' zones; an outside terrace area; and additional retail and catering. GAL commissioned research indicates an average WTP of £2.85/pax for separate quiet and child zones and an outside terraced area (noting that around a quarter of passengers would benefit as the improvements are only to the NT and only to departures, although charges would be spread across all passengers).[55] Based on GAL's estimates the project would pay back by the end of Q6 and provides a positive financial benefit over the 27 year asset life. The project therefore appears to be in passengers' interests.

4.40 **NT/ST check-in** would improve check-in to provide facilities equivalent to NT Zone A (NT check-in areas only), with new technology and processes to reduce waiting times (to a maximum of 30 minutes) at reduced costs. The project involves the introduction of new bag drop machines, replacement of check-in desks and refurbishment of parts of the NT ceilings and floors. The project would lead to an increase in airport charges of £0.08/pax over the 15 year asset life. The incremental costs to passengers would be offset, to some extent, by a reduction in airline operating costs although the

53 Accent for GAL: December 2012, Gatwick Airport Willingness to Pay Research: Final Report

54 CAA, May 2013, CAA passenger research: satisfaction with the airport experience: Heathrow, Gatwick and Stansted, http://www.caa.co.uk/docs/33/CAP%201044%20CAA%20passenger%20research%20satisfaction%20with%20the%20airport%20experience%20(p).pdf.

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

extent to which is unclear. GAL research indicates that improvements and investment to the check-in process is its second highest priority, with improvements to check-in seen as a priority for 32% of passengers. This has dropped in recent years with the opening of NT Zone A.[56] Passengers have a WTP of £0.24/min for reducing check-in queue times (from an average of around 13 minutes to 10 minutes[57]). The CAA also notes that 47% of passengers thought check-in queues were quicker and 13% thought that they were longer than expected. While the aim of the project is to reduce maximum check-in queues, it is also likely to have an impact on average wait times, with BA wait times around half average wait times,[58] although this may be due to staffing levels as well as check-in facilities. Even if check-in queues were reduced by an average of 3 minutes, then taking into account the potential operating cost savings, this project appears to be in passengers' interests. The CAA notes that airlines support the introduction of the bag drop facilities and in one case the refurbishment of the ceilings and floors. DL stated that some refurbishment was clearly required but not at the cost proposed by GAL and reduced their proposed capex allowance by £4.7 million accordingly. The CAA has included DL's suggested costs.

4.41 **NT early bag store** would provide a 1,500 early bag store in the Main North Terminal Baggage Hall and a 1,500 early bag store adjacent to the other North Terminal baggage facility (currently processing easyJet and BA baggage). There will already be a facility in the South Terminal delivered through the ST baggage improvements. GAL states that the new facility will allow passengers to check-in baggage up to 18 hours before departure, with GAL finding that around half of passengers were interested in early bag drop off.[59] Furthermore if the project did not proceed then airlines would need to restrict their check-in opening hours, for example easyJet from 2 to 1.5 hours and, at peak times, BA and Thomson to 1.5 hours in short haul and 3 hours in long haul. The ACC did not support the early bag drop facility (although easyJet supported it) and considered that the data

56 Page 50 YouGov.

57 Accent, December 2012, LGW WTP research final report, December 2012, Figure 14.

58 Accent, LGW WTP research final report, Figure 41 versus Figure 14.

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

supporting the scheme was inconclusive and operational solutions could be found if demand exceeded supply. The project is forecast to increase airport charges by £0.05/pax over the 15 year project lifetime. GAL passenger research indicates a WTP of ~£1.40/pax for early baggage storage (up to 12 hours or more). While an early bag store appears to be in passengers' interests, DL indicated that a smaller, modular facility could provide a better value solution. The CAA has therefore included DL's suggested costs for such a project.

4.42 **NT border zones** would provide 12 e-gates, 13 manual desks and additional queuing space, queue measurement technology and refurbishment of NT arrivals hall. Around 60% of passengers identified passport control as the third highest priority for investment[60] with an average WTP of £0.35/min/pax (for reducing average queues from 15 minutes to 10 minutes[61]). GAL stated that it revised the business case for the project, following a greater understanding of the technology required to deliver capacity. The CAA notes that the net cost of the scheme to passengers over the project remains little changed at around £0.03/pax over 15 years. GAL states that the cost of fitting manual desks rather than e-gates would be cheaper although this would be wasted investment as it would not lead to reduced passenger queuing as even with extra staff not all current desks are used. The ACC stated that UKBF will replace the current machines in 2015 and is already meeting national targets. The ACC also considered that the existing immigration hall has sufficient capacity. The CAA continues to consider that despite the proposed improvements in the Border Zone area, as there is no Service Level Agreement with the UKBF, there was no guarantee that immigration queues would reduce, for example as UKBF could use the improvements to improve efficiency. Consequently while passengers would face increased charges, they may not see an improved service. The CAA has not included the full costs of this scheme in its final projections as it has not been confirmed that the benefits from the scheme would not be absorbed by reductions in UKBF costs. The CAA has therefore included DL's estimate of a reduced scheme, based simply on the refurbishment of the existing area.

4.43 The **runway 2** project would safeguard the area for the potential

[60] Page 54 YouGov.

[61] Figure 21, Accent.

second runway and fund GAL's input to the Airports Commission. The CAA has considered the approach that it took to the costs of the BAA input to the 2003 government White Paper. At the time of the Q4 review the CAA did not allow initial, or preliminary expenditure in the price controls as the government had not published the White Paper and there was no way of knowing which new runway developments the government would support.[62] It was only after the government decision was made, and subject to a number of criteria, that the CAA allowed the costs to be added to the RAB.[63] On the cost of safeguarding, the CAA notes that the costs forecast by GAL appear excessive for something which is essentially protecting the alignment of a runway. The CAA also notes that safeguarding costs are treated as opex in the statutory accounts. On this basis the CAA stated in its initial proposals that it would not allow runway 2 costs to be added to the RAB. While the ACC welcomed the CAA's initial proposals, GAL has not provided a detailed response to the issues raised. Furthermore, the CAA notes that GAL has included the costs of input to the Airports Commission in its operating costs forecasts.[64] For these reasons the CAA has not included runway 2 costs in the final projections. The CAA will publish a regulatory policy statement on the treatment of new runway costs during the next control period.

4.44 **NT Pier service (Pier 6 South extension)** would provide an additional 6 Code E stands (4 could be Code F) and additional 8 Code C stands to ensure delivery of 95% pier service in the North Terminal. The project would increase airport charges by £0.23 per pax over the 40 year asset life.

4.45 The Pier 6 South scheme has been controversial between GAL and the airlines. Only one airline, Emirates, supported the project as it was attracted to the additional A380 stands and the facility to board premium passengers from a lounge directly onto the aircraft. The other airlines considered that 95% pier service could be achieved in

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

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

[64] GAL, January 2013, Revised Business Plan to 2024, page 165.

2018 through stand reconfigurations and increased towing.

4.46 GAL stated that the Pier 6 South extension was in passengers' interests as:

- the project would increase North Terminal pier service by 6% (the CAA notes that this is by 2026 under GAL's high case forecasts) and without the project pier service levels would fall below the service standard by 2018, and traffic forecasts had increased since the modelling exercise was concluded;
- passengers WTP for pier service was £3.79 per passenger, although the CAA notes that this is based on face to face interviews and the average value identified in GAL's willingness to pay research was £1.51 per passenger;
- the project would avoid around 1.2 million coach trips per year from 2018, with current coaching costs of £2.08 per passenger;
- the project was cheaper than previous pier service projects and the alternative Pier 7 project, which would cost more than £400 million,
- the project would directly benefit passengers' with reduced mobility (PRMs) with a reduced requirement for Ambulift journeys which can separate PRMs from their families;
- airline proposals to increase the use of the Multi Aircraft Ramp System (MARSing) of stands (which would allow two narrow body or one widebody aircraft to use suitable stands) would not improve pier service, although there might be some benefit from the reconfiguration of Stands 551/552/553;
- the airlines' proposed reduction in stand planning buffers between arriving and departing aircraft from 30 minutes to 10 minutes would not be operationally robust;
- increased towing could improve pier service however this was only a short term measure and may not be operationally feasible (for example in July 2013 21% of tows were refused);
- the project was well specified; and

- stopping or delaying the project would incur more cost in the long term, for example the Q5 design cost of £8.5 million would be sunk, the project would avoid around £28 million of renewals expenditure in Q6, with a further £13 million in Q7; and due to the need to close a number of pier served and remote stands during construction, will be increasingly operationally difficult.

4.47 The ACC has responded to GAL's comments highlighting a number of concerns with the analysis of the rationale for the Pier 6 South extension:

- the incremental benefits of the scheme would be outweighed by the incremental costs;
- GAL's estimates of coaching were disproportionately high and had not been shared with the airlines;
- the forecast increase in PRMs was unsubstantiated;
- the source of the pier service forecasts was unclear, had not been shared with the airlines and the forecast pier service for 2013 was below current performance;
- it was unclear why these pier service forecasts were correct and superseded previous work;
- airlines had not seen evidence from GAL that it was unfeasible to MARS more wide-body stands;
- airlines have, with one exception, not supported the project and have simply stated that more pier served stands are likely to be required in the future;
- airlines had not previously seen the quantification of the refurbishment costs
- it was likely that Pier 6 South would conflict with infrastructure required for runway 2;
- easyJet's purchase of the Flybe slots could increase pier service as existing Flybe flights are consistently pier served;
- there have been just 4 A380 flights to Gatwick and no airlines have firm plans to operate A380 services to the airport; and

- GAL's late submission adds no extra evidence to make their argument and simply adds confusion.

4.48 GAL have responded to the ACC's letter stating in particular that:

- all the data presented to the CAA (with the exception of the PRM data) had been previously shared with the ACC and the pier service calculation method was unchanged to that agreed with the ACC;
- the difference between the forecast and actual pier service for 2013 reflects additional towing which has been used to maintain pier service levels;
- Pier 6 South was consistent with a second runway; and
- if the project was delayed then this was effectively a decision not to build in that location.

4.49 GAL also stated that its modelling was based to an average busy day, which GAL took as the middle Friday in August. GAL stated that pier service in August was 0.7% below the annual average and that in 2012 pier service on the Friday busy day was above average pier service for the month. The ACC stated that the results of the most recent analysis did not appear to be consistent with that previously shared with the ACC. GAL and the ACC subsequently agreed that the majority of data had been previously shared with the exception of the PRM data, forecast use of coaching and level of use of the Pier 6 south extension (all of which the ACC did not agree with) and the uplift applied to modelled pier service to obtain annual equivalents. GAL has also clarified that its forecasts do not reflect increased towing.

4.50 DL in their assessment identified that Pier 6 South was the only viable long term solution to maintaining 95% pier service in the North Terminal but stated that it was debateable whether GAL had put forward a strong business case for the scheme.

4.51 The CAA has reviewed the evidence on the justification for the Pier 6 South scheme. The CAA has placed weight on DL's statement that the Pier 6 South extension appears to be the only long term option. The CAA also notes that GAL's high case traffic forecast, on which the modelling of pier service is based is similar to the CAA's base case traffic forecast for 2018/19 (39.2 million passengers per annum compared to 38.5 million passengers per annum).

4.52 If the CAA was considering only Q6 then, given the relatively small increase in pier service forecast by GAL (from 93.4% to 96.6% in 2018 based on the average busy day), it appears that increased towing could provide a means of maintaining 95% annual average pier service, in particular as GAL is forecasting similar levels of towing in 2013 (albeit noting the problems GAL outlined above). However, by the end of Q7 then reduction in pier service without Pier 6 South could be substantial at around 5% and GAL has stated that increased coaching at this level would not be operationally feasible. Consequently the CAA considers that Pier 6 South is required to meet airport operational requirements in Q7. If the Pier 6 South extension was delayed until Q7 then this could increase the total costs of the project as the Q5 design work could need to be repeated and there would be additional costs of renewals during Q6. The CAA considers that this would not be in passengers' interests. Consequently, the CAA has included the costs of the Pier 6 South scheme in Q6.

4.53 **NT baggage reclaim** would convert the second domestic belt into a 70 metre international belt. This would be in addition to the existing 70 metre belt and would avoid the need to split baggage from wide bodied aircraft across two belts at peak times. The project would increase airport charges by less than £0.01/pax. The CAA acknowledges passenger priorities for reducing baggage waiting times[65] while noting that the impact of the project on waiting times is unclear. GAL has forecast that there would be a daily period over 3 hours and 3 periods during that time where the wait time would be over 30 minutes when wide-body demand would exceed the capacity of the existing system. The ACC has stated that if demand exceeds capacity then baggage could be split across two belts and an additional wide-body belt was not required. DL considered that the project had merit. The CAA has reviewed GAL's forecasts of wide-body demand. While GAL's long haul traffic forecasts (which drive wide-body demand) are higher than the CAA's, GAL's forecast of 16 to 21 wide-body morning peak North Terminal arrivals appears reasonable compared to 13 wide-body arrivals in August 2013, particularly at the lower end of the range. The CAA therefore considers that the project is in passengers' interests and has included the scheme in the Q6 capex programme.

[65] Page 51 YouGov.

4.54 **NT arrivals** would reconfigure the arrivals area to give a better passenger flow and improved commercial revenue offering. GAL intends that this reconfiguration would lead to improved Quality of Service Measure (QSM) scores for cleaning and wayfinding. GAL airport wide passenger surveys indicate that the arrivals concourse and processes are often areas of complaint. The project would increase airport charges by £0.05/pax over the 15 year project life. GAL surveys indicate that 10% of passengers suggest that wayfinding needs to be improved (down from 25% in 2009) reflecting improvements in GAL's way finding signage. The CAA notes that GAL is meeting both cleaning and wayfinding targets in the North Terminal. The ACC considered that this was an ambience project without any real benefits to passengers. DL suggested the scope of the existing project was difficult to justify and that there might be a case for a less ambitious project aimed at improving the look and feel of the arrivals area. The CAA does not have sufficient evidence to suggest that GAL's proposed project would be in passengers' interests and has therefore included DL's estimate for a reduced scope project.

4.55 **South Terminal IDL** capacity would expand and reconfigure the existing IDL to meet GAL's service standards. This would provide an IDL with a total area of up to 24,000m², including up to 4,900m² of food & beverage, up to 10,000m² of retail, 1,710 – 1,900 seats and 4,700m² to 8,000m² of circulation space. The ACC considered that GAL already provided more space per passenger than many comparator airports. The ACC did not support the project as it did not provide a return within Q6. The project would increase costs in Q6 by £0.02 per passenger but would provide a payback of £0.07 per passenger over the 25 year project life and provide a financial payback from Q7 onwards. DL queried the ACC's argument over space standards and the requirement for the project to be financially positive in Q6. As the project provides net financial benefits to passengers during Q7, the CAA considers the project is in passengers' interests and should be included in the core capex plan.

4.56 **Business systems transformation** covers a range of projects including passenger tracking, queue measurement, dynamic wayfinding, digital media and asset management and internal reporting improvements. The project would increase airport charges by £0.07/pax over the 5 year project life. The ACC accepted that GAL should invest in IT projects during Q6 to improve services to passengers, however it would have expected these to reduce rather than increase costs. The ACC suggested that this project should be held outside the core capital plan and only included when it was developed to a greater level of detail. While the passenger benefits of some elements of these proposals are clear, for example passenger tracking, the benefits of other elements are less clear. GAL indicated as part of the RBP submission that that there may be an opex reduction from some projects, but further work was required to demonstrate this. GAL did not provide an updated business case in response to the initial proposals. DL agreed with the ACC that this project should only be included in the core capital plan as and when further details and a clear rational emerge. On this basis the CAA does not consider that the scheme should be included in the core capex programme for Q6 (although it has included an allowance for minor projects which would allow any proposed schemes in this area to be taken forwards, see below).

4.57 **Hangar facilities** is an additional scheme proposed by GAL to the RBP and would provide a new 16,2000m^2 £5 million concrete base, apron area and allowances for the hangar foundation and services to the site, with a third party providing the hangar itself to suit its requirements. GAL states that the project will not proceed unless there is a positive business case. The ACC does not support this project and is concerned that its speculative nature means it will never be built. The project would increase charges in Q6 but have a neutral impact over the 75 year project life. DL considered that the business case did not appear to be strong and could easily fall into a development project or simply be leased to an entity to undertake all development costs. Given this the CAA does not have sufficient evidence to include the project in the core capital plan.

4.58 **Stands 551 to 553** can accommodate 2 restricted 737s and 1 A319. GAL considers that the gate room capacity is restricted and shared with stand 554. This means that all stands cannot be used at the same time with gate room capacity restricted to two flights at any one time. The ACC, while supportive of a project to reconfigure stands 551 to 553 to ensure that they are usable by a wider range of aircraft, raised concerns that the project reduced stands from 3 to 2 while increasing gate room capacity. The project would increase charges by £0.03 per passenger over the 10 year project life, although the business case states that there would be passenger benefits in reduced congestion and improved facilities for PRMs. DL considered that in total the business case for the project was strong. On this basis the CAA considers that the project has passenger benefits and should be included in the core capex plan.

4.59 GAL included an allowance of £9.4 million for **minor projects** in its response to the initial proposals. In the initial proposals the CAA stated that it would look favourably on proposals to make some small provision now for investments that GAL and airlines have not yet thought about and where the passenger benefit is not yet apparent. The provision was based on the premise that the allowance would be included in the price cap.

Efficient costs of individual schemes

4.60 The CAA has drawn on the SDG and DL consultancy studies to develop its final projections of the efficient costs to be included in the fair price. To be consistent with the price in the commitments and a RAB-based comparator the CAA has only included the costs in the core capex plan. It is notable that under both the commitments and a RAB-based alternative, GAL has proposed that the costs of HBS are held outside the proposed price cap/path. The CAA has not included the costs of hangar facilities and business systems transformation in the core capex plan as the business cases for these projects do not currently appear to be strong. The CAA also excluded the costs related to the development of the second runway from the capital plan.

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

4.62 The CAA notes that GAL has not uplifted for real construction price inflation (COPI) after 2013. The CAA notes that DL's analysis, as set out in figure 4.5, shows that real COPI will be negative over the next few years and only returns to above inflation in the second half of the Q6 period. Given the uncertainty involved in the forecasts the CAA does not consider it appropriate to make a separate allowance for real COPI.

Figure 4.5: Comparison of COPI and RPI

Financial year	COPI	RPI	Real COPI
2012-13	3.9%	4.0%	-0.1%
2013-14	1.70%	3.80%	-2.1%
2014-15	1.00%	3.50%	-2.5%
2015-16	1.40%	3.30%	-1.9%
2016-17	2.60%	3.30%	-0.7%
2017-18	3.30%	3.30%	0.0%
2018-19	3.70%		

Source: DL, OBR

4.63 For renewals, based on the SDG analysis, the CAA considers that the core stretch targets would be appropriate, as the reductions to the various add-ons seem to be broadly based. The CAA considers that the base cost reductions included in the stretch targets appear to be more speculative. The CAA has also included the average SDG estimated cost for HBS of £109.4 million.

4.64 The CAA has used DL's proposals on scheme costs for enhancement schemes, adjusted where appropriate for proposed reductions in scope. Figure 4.6 sets out the CAA's final projections for the Q6 capex programme. The total core capex programme is £790.8 million which is a 13% reduction in GAL's core plan in its response to the initial proposals. This compares to a core capex programme of £793.9 million in the initial proposals.

Figure 4.6: CAA final projections for the core and development capex plan for Q6 (£ million)

	2014/ 15	2015/ 16	2016/ 17	2017/ 18	2018/ 19	Total
Total asset stewardship	**55.1**	**74.3**	**63.5**	**64.3**	**63.1**	**320.3**
South Terminal Baggage & Pier 1	61.9	21.7	0.0	0.0	0.0	83.6
Pier 5	2.7	0.0	0.0	0.0	0.0	2.7
Other carry over projects	1.6	0.0	0.0	0.0	0.0	1.6
Total carry over	**66.3**	**21.7**	**0.0**	**0.0**	**0.0**	**88.0**
Delivery of 95% Pier Service in NT	4.5	43.6	70.5	32.8	0.6	152.0
North Terminal Security Reconfiguration	4.4	6.0	5.3	2.3	0.0	17.9

	2014/15	2015/16	2016/17	2017/18	2018/19	Total
Early Bag Store	0.5	0.6	5.2	5.0	0.5	11.8
Upgrade Check-in & Bag Drop	0.9	2.7	4.4	4.0	22.6	34.6
NT Border Zone	0.0	0.4	0.8	4.2	1.7	7.1
North Terminal IDL Capacity Expansion	18.2	25.0	22.2	8.2	0.0	73.6
Stand Reconfigurations	0.7	7.1	1.4	0.2	0.0	9.4
Long Stay Car Products	0.0	0.0	0.0	0.6	4.1	4.7
Digital Media	0.1	2.4	0.8	0.1	1.6	5.0
CIP Departures	0.1	1.8	0.0	0.0	0.0	1.9
NT Baggage Reclaim	0.0	0.0	0.2	1.3	1.2	2.6
NT arrivals transformation	0.4	1.3	4.0	0.0	0.0	5.7
ST IDL Capacity	0.0	0.4	1.0	9.2	13.9	24.5
CIP Arrivals	0.1	1.8	0.0	0.0	0.0	1.9
Additional NT Coaching Bay	0.1	0.2	0.6	0.9	0.0	1.9
ST Public Transport and DDA Access	0.4	0.3	2.7	4.1	0.0	7.6
Consolidated Car rental and MT facility	0.3	0.9	3.5	0.0	0.0	4.7
Stands 551 and 552	0.8	5.3	0.0	0.0	0.0	6.1
Minor Projects	1.9	1.9	1.9	1.9	1.9	9.4
Total core enhancement capex	33.3	101.8	124.5	74.9	48.0	382.5
Total core capex plan	154.7	197.8	188.0	139.2	111.0	790.8
Business Systems Transformation	3.1	3.1	3.1	2.8	2.8	14.9
Hangar Facilities	3.7	0.0	0.0	0.0	0.0	3.7
HBS replacement	5.9	4.3	49.8	42.7	6.6	109.4
Liquid Explosives Detection	0.0	0.4	1.2	0.0	0.0	1.6
Total development projects	**12.7**	**7.8**	**54.1**	**45.5**	**9.4**	**129.6**
Total capex plan	167.5	205.6	242.1	184.8	120.5	920.4

Source: CAA calculations

4.65 For the first two years of Q7, 2019/20 and 2020/21, GAL has provided an updated view of the Q7 spend for both years combined of £385.2 million. Despite requests GAL has not provided a breakdown of this expenditure. As the CAA cannot verify which projects GAL was intending to proceed with, the CAA has instead used GAL's forecast capex plan included in the RBP but removed the costs of ST IDL capacity and HBS replacement, both of which are forecast to be completed in Q6. Given the early stage of development of many projects it has not been possible for the CAA to undertake a detailed bottom-up review of the expenditure on individual projects. Figure 4.7 sets out the CAA's forecast capex plan for the first two years of Q7. The CAA is also conscious that given the early stage of development costs are likely to change before the project are delivered. Consequently the CAA has maintained GAL's proposed allowance for capex in these two years.

Figure 4.7: CAA's final projections for capex for the first two years of Q7 (£ million)

	2019/20	2020/21
Asset stewardship	78.4	99.2
Long stay capacity (Decking) post 2019	1.9	4.7
CIP building replacement (North Terminal)	9.4	9.4
North Terminal avenue reconfiguration	1.9	4.7
North Terminal Baggage Reclaim reconfiguration	0.0	2.8
NT Short Stay Car Park	1.7	8.6
ST Baggage Reclaim	0.9	0.9
Additional staff car park capacity	2.4	2.7
NT IDL Phase 2 (Post 2019)	18.9	18.9
Baggage capacity expansion (Post 2019)	0.0	1.9
Railway contribution	9.4	9.4
Bridge over railway	0.0	0.9
ST Short Stay MSCP	0.0	1.9
Product development - Car Parking, Post 2019	1.9	1.9
Terminals works Post 2019	4.7	8.0
Piers works (Post 2019)	11.3	16.0
Commercial products (£25m holding figure, scope to be determined)	4.7	4.7
Industrial bays (assume 3 warehouses and associated bays works)	3.8	3.8
Landside restaurant	0.0	0.9
Total	151.4	201.6

Source: CAA analysis of GAL's RBP

CAA final projections

4.66 Based on the above analysis, figure 4.8 sets out the CAA's final projections for GAL's efficiency capex over Q6 and the first two years of Q7.

Figure 4.8: CAA's final projections for capex (£ million)

	2014/15	2015/16	2016/17	2017/18	2018/19	Total	2019/20	2020/21
Asset stewardship	55.1	74.3	63.5	64.3	63.1	320.3	78.4	99.2
Carry over	66.3	21.7	0.0	0.0	0.0	88.0	0.0	0.0
Core enhancement capex	33.3	101.8	124.5	74.9	48.0	382.5	73.0	102.4
Total core capex plan	154.7	197.8	188.0	139.2	111.0	790.8	151.4	201.6
Development enhancement capex	12.7	7.8	54.1	45.5	9.4	129.6	0.0	0.0
Total capex plan	167.5	205.6	242.1	184.8	120.5	920.4	151.4	201.6

Source: CAA calculations

CHAPTER 5

Operating expenditure

5.1 This chapter considers the appropriate opex allowance for the Q6 price control calculation and contains the following sections:

- a summary of the CAA's opex process;
- a description of the opex forecast for Q6 contained in GAL's RBP;
- a summary of the CAA's initial opex proposals for the Q6 opex allowance; and
- a summary of the main issues of disagreement between GAL and the airlines over the Q6 opex allowance;
- the CAA's final projections for the opex allowance over Q6.

Opex process to date

5.2 To date, the Q6 opex process has consisted of the following stages:

- GAL published its IBP in July 2012 providing its initial opex forecast allowance of £1,528 million over Q6.
- Between July and December 2012, GAL and the airlines engaged in a process of CE over the forecasts in the IBP, providing a report to the CAA highlighting areas of agreement and disagreement.
- Opex forecasts were reduced to £1,481 million in GAL's RBP in January 2013, a 3% reduction compared to the IBP. These forecasts were summarised in chapter 5 of the CAA's initial proposals.
- The CAA commissioned several consultancy studies to test the forecasts contained in the IBP and RBP through analysis of historical trends, costs and drivers, the assumptions underlying the business plan, and the potential scope for further efficiency based on benchmarks and other evidence.

- The CAA used this evidence to develop the opex allowance described in the initial proposals. The allowance was for £1,385 million over Q6, a 7% reduction relative to the RBP.

Initial Proposals

5.3 The CAA's initial proposals included an opex allowance for GAL, which would reduce total opex by 1.1% per year over Q6 from 2013/14, leading to a total reduction of £96 million relative to the RBP.

5.4 This was based on evidence that showed that GAL had the potential to reduce costs in several areas including wages, pensions, utilities, police costs, cleaning, maintenance and a more ambitious frontier shift target.

5.5 GAL provided a detailed response to the CAA's initial proposals. This included a variety of points related to the opex evidence, which are described throughout this chapter.

5.6 GAL did not provide an update to its business plan opex forecasts and considers that the opex forecasts in the RBP remain appropriate. GAL did state that its capex programme had developed since the publication of the RBP and that this would have some impacts on the opex forecast. GAL also increased its traffic forecast by 4.7 million passengers over Q6, but assumed that this would have a negligible impact on opex.

5.7 Several airlines including BA, Virgin Atlantic, easyJet and the ACC provided detailed comments on the CAA's opex allowance expressing disappointment in the level of opex efficiency savings and providing suggestions and evidence for further efficiencies. The ACC proposed an allowance of £1,323 million over Q6, 11% lower than the RBP and representing a 2.2% annual reduction over Q6.

Issues

5.8 The CAA recognises that GAL's opex allowance is a key component of the calculation of final prices. It is also an area where there is a stark difference of views between GAL and the airlines as to what constitutes an appropriate allowance for Q6 based on differing assumptions about the scope for efficiency. There is also some uncertainty and informational asymmetry between GAL and the CAA over opex, which requires the CAA to use judgement over several issues.

5.9 The CAA considers that the main areas of contention between GAL and the airlines concerning GAL's opex projections and the CAA's initial proposals have been:

- the analysis and conclusions of the top down benchmarking;
- the analysis and conclusions of the employee pay benchmarking studies and achievability of the proposed efficiency savings;
- the analysis and conclusions of the pensions benchmarking, studies and achievability of the proposed efficiency savings;
- the scope for greater security process efficiency including flow rates, roster efficiency and the potential for security outsourcing;
- the scope for greater efficiency through savings in other areas including maintenance, utilities, rent, rates, police, ANS, cleaning and other cost lines; and
- the CAA's judgement over these issues and the overall scope for efficiency at Gatwick.

Top-down benchmarking

Issue

5.10 The CAA undertook top-down opex per passenger benchmarking as part of the analysis supporting the initial proposals. The CAA concluded that this analysis tended to suggest that GAL had scope for efficiency catch-up based on comparisons of adjusted operating cost per passenger with other airports. The analysis indicated that GAL's adjusted operating cost per passenger was close to the benchmark average but had increased more rapidly since 2000.

Stakeholder Views

5.11 The CAA received two substantive responses on the top-down benchmarking analysis.

5.12 GAL made several criticisms including that the benchmark sample was non-comparable, the time period selection was arbitrary, the data was out of date and the analysis and interpretation of the benchmarking was flawed. GAL stated that evidence of efficiency had been dismissed arbitrarily and that the CAA could not place weight on comparisons between GAL and easyJet. GAL also provided additional top-down benchmarking evidence from AT Kearney, which showed that GAL's opex per passenger is below the average of the sample used in the study.

5.13 The ACC considered that the comparisons between GAL's and easyJet's opex performance was relevant to the assessment of GAL's opex and agreed that the analysis tended to suggest that GAL could achieve a greater level of efficiency.

CAA's final projections

Comparisons with airports

5.14 The CAA accepts that no benchmarking sample is perfectly comparable to Gatwick and that the results of top-down benchmarking need to be interpreted carefully. Comparing opex per passenger at Gatwick against other airports can provide an indication of the potential scope for efficiency gains, but care must be taken to account for unique factors where possible.

5.15 The CAA has updated the benchmarking analysis to take account of stakeholder comments and the latest available data and research.

5.16 The CAA considers that the sample used to benchmark Gatwick is appropriate. Gatwick is above the sample average in terms of passenger numbers, but is close to the average across other characteristics including; Air Traffic Movements (ATMs), total terminal size, number of gates, number of employees and the proportion of long haul traffic.

5.17 The benchmarking analysis in the initial proposals indicated that Gatwick's adjusted operating cost per passenger was £7.82, slightly above the average of the sample (£7.75). The updated analysis (incorporating 2012/13 data for several airports) shows that Gatwick’s adjusted opex per passenger has fallen by 0.5% and is now slightly below the average of the sample.

5.18 This does not change the CAA's conclusion that there could be scope for further catch-up efficiency at Gatwick. This conclusion was based on direct comparisons with more efficient airports within the sample, which are more likely to reflect the efficiency of a firm operating in a competitive market.

5.19 For example, Copenhagen has been identified as the most efficient airport in the ATRS airport benchmarking study and could be considered comparable to Gatwick.[66] Copenhagen Airport has fewer passengers than Gatwick, but a similar level of ATMs, three runways in comparison to Gatwick's one runway and three terminals in comparison to Gatwick's two terminals. Copenhagen Airport has more stands and a similar number of gates to Gatwick and also has a similar level of international passengers.

5.20 Gatwick's ASQ scores for passenger satisfaction are above the European average. The CAA does not have information on Copenhagen's ASQ performance, but notes that the airport has won several awards for service quality.[67] Copenhagen Airport also caters to similar airlines to Gatwick including Norwegian Air Shuttle and easyJet which account for 21% and 14% of flights respectively. Overall the CAA considers that Copenhagen Airport is an appropriate comparator for Gatwick.

5.21 In 2005 adjusted opex per passenger was £8.14 at Copenhagen Airport and £7.83 at Gatwick. By 2012 costs had fallen by 1% (to £7.77) at Gatwick compared to 38% (to £5.05) at Copenhagen (in real terms) meaning that Gatwick is outperformed by Copenhagen Airport by around £2 per passenger. Gatwick is also currently outperformed by Stansted, Dublin, Hong Kong, Edinburgh and Glasgow airports in terms of adjusted opex per passenger, although these airports are less comparable to Gatwick.

5.22 The CAA has also considered the latest benchmarking evidence from ATRS and Leigh Fisher. In summary, this evidence shows the following:

- Analysis of residual productivity[68] in the ATRS study shows that

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[66] ATRS, 2013, Airport Benchmarking Report – 2013.

[67] Including Skytrax 2013, Best Airport in Northern Europe and ACI Airport Service excellence awards in 2005.

[68] Residual productivity is an econometric concept which measures the productivity of an airport

Gatwick is ranked in 15th place behind Copenhagen, Zurich, Amsterdam and Manchester airports with an efficiency gap of around 55% relative to the frontier.[69]

- The Leigh Fisher study shows that Gatwick's adjusted operating cost per passenger is £9.60, £0.42 above the European average and also above Copenhagen and Manchester airports.

5.23 The AT Kearney study provided by GAL shows that Gatwick's operating costs per passenger are slightly below the sample average. This is consistent with the CAA's own findings. However, the study provided no comparison of Gatwick’s performance against the most efficient airports in the sample.

5.24 Due to confidentiality concerns, AT Kearney was not able to provide the details of the airports included in the sample. AT Kearney stated that around half of the airports were state owned with privatised airports likely to be subject to some form of regulation. This raises concern whether the sample used in the study is comparable with Gatwick.

5.25 Gatwick has the highest proportion of low cost passengers within the AT Kearney sample. Airports with high proportions of low cost passengers tend to have lower operating costs. The CAA is also conscious that total opex benchmarking was not the primary focus of the study which was based on bottom up analysis of the costs of support and IT functions and did not undertake a detailed analysis of other areas such as security, staff costs utilities and cleaning.

5.26 Gatwick’s adjusted opex per passenger increased by 29% between 2000 and 2008 compared to a 3% increase in the sample average. Since 2008 adjusted operating costs per passenger have fallen by 13%, similar to the sample average. This suggests that GAL’s performance has improved since 2008 but that there may be scope for further catch-up efficiency to address the relatively high growth in costs between 2000 and 2008.

5.27 Overall the available benchmarking evidence indicates that in terms of opex per unit output, Gatwick is operating at around the average level of airports of its size and characteristics. Comparisons with more

accounting for its different inputs and outputs.

69 ATRS, Airport Benchmarking Report - 2013, Part I, page 53.

lower cost airports indicates that there is scope for further catch up efficiency, particularly given the relative increase in Gatwick's adjusted opex per passenger since 2000 relative to the sample average.

Comparisons with airlines

5.28 The CAA accepts that comparisons of opex performance between airports and airlines are imperfect, and that airlines have a more flexible cost base that may make them more efficient.

5.29 However, airlines and airports operate in the same sector and share many of the same cost drivers, including exposure to similar labour markets and technical and security requirements. One of the main differences between the sectors is the level of competition.

5.30 Airlines have experienced higher input cost inflation than airports over recent years due to rising fuel costs. Fuel costs have risen from 14% to 32% of easyJet’s total operating costs since 2000, reflecting large increases in fuel prices over this period.

5.31 As a result of competitive pressures, airlines have made several changes to their businesses in recent years to control costs, including reducing pension costs, limiting wage growth and restructuring. These changes could also be implemented at Gatwick.

5.32 The CAA notes GAL's comments on the rapid growth and structural changes at easyJet which could affect the analysis. However, other airlines show similar levels of cost reduction including BA and Ryanair and comparisons of Gatwick with these airlines produce the same conclusions.

5.33 The CAA accepts that no benchmarking sample can be regarded as a perfect comparison to Gatwick. However, the available top-down benchmarking analysis confirms our original conclusion that whilst opex per passenger is close to the average at Gatwick, costs have risen faster than comparable airports and airlines and that there is likely to be scope for further catch-up efficiency.

Employee pay

Issue

5.34 The IDS employee reward benchmarking study examined GAL's staff costs against comparators finding that total staff reward was between 9% and 13% higher than benchmarks.

5.35 Based on the data published in GAL's regulatory accounts, in 2011/12 total staff costs were £141 million.[70] This implies that if GAL could reduce its staff costs in line with the IDS benchmarks it could reduce costs by between £13 million and £19 million per year by the end of Q6 taking account of changes in headcount. This does not include any savings that could be achieved through changes to rosters, closer matching of labour supply and demand, staff grading or changes to pension provision.

CAA's initial proposals

5.36 The CAA's initial proposals stated that GAL could reduce staff costs by between £13 million and £19 million per year by the end of Q6 based on reducing costs by 9% to 13% in line with the IDS analysis.

Stakeholder views

5.37 GAL responded that the efficiencies related to the IDS evidence failed to account for the limitations of benchmarking evidence, and the achievability of key conclusions. GAL specifically highlighted the IDS benchmarking study for the recent NATS (En-Route) plc (NERL) review undertaken for the CAA, in which observations of staff costs within 10% of benchmarks were disregarded by IDS from the analysis as statistical noise. This made the GAL study inconsistent with similar studies undertaken by IDS.

5.38 GAL acknowledged that its pay rates were high in some areas, but highlighted that it had taken several steps to reduce this cost including closing the Defined Benefit (DB) scheme to new entrants, improving roster efficiency, reviewing management structure and seeking to de-link pay settlements from standard RPI plus settlements.

5.39 GAL stated that the pace of change of staff costs is limited by industrial relations constraints, and that it has significant concerns about the pace of change implied by the judgements drawn by the CAA.

5.40 The ACC stated that they were concerned that the initial proposals failed to account for the ✂ wage increase included in GAL's RBP.

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[70] Data on staff costs is available for 2011/12 however the IDS analysis is based on staff costs in 2011, therefore for consistency the CAA has used 2011/12 data to estimate the potential for reductions in staff costs.

CAA's final projections

5.41 The CAA agrees with the ACC that given the evidence that staff pay at Gatwick is high, further real terms increases included in the RBP are inefficient. The CAA estimates that removing this increase would reduce staff costs by around £6.6 million by 2018/19.

5.42 The CAA assumed that staff costs could be reduced by between 9% and 13% in real terms based on the IDS benchmarking evidence. The CAA has considered the achievability of the proposed reduction in staff costs. Assuming an average RPI inflation rate of 3.5%[71] over Q6, the CAA estimates that staff costs could be reduced by around 20% in real terms by the end of Q6 by applying a nominal wage freeze. This suggests that the proposals are achievable with moderate wage restraint over Q6.

5.43 Similar measures have been applied in other parts of the economy including throughout the public sector, parts of which have experienced a two year nominal wage freeze from 2010[72] followed by a 1% nominal average pay growth from 2013.[73]

5.44 Current rates of staff turnover at Gatwick are around 6%, lower than benchmarks of 13% in the wider economy.[74] This may suggest that current rates of pay are better than alternatives and there is scope for real terms reductions over Q6.

5.45 Furthermore, GAL has provided the CAA with its own internal benchmarking evidence undertaken by Hay Group which estimates that total cash staff costs at Gatwick are ✂ above upper quartile and median benchmarks. This evidence strongly supports the conclusions of the IDS study and suggests that the IDS benchmarks could provide a conservative estimate of the potential for efficiency.

5.46 GAL also has other methods of reducing staff costs, for example by bringing rates of absenteeism into line with benchmarks, which the

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71 Forecast is based on forecasts from the Office of Budgetary Responsibility, March 2013.

72 HM Treasury Budget 2010, page 17.

73 The 2011 Autumn Statement announced that public sector pay awards will average 1 per cent for the two years following the pay freeze. This guidance was restated in the HM Treasury Civil Service pay guidance 2013-14. The 1% increase includes all elements of pay including staff progression increments.

74 IDS, Benchmarking Employments Costs – Gatwick, 2013.

CAA estimates could save up to £1 million per year. GAL could also seek to introduce lower rates of pay for new staff.

5.47 On the other hand, recent improvements in economic outlook[75] mean that wage growth could begin to increase through Q6 so that the current benchmark target may drift upwards. This suggests that it may be appropriate to select a lower point in the range of potential savings to account for higher general wage growth than assumed in the initial proposals.

5.48 GAL's reference to the interpretation of benchmarking evidence in the IDS study of NERL wage costs is not relevant. IDS's advice on this study was provided in reference to the interpretation of the benchmarking of individual job roles and not overall staff cost efficiency at a company level. It would be inappropriate to disregard individual job roles when assessing total company staff costs. The other points raised by GAL were accounted for during the drafting phase of the study or have been considered directly by the CAA.

5.49 The IDS study was based on 2011/12 data and has taken account of the changes to GAL's staff costs since the airport's sale. This is reflected in the relative benchmarks between Heathrow, Gatwick and Stansted, which indicate that Gatwick is more efficient than these airports in terms of staff costs.

5.50 The CAA accepts that GAL has made improvements to its roster system since its sale by BAA. This is discussed further in a later section.

5.51 Taking account of the points described above the CAA considers that GAL could reduce staff costs forecasts in its business plan by between £19.4 million and £25.1 million per year by 2018/19 relative to the RBP.

Pensions - future service costs

Issue

5.52 In the CAA's Q5 November 2007 proposals for Heathrow and Gatwick, the CAA stated that BAA's pension costs should be capped

[75] For example, increases in GDP growth forecasts, increases in the employment rate, decreases in the unemployment rates and general improvements in business and consumer sentiment.

"on the basis of cash contributions to the pension fund each year" but that these should be capped at an appropriate level, to ensure airport users are not disadvantaged by the relative generosity of the scheme. The CAA decided that it would allow a cap of 25% of pensionable pay in cash contributions on average.

5.53 A study conducted by IDS estimated that pension costs will be equivalent to 24% of pay in 2013 (31% for the DB and 10% for the Defined Contribution scheme).

5.54 Whilst below the Q5 cap, this was estimated to be higher than comparative benchmarks of 20% for DB schemes and 7% for DC schemes. Based on this evidence, the CAA included an additional pension efficiency of up to £5 million by 2018/19.

CAA's initial proposals

5.55 The CAA's initial proposals included a pension efficiency of £5 million per year based on reducing pension costs into line with benchmarks.

Stakeholder views

5.56 GAL stated that it was concerned that the companies used to benchmark GAL were not comparable, suggesting that direct comparisons with other airports, regulated businesses, or former state companies would be more appropriate.

5.57 GAL also highlighted that the benchmark sample was based on a period between 2007 and 2011 when returns on pension assets were significantly lower than in 2012 when the analysis of GAL's pension costs was undertaken. GAL argued that this results in Gatwick's costs appearing high relative to the benchmark sample due to the higher level of cash contributions required to offset reduced asset returns.

CAA's final projections

5.58 The CAA commissioned the Government Actuary's Department (GAD) to review the pension benchmarking analysis undertaken by IDS and to account for comments on the initial proposals. The study concluded that DB costs are based on a number of factors including the type of benefits provided, actuarial assumptions and investment returns. GAD considered that these factors created some uncertainty over the comparability of the benchmarks in the IDS report.

5.59 GAD considered that it would be appropriate to provide an allowance for GAL's DB scheme costs based on the scheme actuarial assumptions. This implies an allowance of around 28%, ✂ assumed by GAL.

5.60 GAD also considered that it was appropriate for the CAA to assume further efficiencies in Gatwick's pension scheme and analysed two changes based on comparisons with other typical schemes; increasing the normal retirement age from 60 to 65, and reducing the scheme's accrual rates from 1/54ths to 1/60ths. These were the same changes considered by the Competition Commission for the Q5 settlement.

5.61 Based on these changes and applying GAL's actuarial valuation assumptions, GAD estimated that an appropriate allowance for DB pension costs would be 20% to 22% of pay. GAD also stated that a rate towards the lower end of this range would be appropriate to align the costs estimated by the 2010 actuarial valuation. The CAA has taken account of GAD's advice and assumed a contribution rate of 20% through Q6. This results in an efficiency of £3.4 million per year by 2018/19.

5.62 GAL also has relatively high average DC contribution rates of 11% in comparison to average rates of 7%.[76] Reducing the contribution rate to 7% would result in an efficiency of £1.5 million per year by the end of Q6. However the benchmark comparisons may be affected by the organisation of pension payments, in particular GAL has implemented a salary sacrifice scheme which would tend to increase its pension payments relative to benchmarks.

5.63 Overall the CAA considers that GAL has scope to reduce future service pension costs by between £3.4 million to £5.0 million by the end of Q6.

Pensions - deficit

Issue

5.64 A report by the GAL scheme actuary in November 2011 estimated that a deficit of ✂ million was likely to arise at the next scheme valuation in September 2013. Based on a recovery period of 10 years, GAL has stated that it wishes to include deficit recovery costs

[76] Occupational Pension Schemes Annual Report 2010 (ONS), page 31.

amounting to ✂ million over Q6.

CAA's initial proposals

5.65 The CAA stated that it was not minded to include the costs of the pension deficit in the final proposals. Pension costs were an issue for GAL in setting their benefits and contribution rates.

Stakeholder views

5.66 GAL disagreed with the CAA's 'minded to' position stating that the expected pension deficit was mainly the result of changes in corporate bond yields and inflation which are outside the control of management and that the scheme had been adequately funded through Q5. GAL also highlighted the CAA's position on Heathrow's deficit as inconsistent with the initial proposals for Gatwick. GAL also cited the treatment of BAA's pension cost holiday in Q5 as providing precedent for the recovery of scheme deficits.

CAA's final projections

5.67 The CAA commissioned GAD to consider the treatment of the pension deficit. GAD concluded that there are two possible regulatory approaches to pension deficits:

- users meet the expected costs of benefit accruals, but the management of the scheme’s liabilities is a matter for the company; or
- users meet total pension costs including deficit contributions (and therefore also benefit from any surplus) subject to those costs being efficiently incurred.

5.68 Based on consistency with the historic treatment of BAA's pension deficit costs, GAD considered that the latter principle was most appropriate for GAL and that deficit costs should therefore be included in the Q6 allowance in principle.

5.69 However GAD also concluded that GAL's latest interim funding update in September 2012 shows a total deficit of £1 million, which would be immaterial to the opex allowance once spread over the 10 year recovery period.

5.70 GAD concluded that GAL’s forecast of the scheme deficit was based on an assumption that future salary growth would be ✂ higher than assumed in the scheme actuary's interim funding assessment. GAD did not consider this an appropriate adjustment and recommended using the estimate in latest interim funding valuation. This estimate shows that deficit costs are likely to be immaterial over Q6.

5.71 The CAA has accepted GAD's conclusion that in principle deficit costs should be included in the opex allowance based on the latest available full or interim pension funding valuation. GAL's estimate is based on different assumptions, which have not been justified. Excluding GAL's deficit cost estimate reduces the opex allowance by £1.4 million by the end of Q6.

Pensions - commutation payment

Issue

5.72 In 2010 GAL made a commutation payment of £104.7 million to BAA at the time of the sale of the airport, which removed GAL's liabilities to former employees in the BAA pension scheme. GAL stated that this payment should be included in the RAB as it was an investment by GAL which reduced ongoing opex costs.

CAA's initial proposals

5.73 The CAA stated that it was minded not to include the commutation payment as part of the RAB, as the payment would have been accounted for in a lower sale price of the airport.

Stakeholder views

5.74 GAL disagreed with the CAA's proposal to disallow the commutation payment stating that without the commutation payment there would be a greater number of members within the GAL DB scheme, requiring greater contributions, and that those contributions would be likely to increase over time reflecting ongoing changes in pension costs. It significantly de-risked the scheme. This meant that the payment was likely to be efficient in reducing costs and should be included in the RAB.

5.75 GAL stated that in the absence of the commutation payment, these costs would have been included in the business plan and remunerated through the regulatory settlement.

5.76 GAL questioned the CAA's reasoning that the commutation payment would be captured in a lower sale price stating that the construction of a RAB price is concerned with the cost base of the airport and that pension liabilities are part of this cost base. GAL therefore considered that payments to reduce these liabilities should be included in the RAB regardless of the sale price. GAL stated that the RAB was independent of the sale price. GAL cited precedents in airport regulation for adjustments to the RAB in respect of pension liabilities, including the treatment of BAA's Q3 pension payment holiday in the Q5 settlement.

CAA's final projections

5.77 The CAA commissioned GAD to provide advice on the treatment of the pension commutation payment. GAD concluded that the commutation payment has reduced GAL's pension liabilities and in principle the costs should be allowed into the RAB because:

- the payment relates to liabilities for employees at Gatwick;
- had the payment not been made, GAL (not HAL) would have been liable for additional pension contributions;
- information provided by HAL indicates that the funds to meet the commutation payment were provided by the purchaser of Gatwick;
- HAL has not sought to recover the amount of the commutation payment through its pension allowance, whereas Gatwick is seeking to do so; and
- GAD evaluated the basis of the commutation payment relative to the pension liabilities avoided and concluded that:
  - the payment was likely to be higher than the expected costs of the liabilities avoided; but
  - the payment was around 45% of the section 75[77] estimate of the liabilities avoided, meaning that the risk associated with those liabilities has been removed at a relatively low cost.

5.78 Based on the latter point GAD concluded that it would be reasonable to include the full amount within the Q6 opex allowance. GAD also stated that excluding part of the commutation payment would create inconsistencies with HAL's pension cost allowance, where the full

[77] Section 75 is a method of valuing pension liabilities, which is usually considered to be the benchmark of providing benefits with no ongoing funding risk or obligation.

amount of the commutation payment has been taken into account in the scheme deficit.

5.79 The CAA has accepted GAD's recommendations that the commutation payment should be included in GAL's Q6 allowance in full. The CAA has included the full payment of £104.7 million in GAL's opening RAB.

Central support costs

Issue

5.80 The CAA commissioned Helios to examine the central support cost projections in GAL’s business plan. The study was not completed in time to inform the CAA's initial proposals.

CAA's initial proposals

5.81 The CAA did not include any efficiencies related to central support costs in the initial proposals, but stated that it would take account of this evidence in its final proposals.

Stakeholder views

5.82 GAL responded with various criticisms of the Helios study and stated that the study was not consistent with reliable evidence. GAL stated that the study failed to account for the difference between GAL and the comparators, explain the relationship between the costs and underlying drivers or assess the achievability of the proposals.

5.83 GAL also provided further benchmarking evidence undertaken by AT Kearney which showed that GAL's central support costs were close to or below average European airport benchmarks in most areas in 2012.

5.84 The airlines stated that they were disappointed that the Central Support study had not been available for the initial proposals or to inform their responses.

Summary of the Helios Central Support Report

5.85 The Helios study examined historic and forecast central support costs at GAL and collected a range of benchmarks based on costs at other airports, airlines and bespoke Hackett and Gartner data specifically tailored to companies with similar characteristics to GAL. GAL's costs were compared against these benchmarks to estimate the potential for greater efficiency in GAL's business plan.

5.86 The study concluded that GAL could potentially reduce central support costs in several areas including finance, HR, IT and airport management. Overall the study concluded that GAL could reduce central support costs by between £2.9 million and £5.4 million per year by the end of Q6.

5.87 The 'core' target was based on GAL maintaining current levels of cost over Q6 and removing unjustified increases in the business plan including insurance and consultancy costs. The higher 'stretch' target was based on bringing finance, IT and airport management costs into line with more ambitious external benchmarks.

CAA's final projections

5.88 In considering how to interpret this evidence the CAA has considered several factors including:

- the wide range of benchmarks used in the report which sometimes provide conflicting assessments of efficiency and suggest that there is a wide range of cost levels in central support functions;
- the lack of detailed understanding of the drivers of central support cost provided by the report, and a lack of detailed cost saving proposals to support the potential efficiency savings suggested by the benchmarking evidence;
- the AT Kearney report provided by GAL which indicates that GAL is at or below average levels of cost in most areas of central support in comparison to an undefined sample of European airports;
- the impact of proposed staff cost efficiency on central support costs; and
- responses from the airlines and GAL to the CAA's initial interpretation of the evidence.

5.89 Both the AT Kearney and Helios studies indicate that GAL's performance in central support is generally close to comparable benchmarks of average performance. This suggests that GAL is not inefficient in this area. However the Helios study did indicate that there was: scope for improvement relative to more efficient benchmarks companies, that staff costs are relatively high and that in some areas GAL's business plan implies an unjustified deterioration in performance over Q6.

5.90 On balance the CAA considers that it would be appropriate to incorporate the 'core' efficiencies proposed by the report after taking account of the reduction in central support staff costs linked to the wage cost efficiency described above.

5.91 Central support staff account for around 10% of total staff costs and this proportion of the staff cost efficiency can therefore be attributed to central support (£2.2 million by 2018/19). Accounting for this, the CAA has incorporated a savings of £0.7 million by 2018/19 into its efficiency estimate.

Other opex

Issues

5.92 The CAA commissioned SDG to examine the 'other opex' costs in GAL's business plan, including costs related to; rent and rates, utilities, police, NATS, PRM, cleaning and other items. The study proposed 'core' and more ambitious 'stretch' efficiencies in several areas based on a combination of benchmarking with other airports and changes to the assumptions underlying the business plan. The original report concluded that GAL could achieve savings of between £4.6 million and £6.0 million relative to its business plan.

CAA's initial proposals

5.93 The initial proposals were based on savings of between £4.6 million and £6.0 million based on SDG's core and stretch scenario efficiencies.

Stakeholder views

5.94 GAL made several specific responses to the SDG study, stating that there were limitations to the benchmarking analysis undertaken by SDG, the number of comparators used was often limited and could not be used to draw firm conclusions, and that there was a lack of transparency in the benchmarking.

5.95 GAL also stated that the efficiencies were often derived without sufficient evidence and did not take account of achievability or differences in service quality. GAL stated that it was unreasonable to require GAL to reach the highest benchmark in every area of its operations and that the assessment was unbalanced and did not take account of the mixed assessment of efficiency.

CAA's final projections

5.96 The CAA commissioned SDG to update their report to take account of stakeholder feedback on the initial proposals. SDG reviewed the evidence provided by stakeholders and provided an update to their report.

5.97 SDG responded to GAL's comments.

- No benchmarking dataset can be considered perfectly comparable to Gatwick, but several steps were taken to improve the comparability of the data with that provided by GAL, including adjusting terminal areas and costs and seeking a wide range of benchmarks.
- The data used in the benchmarking was provided on condition of confidentiality and cannot be disclosed. The sample has been discussed with the CAA and SDG considered that it provided a reasonable group of comparator airports.
- The benchmarking evidence was used to support coherent rationales for efficiency savings based on changes to business practises and not made in isolation.

5.98 Overall SDG concluded that the responses to the initial proposals did not raise any new evidence or arguments that had not been considered in the earlier phases of the study. SDG did not propose any changes to their efficiency estimates.

5.99 The CAA has considered GAL's points and does not agree with its criticisms of the SDG report. Many of the efficiencies proposals are based on the application of less conservative assumption in the business plan including the use of official forecasts or policy for utility and police cost growth. The CAA considers that this is appropriate and GAL has not provided an adequate explanation for different assumptions applied in its business plan. The CAA has included savings of between £4.6 million and £6.0 million per year in its efficiency proposals based on the SDG Other Opex report.

Maintenance costs

Issue

5.100 The CAA commissioned SDG to assess the appropriate level of maintenance costs over Q6. SDG examined the maintenance and asset renewal costs in the RBP, including benchmarking against eight other airports. The study concluded that some efficiency was likely to be possible through either maintaining maintenance costs per square metre at 2012/13 levels over Q6 or a reduction in maintenance costs in line with more efficient external benchmarks. On this basis SDG concluded that GAL could reduce maintenance costs by between £0.8 million and £4.2 million by the end of Q6.

CAA's initial proposals

5.101 The initial proposals were based on savings of between £0.8 million and £4.2 million by 2018/19 based on SDG's core and stretch efficiencies.

Stakeholder views

5.102 The CAA received three responses which specifically commented on the level of maintenance costs assumed in the initial proposals.

5.103 GAL made several points about the study including that:

- GAL had achieved PAS55 asset management certification which demonstrated its efficiency in terms of maintenance and asset renewal costs;
- the report contained factual inaccuracies;
- the evidence was insufficient to draw reliable conclusions about efficiency;
- there were contradictory and unbalanced comments in the report; and
- there was a failure to take account of information provided by GAL.

5.104 The ACC, Virgin and BA argued that the CAA had been too cautious in its interpretation of the evidence, noting that the higher efficiency savings suggested by SDG were based on halving the gap with external benchmarks (in terms of maintenance costs per square metre) and that it would be reasonable for the CAA to expect GAL to close the full gap.

CAA's final projections

5.105 The CAA commissioned SDG to update their report to take account of stakeholder feedback on the initial proposals.

5.106 SDG did not accept most of GAL's comments that the report contained factual inaccuracies or that the assessment of efficiency was unbalanced. SDG stated that GAL's achievement of PAS55 certification does provide evidence of a basic level of competence and efficiency with regard to asset management but does not imply that further efficiency cannot be achieved. In particular there was no evidence that alternatives to the present capital renewals programme had been investigated which suggested that greater efficiency was possible, this was supported by benchmarking evidence which showed that costs per square metre were high relative to other airports.

5.107 In response to the airlines' comments, SDG stated that it would not be appropriate to propose efficiencies based on the closure of the full benchmark gap due to the imperfect comparability of the benchmarks and Gatwick's characteristics as a multi-terminal airport, which could increase its costs relative to other airports.

5.108 Overall SDG concluded that the responses to the initial proposals did not raise any new evidence or arguments that had not been considered in the earlier phases of the study. SDG did not propose any changes to their efficiency estimates.

5.109 The CAA has adopted efficiency savings of between £0.8 million and £4.2 million within its efficiency proposals based on SDG's report.

Efficiency frontier

Issue

5.110 In calculating the level of efficient operating costs over Q6, the CAA has to make an assumption as to how the "efficiency frontier" (the level of costs that a hypothetical efficient operator might incur) might move over time. The CAA commissioned independent consultants CEPA to examine this question.

5.111 CEPA estimated that, based on estimates of Total Factor Productivity (TFP) across a range of industries, an efficient organisation with a cost structure similar to GAL should expect to see ongoing net frontier efficiency gains of between 0.9% and 1.0% per year.

CAA's initial proposals

5.112 The CAA's initial proposals assumed a 1% per annum improvement in the efficiency frontier was appropriate for GAL based on the CEPA evidence. This is equivalent to savings of £42.4 million over Q6. The RBP included a stretch efficiency target of around £22 million over Q6 based on ongoing reductions in security costs equivalent to £4.1 million per year. The CAA therefore proposed a further efficiency of £22 million over Q6, equivalent to £7.4 million by 2018/19.

Stakeholder views

5.113 The CAA received four responses which commented on the efficiency frontier analysis.

5.114 BA and Virgin stated that it was not appropriate to include only half of the frontier shift target suggested by the CEPA report.

5.115 GAL provided a detailed response to the CEPA study (undertaken by Oxera) which criticised the conclusions of the study in respect of both catch-up and ongoing efficiency on several points including the rationale for the comparators, failure to account for GAL's separation from BAA, failing to capture the impact of changes in the economic climate, failure to account for increases in airport security costs and that the estimate of frontier shift was not consistent with regulatory precedent based on decisions by Postcomm in 2005 and Water Industry Commission for Scotland (WICS) in 2009, which did not include assumptions for ongoing efficiency.

5.116 The ACC criticised the use of 2013/14 for the starting point for the frontier shift efficiency analysis and stated that regulatory precedent suggests that using the last year of real cost data (as opposed to a forecast) would be more appropriate. It also stated that the target should be higher than the net 0.5% applied by the CAA.

CAA's final projections

5.117 The CAA commissioned CEPA to update its study in response to the evidence submitted by GAL.

5.118 CEPA considered that the points raised by Oxera on behalf of GAL had already been accounted for in their study. It did not agree with

Oxera that it was inappropriate to compare HAL, GAL and STAL to other regulated utilities and that they had adopted standard practise for the estimation of frontier shift, consistent with regulatory precedent. It also stated that their report had undertaken the sensitivities suggested by Oxera and that some of Oxera's comments appeared to be based on an earlier draft version of the report, which was no longer relevant. CEPA stated that the examples cited by Oxera were not relevant to Gatwick. The WICS decision was based on recognition that there would be significant upward pressure on opex resulting from the requirements for Scottish Water to improve its performance. The Postcomm decision was contingent on the level of investment undertaken by Royal Mail.

5.119 CEPA concluded that their recommended frontier shift range of between 0.9% and 1% remained valid.

5.120 The CAA has adopted CEPA's recommendation for a frontier shift target of between 0.9% and 1%, and has used this to estimate an efficiency saving for GAL accounting for the stretch savings included in the RBP.

5.121 Basing the frontier shift estimate on the latest year of actual data rather than the forecast of opex costs in 2013/14 in the business plan would not make a material difference to the total frontier shift saving.

5.122 The CAA has included a saving of between £6.0 million and £7.4 million per year by 2018/19 in the range of potential opex savings.

Security process efficiency - flow rates

Issue

5.123 Peak hour security processing flow rates at Gatwick are around 250 passengers per hour per lane in the South Terminal and 200 in the North Terminal (fluctuating between summer and winter seasons). Benchmarking evidence provided by GAL indicates that this is relatively high in comparison to other airports with a benchmark sample average of around 170.[78]

5.124 GAL is also proposing further reductions in security cost per

[78] Confidential report supplied by GAL: Benchmark Analysis of 10 European Airports, Copenhagen Airports.

passenger in its RBP associated with the introduction of the North Terminal Security project, which is likely to increase flow rates to around 250. GAL has also included a stretch saving of £4.1 million per year based on ongoing improvements in security efficiency (as described above).

CAA's initial proposals

5.125 The CAA did not propose further efficiencies related to security process efficiency.

Stakeholder views

5.126 The CAA received four responses to its initial proposals which commented explicitly on security flow rates.

5.127 The ACC stated that security processing efficiency could be improved through the increased utilisation of the Archway Metal Detectors (AMD), estimating that this could reduce costs by £5.5 million per year.

5.128 GAL highlighted that the scope for further efficiencies in security processing was limited and highlighted the North Terminal and Consolidated Security Gate projects which would further reduce security costs. GAL also suggested that the CAA has misunderstood the drivers of security efficiency stating that the "one bag policy" operated by easyJet tends to increase the amount of luggage taken through security relative to Full Service Carriers such as BA meaning that Gatwick faces greater pressure on its security flow rates than airports such as Heathrow.

CAA's final projections

5.129 The CAA notes GAL's comments on airline baggage policy that a one bag policy will tend to encourage passengers to take larger amounts of luggage through security. It is difficult to determine whether Heathrow or Gatwick face greater demands on security processes, however BA's baggage policy allows for two separate cabin bags, which on balance seems likely to increase the number of images per passenger and overall pressure on security flow rates at Heathrow.

5.130 Overall, GAL's flow rates appear to be high in comparison to benchmarks and the business plan incorporates further improvements. Passengers per security Full Time Equivalent (FTE) are expected to rise by 10% by 2018/19 indicating a general improvement in security performance. The CAA does not therefore propose further efficiencies related to security flow rates.

Security process efficiency - rostering

Issue

5.131 The IDS study undertook some analysis of security staff rostering efficiency at GAL and found that overall the new roster system performed well, although there could be scope to improve efficiency through better alignment of staff supply and demand.

CAA's initial proposals

5.132 The CAA's initial proposals noted its consultants' finding that overall rostering at GAL had improved, but that there could be potential for further improvements. The CAA's initial proposals did not propose any efficiencies based on improvements in security rostering.

Stakeholder views

5.133 GAL stated that the IDS study highlighted the flexibility and efficiency of their roster system and that their roster system had improved since the airport was sold by BAA. GAL also compared its performance with Heathrow, highlighting that ✂ of its staff are on a flexible roster compared with ✂ at Heathrow, and that overtime accounts for ✂ compared to ✂ at Heathrow.

CAA's final projections

5.134 The IDS study indicates that GAL's roster system is relatively efficient and that rates of overtime are not high. GAL has made several improvements to this area of its operations since the sale of the airport. The CAA does not propose to include further efficiencies related to roster efficiency.

Absence management

Issue

5.135 GAL has relatively high levels of staff absence at 10 days per year, which is higher than benchmarks of between 6-8 days. GAL is planning to reduce levels of absenteeism for example through reducing the number of lower body searches (which require staff to bend down causing back strain), but no allowance has been included in the business plan.

CAA's initial proposals

5.136 The CAA noted that levels of absence were high and that there could be scope for efficiency by reducing absences in line with benchmarks. No explicit target was included in the initial proposals.

Stakeholder views

5.137 GAL stated that it is introducing body scanners to reduce staff manning per lane and that reductions in absence could be a secondary impact. It did not consider that any absence reduction from this project was likely to be tangible and therefore no reduction has been included in the business plan. GAL also stated that the recording of staff of absences had been improved, this should be taken into account when comparing GAL to benchmarks.

5.138 The ACC stated that the CAA's wage efficiency target was conservative and did not include savings available from reducing absence rates.

5.139 BA stated that the consultancy evidence indicates that sickness levels at GAL are running at 10 days per annum on average versus an industry standard of 6 days and that this should be addressed. BA estimated that this would reduce costs by around £5.4 million per year.

CAA's final projections

5.140 GAL has relatively high rates of absenteeism and there is likely to be scope for GAL to reduce staff costs by bringing rates of absenteeism into line with benchmarks. The CAA notes that this is an area where GAL could reduce costs and has estimated that GAL could reduce costs by around £1 million per year by the end of Q6 by bringing rates of absence into line with benchmarks.

5.141 The CAA considers that this is one method through which GAL could seek to achieve the wage cost efficiency described above and has not included further efficiencies related to absenteeism.

Security process efficiency - outsourcing

Issue

5.142 Security outsourcing has been introduced at several European airports, including Birmingham and Oslo and has been proposed as an option for GAL by the airlines. Outsourced security staff are also used by the Airline Operators Committee (AOC) to operate baggage security at Heathrow. The airlines consider this activity as analogous to passenger security in terms of scale, complexity and staff skill and have proposed outsourcing as a cost saving measure at GAL.

CAA's initial proposals

5.143 The CAA's initial proposals stated that the CAA would not dictate to GAL how it organised its security function, but would seek to ensure that the function was provided at an efficient cost.

Stakeholder views

5.144 The ACC and Virgin stated that the initial proposals do not account for evidence showing that security costs at Gatwick are significantly higher than benchmarks based on comparisons with outsourced security tender proposals suggesting that GAL could reduce security staff costs by 42%.

5.145 Virgin stated that it understood that the CAA cannot dictate to GAL how its operation should be run, but stated that the operation is not cost efficient, based on benchmarking evidence.

5.146 GAL stated that it does not accept the comparison of staff costs between passenger security staff and baggage handling staff due to the need for the former to interact with passengers. GAL criticised the proposals for increased utilisation of the AMDs made by the airlines.

CAA's final projections

5.147 The ACC's evidence of potential savings is based on benchmarking GAL against bids from outsourced companies. The CAA considers that GAL's security processes are relatively efficient and therefore, differences in cost are likely to be caused by GAL's relatively high staff wage and pension costs. This has been taken into account through the employment benchmarking analysis and proposed wage and pension cost efficiencies described above. An outsourced provider would be likely to make savings through the same methods. Therefore applying further savings based on this evidence is likely to double count the potential for reductions in security costs.

Other Issues

5.148 Several other issues were raised through the stakeholder responses, not immediately relating to the issues described in the initial proposals. These issues included:

- The airlines raised concerns over the CAA's methodology of setting the opex allowance, including the treatment of the CAA's higher passenger forecast and over-conservative interpretation of the evidence. Airlines suggested that this should be treated separately and not taken in the round.
- Additional evidence provided by the airlines highlighting inefficiency in security and cost control by GAL including evidence from outsourced security tenders and changes in prices at airlines' suppliers including security, cleaning, ground handling and hotel suppliers.

CAA's View

CAA's Opex Methodology

5.149 The CAA has considered the differences between GAL's passenger forecasts and the CAA's higher passenger forecasts assumptions and considers that it is appropriate to take account of this factor explicitly.

5.150 The CAA has assumed that traffic growth will be around 6% higher than GAL's RBP assumptions over Q6. This will increase opex in some areas of the business including security costs for example. To account for this the CAA has increased the opex allowance by £6.6 million by the end of Q6 based on an elasticity of 0.3.[79]

5.151 The CAA considers that it has provided a clear explanation of the factors in its judgement of the appropriate point within the range of potential opex efficiency. These points are discussed further in the final projections section below.

Additional Evidence from Airlines

5.152 The CAA considers that most of the evidence provided by airlines has been considered either directly by the CAA or through one of the consultancy studies. Many of the proposals made by the airlines are likely to be implemented by GAL to achieve the efficiencies proposed by the CAA, for example reductions in wage rates, pension costs,

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[79] The Q5 Competition Commission report for Stansted estimated an elasticity of opex with respect to passenger numbers of 0.3. This analysis was updated in the Steer Davies Gleave Stansted Mid Q5 Review, which indicated that the elasticity between passenger numbers and opex was around 0.5 taking account of more recent data.

absenteeism and security costs.

CAA final projections

5.153 Based on the responses to the CAA's initial proposals and further work conducted since April 2013, the CAA has amended its projections in the following areas.

- Additional efficiencies related to the removal of GAL's forecast ✂ wage increase (reducing opex by £6.6 million by 2018/19).
- Consideration of the movement of the staff costs benchmark over Q6, taking account of an emerging economic recovery which would suggest reducing the target efficiency associated with the IDS benchmark evidence.
- Additional efficiencies related to the Helios central support study, equal to £0.7 million by 2018/19 (after accounting for the impact of staff cost efficiencies on central support costs).
- Pension cost efficiency based on GAD's conclusions that an appropriate benchmark for GAL's DB future service pension costs would be 20-22% of wages (efficiency of between £3.4 million and £5.0 million by 2018/19).
- Exclusion of GAL's deficit cost estimate, which is equal to £1.4 million by the end of Q6.
- Explicitly accounting for the impact of the CAA’s higher traffic forecasts, increasing opex by £6.6 million by the end of Q6 based on an elasticity of 0.3.

5.154 These points have changed the CAA's assessment of the scope for efficiency at Gatwick. Overall, the CAA estimates that the potential range of efficiency relative to the RBP is between £29.7 million and £43.1 million by 2018/19 (compared to £26 million and £42 million in the initial proposals).

5.155 A breakdown of the lower and higher efficiency savings associated with each piece of evidence is shown below in figure 5.1.

Figure 5.1: Breakdown of lower and higher efficiency proposal

£ millions	Lower	Higher
	2018/19	2018/19
RBP	301.2	301.2
Other opex	-4.6	-6.0
Maintenance	-0.8	-4.2
Central support	-0.7	-0.7
Wage efficiency	-12.8	-18.5
Wage growth	-6.6	-6.6
Pension efficiency	-3.4	-5.0
Pension deficit	-1.4	-1.4
Frontier shift	-6.0	-7.4
Traffic	+6.6	+6.6
Total	-29.7	-43.1
CAA	271.6	258.1

Source: CAA

5.156 In coming to a judgement over the appropriate point within the range the CAA has considered several factors including:

- evidence that opex per passenger at Gatwick is close to the average of European comparators;
- some of the higher efficiency targets identified in the consultancy studies are based on comparing GAL with the most efficient benchmarks, which may not reflect the typical efficiency of a business operating in a competitive environment.;
- evidence of good performance in some areas of GAL's business including security processing;
- the possibility for overestimating efficiency by assuming that GAL could achieve the greatest level of efficiency in every area of its business;
- the inherent risk in efficiency proposals based on benchmarking evidence, which cannot perfectly account for specific factors at Gatwick.

- the need to ensure that GAL has a realistic chance of outperformance as a regulatory incentive; and
- the achievability of the opex allowance and the risk for service quality impacts from reductions in opex including the significant pension and pay efficiencies proposed by the CAA.

5.157 On balance, taking account of the factors described above, the CAA considers that it would be appropriate to adopt a target above the lower proposal, but below the mid-point of the range.

5.158 The CAA proposes an overall efficiency target of £32.5 million by 2018/19 which is equivalent to a reduction of 1.2% per year and results in a total allowance of £1,378.3 million over Q6. This is equivalent to a 7% reduction relative to GAL's RBP.

CAA forecasts

5.159 Based on the CAA's decisions above, its projections for GAL's opex allowance over Q6 are set out in figure 5.2 below.

Figure 5.2: CAA's final projections for opex (2011/12 prices)

£ millions	2014/15	2015/16	2016/17	2017/18	2018/19	Total
RBP	287.8	294.4	297.3	300.4	301.1	1,481.1
CAA - initial	283.1	280.0	276.9	273.8	270.8	1,384.6
CAA - final	282.6	279.1	275.6	272.2	268.7	1,378.3

CHAPTER 6

Commercial revenues

6.1 This chapter discusses GAL's commercial revenues for the Q6 period and includes CAA's initial proposals, summary of stakeholder views and CAA's final projections.

6.2 The forecasts for GAL's commercial revenues (revenues from retail, car parking and property) are significant as they are deducted from the revenue required from airport charges under the single till approach.

Commercial revenues process to date

6.3 To date, the Q6 commercial revenues process has consisted of the following stages:

- GAL published its IBP in April 2012 providing its initial forecast of commercial revenues.
- During the CE process between April and December 2012 the airlines' consultants, Javelin and Airport Commerce and Talent Management (ACTM) considered that there should be more ambition in GAL's commercial revenue projections. There was, however, little discussion on commercial revenues during CE.
- GAL's final commercial revenue forecasts were published in the RBP in January 2013.
- CAA's initial forecast was discussed in chapter 7 of CAA's initial proposals which were based on a report from the CAA's independent consultants SDG. SDG provided an updated report in September 2013 as an input to the final projections.

CAA's initial proposals

6.4 The CAA's initial proposals forecast total commercial revenues of £981 million over the Q6 period.

6.5 The CAA's initial proposals used SDG's commercial revenue per passenger forecasts together with the CAA's traffic projections. This resulted in Q6 commercial revenues that were around 10% lower than forecast by ACC, 8.4% higher than forecast by GAL and 3.1% higher than forecast by SDG. The projections are presented in figure 6.1 below.

Figure 6.1: Forecasts for commercial revenues in Q6

£m 2011/12 prices	2014/15	2015/16	2016/17	2017/18	2018/19	Q6 Total
GAL RBP	183.4	173.4	179.0	181.1	188.0	904.9
ACC*	209.4	208.1	211.1	222.3	233.8	1084.7
SDG	188.2	181.8	189.0	192.3	200.2	951.2
CAA initial proposals	190.5	185.8	195.2	199.9	209.5	981.0

*Based on Javelin/ACTM's retail and car parking forecasts, SDG property forecast and ACC's traffic forecast

Source: GAL, ACC, SDG and CAA

6.6 Several respondents commented on the CAA's initial proposals for the overall level of commercial revenues:

- GAL considered that SDG's forecasts were over-optimistic;
- the ACC considered the forecasts to be somewhat conservative based on work by its consultants Javelin and ACTM;[80]
- Virgin stated that it supported the points made by the ACC on commercial revenues; and
- BA stated it agreed with the ACC that there was upside potential in relation to retail and car parking revenues.

Issues concerning commercial revenues

6.7 The CAA has considered stakeholder responses grouped by the main categories of:

- retail;

[80] The response to SDG's commercial revenues forecasts presented by the Javelin Group with consideration of consultancy work by ACTM is further referred to as the Javelin/ACTM response.

- car parking;
- property; and
- overall commercial revenues.

Retail

Issues

6.8 The main issues concerning the projections for GAL’s retail revenues were:

- the impact of the Tobacco Display Act (TDA) on duty free sales;
- retail margins, space and reallocation of space;
- bookshops and the challenges deriving from the increase in digital media and e-commerce;
- advertising; and
- other issues - telecoms.

CAA’s initial proposals

6.9 The CAA’s initial proposals were based on SDG’s forecasts, which encompassed:

- a 12% fall in tobacco sales from the TDA;
- an increase in retail margins from striking a different contractual arrangement with ✂ and a reallocation of retail space from catering to retail;
- a reduction in the fall in bookshop revenues;
- an increase in advertising revenues from additional sponsorship; and
- growth in telecoms income in line with passenger volumes.

Stakeholder views

6.10 The main area of disagreement between GAL and the airlines was the impact of the TDA on duty free sales. GAL considered that the TDA would reduce tobacco revenues by 50% and the benchmarks used by SDG did not take into account underlying performance or the effects of the change in law. The ACC's consultants Javelin/ACTM considered that the TDA would have a negligible impact as any reductions in income could be compensated by effective category management and sales of other duty free products. The ACC also pointed out that Javelin/ACTM's findings suggested that revenue decreases from tobacco restrictions noted at other airports were not entirely due to the restrictions themselves but coincided with a drop in passenger traffic and reductions of tobacco space.

6.11 GAL considered that SDG's assumptions of adding new retail space and higher ✂ concession margins in return for a contract extension were speculative and it would never introduce such measures. GAL did not agree with SDG's proposal to switch space from catering (less profitable) to duty free (more profitable), as this would not enhance the passenger experience, and did not consider that additional retail space should be provided, potentially resulting from the difficulty of reaching agreement with airlines on existing projects. Further GAL stated that additional revenues from e-commerce initiatives were not evidenced and ran contrary to recent moves to introduce free wifi.

6.12 The ACC pointed out that GAL has recently made investments to improve the retail offer during which space has been removed. The ACC therefore suggested that there would be a noticeable increase in retail space this year and at the start of the Q6 and this should be reflected in forecasts. The ACC also considered that there could be further revenue upside from highlighting to non Ryanair passengers the opportunity to take one cabin and one shopping bag on board.

6.13 GAL considered that SDG had overlooked the threat to bookshop revenues from technology changes. However Javelin/ACTM considered that SDG's concerns about the challenges faced by retail sectors (books, music, media) in an increasingly digital world were overstated as the decline in sales had been noted for many years now. Javelin/ACTM also considered that technology sales would grow due to evolution of new devices and upgrades.

6.14 GAL did not agree with the forecast increase in advertising income per passenger. However Javelin/ACTM considered that GAL had opportunities to further increase advertising income, for example by the inclusion of one of the "top two" advertisers – Clear Channel or JC Decaux.

6.15 GAL did not agree with SDG's assumptions to increase telecoms revenues in line with passenger volumes.

Independent consultancy

TDA impact

6.16 In relation to the TDA impact, in the update report SDG disagreed with Javelin/ACTM's view of negligible impact, as the legislation was meant to generate a consumer response. However, SDG considered that the TDA would have a smaller impact than projected by GAL. SDG pointed out that the TDA was a different issue to the reduction in the size of the market that was experienced in 1999 (abolition of intra EU duty free) and 2004 (enlargement of the EU). SDG commented that its analysis had also considered the potential initiatives of the World Health Organisation. SDG also clarified that while it had noted Javelin/ACTM's view that the potential reduction in tobacco sales could be mitigated by allocating tobacco space to other product categories, this was not included in SDG's final forecasts. Overall SDG found no compelling reason to change its earlier prediction of a 12% reduction in tobacco sales from the TDA.

Retail margins and space

6.17 SDG pointed out that the travel retail market appeared to be strong with the Travel Retail Business Magazine stating that the sector grew by 7% in 2012. SDG noted that Heathrow Airport had announced its retail revenue growth for the first 6 months of 2013 at +4.6%.[81] Public announcements had also been made by executives of specialist shops in Gatwick Airport underlining the good performance of their airside shops. SDG also pointed out that the historic performance of travel retail when the UK economy as a whole was weakened was unlikely to be representative of the Q6 period.

6.18 SDG considered that GAL should be able to maintain previous retail margins and saw potential for further increases in margin through contact renewals and possible extensions and the planned expansion in the North Terminal. SDG commented that as a developed airport Gatwick should be expected to make greater progress when

81 The CAA recognises the differences between GAL and HAL and while HAL can be a useful comparator for GAL, it has not been treated as a key comparator. SDG further assured the CAA that both the April and September reports did not overly rely on benchmarks to drive conclusions about potential income growth.

developing new retail schemes and leasing through a competitive tender process. SDG pointed out that there was greater potential for GAL to collaborate with retailers ✂. SDG identified that contract extensions could be value enhancing for retailers, as company valuations are usually based on the earnings before interest, tax depreciation and amortisation (EBITDA) over the life of the contract. SDG therefore maintained its original forecast ✂ for the whole of the Q6 period, although acknowledged that this could be delivered through a combination of deals with other operators.

6.19 Following further explanations from GAL management on the potential implications of a transfer of catering to duty free space and after consideration of Javelin/ACTM's suggestions, SDG reduced its earlier forecast of the potential revenue increase by 50%.

6.20 In relation to the comments made by GAL, SDG stated that the potential of adding retail space was presented as a 'super stretch' target and hence was not part of the 'core' projections used in CAA's initial proposals. SDG additionally stated that its forecasts made no additional allowance for retail e-commerce initiatives, contrary to the statement made by GAL.

Bookshop revenues

6.21 SDG pointed out that the bookshop sector in Gatwick relates primarily to WH Smiths which covers a general range of merchandise in addition to books and at the time of SDG's update report WH Smith had a share price of around £7.70 compared with £5.50 a year earlier suggesting that shareholders had confidence in the management's direction. SDG made a minor adjustment to the forecasts based on the 2012/13 performance but had continued to assume that bookshop revenues would remain flat in real terms to the end of Q6.

Advertising revenues

6.22 SDG commented that although there was no agreement between GAL, airlines and SDG on the level of advertising revenues, the size of financial difference was not large. SDG commented that the existing operator Eye Corp appeared to be performing well and although a new adviser was always an option, SDG did not believe it was the right time to introduce another operator. SDG did however see opportunity in involving specialist agencies to develop sponsorship revenues and maintained its original forecast.

Telecoms revenues

6.23 SDG stated that beyond stating that GAL disagreed with SDG's telecoms revenue assumptions, GAL did not provide any further evidence and so SDG maintained their original forecasts of increasing telecoms revenues in line with passenger volumes.

Overall retail revenue forecasts

6.24 Based on an analysis of the above mentioned updated findings, the CAA decided to use SDG’s forecasts for its final proposals. Figure 6.2 presents SDG's earlier and updated forecasts of retail revenues per passenger in Q6.

Figure 6.2: SDG retail revenues forecasts per passenger in Q6

£ per pax 2011/12 prices	**2014/15**	**2015/16**	**2016/17**	**2017/18**	**2018/19**
SDG April 2013	3.68	3.52	3.69	3.68	3.82
SDG September 2013	3.68	3.51	3.68	3.67	3.82
% change	0%	-0.2%	-0.2%	-0.2%	0%

Source: SDG

Car parking

Issue

6.25 SDG suggested that there was the potential to outperform GAL’s revenue forecast for car parking due to:

- increases in long stay pricing for pre booked products in the peak season;
- above inflation increases in long stay roll up parking;
- additional revenues from the licensing scheme; and
- enforcement of forecourt pick-up activity into short stay car parks.

CAA's initial proposals

6.26 The CAA's initial proposals were based on SDG’s forecasts.

Stakeholder views

6.27 GAL commented that SDG’s car parking projections were based on flawed assumptions and did not take into consideration the competition from off-airport and on-airport car parking operators. In particular GAL stated that:

- SDG's single-point benchmarking of car parking prices was flawed as there were 50,000 individual price points issued every day;
- above inflation increases in long stay roll up parking were not possible as revenues had declined by a quarter over the last financial year, and continue to decline at the same rate;
- e-commerce initiatives were speculative;
- the licensing scheme would generate £0.3 million per year from licensing 15 operators, much lower than the £1.2 million forecast by SDG; and
- the traffic needed to generate the level of revenue forecast by SDG through better enforcement of the no pick-up rule on the forecourts was not credible.

6.28 BA and the ACC (based on Javelin/ACTM's assessment) stated that car park income per passenger could be lower than they previously forecast but did not consider it would fall as low as the SDG forecast. Javelin and ACTM commented that GAL could improve short term yield management techniques and focus on more cross selling with third parties and further product differentiation and considered that the car parking revenue per passenger would remain constant throughout the Q6 period at £1.09.

Independent consultancy

6.29 SDG considered each of the points raised by stakeholders in its updated report. In relation to competition for on-airport car parking SDG sought opinions from Airport Parking and Hotels (APH), Holiday Extras and Meteor Meet and Greet. SDG also reviewed the Crawley Borough Council's Local Plan, which remained committed to the policy of permitting additional parking only within the airport boundary. The Council's annual count of authorised and unauthorised car park spaces in the area reported that the airport had a significant market position. SDG also pointed to GAL's ability to spend some £2.4 million per year on online marketing to maintain its leading position in the local parking market. SDG concluded that while it recognised that GAL faced competition from other parking providers, it had not underestimated this competition and there was no evidence to suggest that there would be a material change in competition over Q6.

6.30 SDG maintained that there was potential to increase car parking revenues compared to those forecast by GAL’s RBP. For pre-booked car parking SDG undertook further sample test bookings for a number of different periods which collaborated its earlier findings. SDG also noted that since the publication of their earlier report car parking revenues had improved. SDG therefore remained convinced that there was potential to increase revenues from pre-booked car parking in line with its earlier forecasts. SDG therefore maintained its earlier forecast in relation to long stay roll up traffic pointing out that the current charge could be increased as it is used by less price sensitive customers and appeared low in comparison with other UK airports.

6.31 SDG commented that the projected increase in car park revenues from e-commerce initiatives (equivalent to 0.5% of parking revenues) was based on a comparison to other airports which offer additional service-related products such as lounges, security, car wash, insurance and bureau de change. SDG continued to consider that e-commerce income driven by pre-book parking was achievable. SDG also clarified that SDG's e-commerce initiatives apply only to car parking (retail initiatives are consistent with those planned by GAL).

6.32 In relation to revenue from the enforcement of pick up into the short stay car parks SDG reviewed its forecasts under the assumptions that the enforcement would be successful and that an average of 2 passengers per car would be charged £3 (£2.83 in 2011/12 prices) for a 30 minute stay. The results lead to a slight reduction of the forecast by 1% to £3.8 million per year. SDG pointed out that the revised revenue forecast equated to about 95 additional cars per hour throughout the year (assuming this volume is concentrated on 8 peak hours per day).

6.33 SDG commented that GAL’s forecast for income from the licence agreement to official “meet and greet” operators assumed a maximum of 15 operators out of potentially up to 50 operators. Based on GAL's income estimates, SDG considered that the key 15 operators would predominantly choose the forecourt rather than the short stay car parks at the higher transaction fee of £6. If only 15 operators were licensed SDG considered that the remaining unlicensed operators would choose to operate their business from the car park passing costs onto the customers, so in both instances SDG considered that

GAL will receive incremental revenue. Based on the latest available evidence, SDG reviewed their forecasts of income from the scheme and reduced its original forecasts of income from the licensing by 4%, or £0.2 million.

6.34 SDG also reviewed the latest available data on car parking revenues from GAL. Since SDG's earlier report car parking revenue performance at Gatwick has improved through greater collaboration with consolidators, increase in Valet capacity at North and South Terminals, the sale of a new pre-booked product and the pricing of pre-book short stay. This increased the forecast car parking revenue from £1.08 to £1.11 per passenger for 2013/14 and from £1.09 to £1.13 per passenger for 2014/15.

6.35 Figure 6.3 presents SDG's earlier and updated forecasts of car parking revenues over Q6.

Figure 6.3: Car parking revenues forecasts per passenger in Q6

£ per pax 2011/12 prices	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	Q6 CAGR
SDG April 2013	1.11	1.08	1.09	1.06	1.02	1.00	1.00	-1.8%
SDG September 2013	1.17	1.11	1.13	1.10	1.07	1.04	1.04	-2.1%
% change	5.0%	2.9%	3.8%	3.7%	4.8%	4.0%	3.9%	n/a

Source: SDG and CAA

Property

Issue

6.36 SDG forecast an additional £5.6 million over Q6 in property revenues based on a combination of:

- further income from re-letting of office and ramp voids;
- ad hoc contractors' accommodation; and
- additional turnover-related income from hotels.

CAA's initial proposals

6.37 The CAA's initial proposals were based on SDG's forecasts.

Stakeholder views

6.38 SDG's and the CAA's property projections were supported by BA, Virgin and the ACC.

6.39 GAL considered that SDG's projections were unachievable due to the general UK economic position and its impact on the property business, the change in airline mix resulting in smaller property requirements, restrictions preventing GAL from letting to a wider market place and competition with Crawley.

6.40 GAL also did not agree with SDG’s assumptions of potential income growth for Concorde House, Ramp, Hotels and ad hoc contractor’s accommodation.

Independent consultancy

6.41 SDG updated its analysis and considered the issues raised by GAL as well as new data and information. SDG maintained increased forecasts of property revenues compared to those of GAL’s RBP but made a minor downwards adjustment compared to the earlier report.

6.42 SDG commented that the weakened performance of the national property market reflected the generally weak UK economy and may not be an indicator of trends in Q6, if, as predicted by many commentators, the economy reverts to a steady growth path.

6.43 SDG continued to consider that Concorde House would not remain void for the entirety of Q6 as GAL has found alternative uses for other office space (reducing available space at the airport) and recent reports from Colliers, Knight Frank and CBRE suggested the office market in the South East was improving. SDG considered that Concorde House would remain void for 12 months while refurbishment was carried out with a phased occupation over Q6.

6.44 On ramp accommodation, SDG considered that airline moves and consolidations which had lead to a reduction in occupancy levels in Q5 had largely been completed. Given the forecast increase in passenger traffic SDG did not agree with GAL that there would be no increase in the take-up of ramp accommodation over Q6 despite the increase in availability from the completion of Pier 5 and Pier 6. Furthermore SDG considered that given GAL's proposed capital programme it was unreasonable to assume that there would be no letting of contractors’ accommodation and had assumed an income of

£100,00 per year, ✂. Consequently SDG did not consider it should change its earlier forecasts for ramp and contractors' accommodation.

6.45 SDG continued to consider that the new hotel operators would reach the threshold to trigger a turnover related payment within Q6 and considered that this trigger would be met earlier than originally forecast due given the recent success of the Premier Inn at the North Terminal, the limited number of hotels at the airport and the higher passenger traffic forecasts from the CAA compared to GAL's FBP.

6.46 Figure 6.4 provides SDG's earlier and updated forecasts of property revenues.

Figure 6.4: Property revenues forecasts per passenger in Q6

£ per pax 2011/12 prices	**2014/15**	**2015/16**	**2016/17**	**2017/18**	**2018/19**
SDG April 2013	0.68	0.67	0.69	0.76	0.75
SDG September 2013	0.68	0.67	0.69	0.75	0.75
% change	0%	0%	0%	-1%	0%

Source: SDG and CAA

Benchmarking of overall commercial revenues

6.47 As part of its response to the initial proposals GAL commissioned consultants AT Kearney to benchmark its IT and support costs. As part of this work AT Kearney also carried out some overall benchmarking of commercial revenues. AT Kearney showed that GAL's commercial revenues per passenger were 2% above the average benchmark. GAL stated that this demonstrated that commercial returns are already competitively placed against other airports, and consequently, if SDG's trajectory of further improvement were overlaid on this base, it would result in unachievable forecasts.

6.48 SDG commented that the AT Kearney benchmark mentioned by GAL was essentially based on airport costs rather than commercial revenues and questioned its validity as the 32 European and Asian airports had not been named, making it hard to comment on whether they were a reasonable comparator. SDG pointed out that the data in the panel suggested that Gatwick's market position and size was different from other airports in the benchmark set and hence SDG was not surprised that GAL's commercial revenues per passenger were not at the average level of the comparator benchmark. SDG also noted GAL's earlier comments that GAL's commercial revenue performance should be benchmarked against second airports serving major European population centres but considered that the comparison could be distorted by scale as GAL is by far the largest such airport.

6.49 The CAA has subsequently clarified with AT Kearney that the sample used for benchmarking Gatwick consisted only of European airports. The airports in the sample had an average annual traffic of 25 million passengers and only around half of the sample was privatised airports that were at the same time subject to some form of regulation. Seeing as despite requests little information was provided on the sample, the CAA cannot comment further on the comparability of Gatwick to airports it was benchmarked against in the AT Kearney study. The CAA also notes that the main focus of the AT Kearney study was support and IT costs and not the benchmarking of commercial revenues. The CAA has considered the benchmarking of airport revenues undertaken as part of the Leigh Fisher airport comparator study, where the airport comparators and method of identifying comparators is transparent. This study suggested that GAL's commercial revenue performance in 2010 appeared to be close to that of the average of the benchmark range. The CAA also notes that as part of its work SDG undertook a range of top down and bottom up benchmarks as a basis for its projections and that the main findings from SDG were focused more on a lack of ambition in the projections from GAL rather than adjustments to reflect shortcomings in current performance by GAL. On this basis the CAA considers that the SDG forecasts are reasonable.[82]

6.50 In addition the CAA notes that GAL has updated the business cases for some of its capex projects and this will have a positive impact on retail forecasts, which does not appear to have been reflected in GAL's or SDG's forecasts. The CAA considers that this is a potential upside to the forecasts produced by SDG.

[82] The CAA has used SDG's forecasts of commercial revenues purely for the calculation of a fair price. It is without prejudice to any action that the CAA might take if warranted by its research into road access and forecourt access mentioned in chapter 12.

CAA forecasts

6.51 The CAA has based its commercial revenue forecasts based on the forecasts provided by SDG, adjusted to reflect the CAA's traffic forecasts, as set out in figure 6.5 below. For the two years following Q6 where SDG did not provide projections, the CAA has assumed that the difference between the SDG and GAL per passenger commercial revenue forecasts remains constant.

Figure 6.5: CAA's final projections for commercial revenues per passenger

2011/12 prices	2014/ 15	2015/ 16	2016/ 17	2017/ 18	2018/ 19	2019/ 20	2020/ 21
£ per pax							
Retail	3.68	3.51	3.68	3.67	3.82	n/a	n/a
Car parking	1.13	1.10	1.07	1.04	1.04	n/a	n/a
Property	0.68	0.67	0.69	0.75	0.75	n/a	n/a
Total	5.49	5.28	5.44	5.47	5.61	5.57	5.47
CAA final passenger forecast	35.8	36.6	37.2	37.9	38.5	39.2	39.8
£m							
Retail	131.7	128.6	137.0	139.2	147.0	n/a	n/a
Car parking	40.5	40.2	39.8	39.4	40.0	n/a	n/a
Property	24.3	24.6	25.6	28.6	29.0	n/a	n/a
Total	196.4	193.4	202.3	207.2	216.1	218.2	217.9

Note: numbers may not add up due to rounding

Source: SDG and CAA

6.52 The CAA’s final projections give total commercial revenues of £1,015.3 million over the Q6 period. The breakdown of total commercial revenues for Q6 is as follows:

- Retail: £683.4 million;
- Car parking: £199.9 million; and
- Property: £132.0 million.

6.53 This represents a £34 million increase in the commercial revenue forecasts compared to the initial proposals, driven by the higher passenger forecasts and higher car parking revenue per passenger, somewhat offset by the lower property and retail revenue per passenger.

CHAPTER 7

Other charges

7.1 This chapter considers the appropriate level of other charges to be taken into account in the fair price calculation. Under a single till approach this revenue is included in the calculation of a RAB-based price control. The revenue is from charges on airlines and other companies operating at the airport for facilities and services that are essential for their operations.

Other charges process to date

7.2 CE did not discuss revenues from other charges. GAL included forecasts of revenue from other charges in its January 2013 RBP. As much of the revenue is a recharge of GAL's costs, GAL mentioned that the level of revenue was directly related to its cost forecasts.

CAA's initial proposals

7.3 As the forecast revenues were not discussed during CE the CAA did not take a view on GAL's forecasts in its initial proposals. However, as it needed a forecast to calculate a fair price for Gatwick, the CAA used GAL's January 2013 RBP forecasts. As the forecast revenue is a recharge of GAL's costs, the CAA could have adjusted them to reflect the cost efficiency assumptions it had used in calculating a fair price. However, it chose not to do so at that relatively early stage of the price control process, as the effect on the price level was unlikely to be large and there was scope for the CAA's efficiency assumptions to change before the CAA's decision on a fair price for GAL.

7.4 The CAA used the following forecast other charges revenue in its initial proposals.

Figure 7.1: Forecast revenue from other charges in Q6 (£m in 2011/12 prices)

2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
51.5	54.2	55.5	56.9	57.3	58.0	58.6

Discussion of key issues

7.5 The CAA has identified two key issues in relation to the forecasts of revenue from other charges:

- the use of GAL's forecasts of other revenue; and
- adjusting GAL's forecasts to reflect the CAA assumptions of opex and traffic.

Forecast revenue for other charges

Issue

7.6 The use of GAL's forecasts of other revenue.

Stakeholder views

7.7 GAL supported the CAA's use of GAL's other revenue forecasts. GAL said that since its RBP it had made some small changes to some of the charges. These were:

- to remove a proportion of allocated costs, or, where appropriate, to ensure there is an alternative apportionment basis post Q5;
- for electricity charges to remove both an allocated cost and a legacy capital charge, and replace with GAL's direct infrastructure distribution costs; and
- to uplift staff car parking prices in line with the local car parking market, which would mean in 2014/15 a 10% increase on the mid Q5 charge.

7.8 GAL provided an update of the forecast revenue from other charges, which showed that the lower revenue from the structural changes broadly offset the additional revenue from staff car parking.

7.9 The ACC also supported the CAA's use of GAL's forecasts of other revenues. The ACC mentioned that check-in and baggage, PRM, and utilities which accounted for 80% of other charges revenue all showed material real increases during Q6. The ACC saw this as an example of the poor management of costs. The ACC wanted the continuation of the CAA's policy during Q5 that it did not expect to see any material upward shift in these charges resulting from any change by GAL in accounting or cost-recovery policy. The ACC thought that any such charge increase should be considered by the CAA in setting price caps for the next control period.

CAA's assessment

7.10 The CAA welcomes the agreement between GAL and airlines over the use of GAL's other revenue forecasts in its initial proposals. Noting this agreement the CAA has used GAL's revised forecasts in these final projections. The CAA notes airline comments about GAL's management of costs and does not propose to depart from its Q5 policy of not expecting any material increase in other revenues in Q6 resulting from changes in GAL's accounting or cost-recovery policy. If there are material changes the CAA might take them into account in its price regulation subsequent to Q6.

Issue

7.11 Updating the revenue forecasts so they reflect the CAA's assumptions on operating costs and traffic forecasts.

Stakeholder views

7.12 GAL noted that as a major portion of revenue from other charges was the cost recovery of operating costs, the forecasts should be adjusted in line with the CAA's operating costs forecasts.

7.13 The ACC said it considered that there may be some opportunities to reduce the costs, and therefore the revenues, but it noted that this was unlikely to have any net impact on Q6 prices as both the costs and revenues would reduce by the same amount.

CAA's assessment

7.14 The CAA acknowledges the ACC's view that cost reductions would lead to reduced revenue and that the net effect on the fair price may well be negligible. However, it considers that it should use the best possible forecasts of GAL's opex and other revenues in its calculations of a fair price even if they largely cancel each other out. The CAA has, therefore, reduced GAL's other revenue forecasts to take account of its lower opex forecasts. As the opex forecasts vary according to traffic and the other charges are largely based on cost recovery, this adjustment also picks up the effects of the CAA's amended traffic forecasts.

CAA forecasts

7.15 Based on the CAA's decisions above, its projections for GAL's revenue from other charges over Q6 are set out in figure 7.2 below.

Figure 7.2: Forecast revenue from other charges(£m in 2011/12 prices)

	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
Check-in/baggage	18.09	20.02	20.20	20.92	20.75	20.77	20.73
Staff car park	6.80	6.87	6.94	7.01	7.08	7.15	7.22
Fixed electrical ground power (FEGP)	2.41	2.43	2.50	2.49	2.49	2.49	2.50
Identity cards	1.03	1.04	1.04	1.05	1.05	1.06	1.06
Bus & coach	0.63	0.63	0.63	0.63	0.63	0.63	0.63
Airside licences	0.08	0.08	0.08	0.08	0.08	0.08	0.08
Electricity	6.58	6.80	7.22	7.30	7.41	7.54	7.69
Water & sewerage	0.77	0.77	0.76	0.76	0.75	0.75	0.75
Heating	0.23	0.23	0.23	0.25	0.25	0.24	0.24
Gas	0.16	0.16	0.19	0.20	0.21	0.22	0.23
PRM	6.09	5.89	6.20	6.54	6.90	7.28	7.69
Vehicle fuel and oil	2.62	2.63	2.63	2.62	2.63	2.63	2.64
Other non-specified revenue	3.11	3.28	3.46	3.65	3.65	3.65	3.64
TOTAL	48.62	50.82	52.09	53.50	53.87	54.50	55.10

Source: GAL revised forecasts adjusted to reflect the CAA's opex efficiency assumptions[83]

83 GAL's forecasts include revenue under the following categories: check-in baggage, staff car park, FEGP, identity cards, bus and coach, airside licences, aviation fuel, electricity, fuel, water and sewerage, heating, gas, PRM, vehicle fuel and oil, intercompany, and other non-specified

CHAPTER 8

Q6 RAB

8.1 This chapter:

- summarises the CAA's analysis and its April initial proposal with respect to GAL's RAB, and
- concludes with the CAA's proposal for the RAB which is incorporated in its financial modelling of its final price control proposals.

Deriving the opening RAB for Q6

CAA's initial proposals

8.2 The CAA's initial projection of GAL's opening RAB is based on GAL's projections for the value of capex spent in Q5 and depreciation charges during Q5 and Q5+1. The CAA has validated GAL's capex and depreciation charges and proposed the opening RAB for Q6 to be £2,370 million in 2011/12 prices, which is consistent with the forecast opening RAB in GAL's January RBP.

Stakeholder views

8.3 GAL argued that a RAB-based approach to regulation is not in the interests of passengers, airlines or GAL, and did not propose a value of the opening RAB.

8.4 In addition, GAL highlighted a £104.7 million commutation payment made by GAL to the BAA pension scheme in 2009 upon the sale of the airport. GAL considered that this payment had reduced pension costs and future risks at GAL and should therefore be included in the RAB.

8.5 BA proposed an opening RAB of £2,370 million based on capital expenditure of £1,172 million in Q5.

revenue. The CAA is not proposing that all of these categories should be covered by the transparency condition.

8.6 The ACC was unable to support a small proportion of the Q5 investment and considered that the CAA should remove or reduce this from the opening RAB. The ACC was concerned that if the CAA included all investment then GAL would treat all future consultation as a mere formality. The individual projects that the ACC wished the CAA to consider removing from the opening RAB are summarised in figure 8.1.

Figure 8.1: ACC's view on adjustments to the opening RAB

Q5 Projects	Reasons for removal or reduction from the opening RAB
The NT baggage system	Costs increased without good reason and without proper consultation.
The ST immigration project	The project proceeded without airline support and in particular the costs of e-gates should be removed given the CAA's views in the initial proposals on the NT scheme.
The new snow ploughs and snow clearing equipment	The ACC had not signed off the associated costs as the ACC considered that GAL had agreed to provide a service level agreement for the equipment usage but it has not been possible to reach agreement to date.
The A380 stand on Pier 6 south	The project was speculative without any evidence that the A380 stand would be used.
The ST Crew Reporting project	The project has not been consulted in line with Annex G and best practice project management has not been followed.

Source: ACC

CAA's final projections

8.7 The CAA commissioned GAD to provide advice on the basis for and regulatory treatment of the commutation payment. GAD concluded that it would be reasonable and consistent with regulatory principles to include the commutation payment in the RAB in full. The CAA has therefore accepted GAD’s recommendation that the full £104.7 million commutation payment be included in the RAB. The rationale for this is discussed in the opex section of the report (Pensions – commutation payment).

8.8 As an input to the initial proposals the CAA commissioned consultants

URS to review GAL's Q5 capex.[84] The main findings of the review were that:

- Each of the specific projects appeared to have delivered an effective solution, the processes for specific projects have been reasonably applied and almost all the changes are explicable in the light of circumstances.
- There were two projects that may not have met the twin Q5 tests for inclusion of expenditure in the RAB: effective project management and consultation in line with the requirements of Annex G of the Q5 Gatwick decision document.
- North Terminal extension where up to £4 million of expenditure may not have followed best practice project management.
- Crew reporting where there appeared to be no evidence to confirm the consultation on costs changes (around £7 million of relevant expenditure), which did not appear consistent with the requirements of Annex G.

8.9 On this basis the CAA considered that it required further evidence from GAL that the regulatory tests of efficient project management and effective consultation have been met before including the expenditure in the Q6 opening RAB.

8.10 GAL has provided further information that the expenditure on the North Terminal extension had been agreed with the JSG. The CAA is therefore content to include this expenditure in the opening RAB.

8.11 On crew reporting, GAL has provided further information on the consultation of the project. During the period in which the design of the project changed to meet airline requirements GAL stated that it did not provide a revised cost estimate as it did not have an accurate picture of the increased costs. GAL stated that it provided an assessment of the increased estimate once a costed proposal was received from the successful contractor. From the documentation it appears to the CAA that GAL did not provide airlines with fully costed options when they were making their decision on potential changes. It also appears to the CAA that airlines should have been aware that

[84] URS, March 2013, Gatwick Airport Review of Q5 capex, http://www.caa.co.uk/docs/78/Q6URSGwCapexConsult.pdf

meeting their requirements would have led to increased costs. If the CAA disallows this expenditure it could lead to GAL delaying projects until full costings of every option are available. Given that there does not appear to be an endemic problem in GAL's consultation procedures as evidenced by the URS study it does not appear to be in passengers' interests to disallow this expenditure. However GAL should not assume that the CAA will take the same approach in Q6, if further problems arise and the CAA continues to be using a RAB-based approach.

8.12 On the South Terminal immigration project, snow ploughs and A380 stand the CAA notes that the requirements of Annex G are to consult with airlines and to undertake best practice project management. While one of the objectives of Annex G is to achieve agreement within an appropriate timescale, however, it notes that this may not always be possible and there should be a process to resolve disagreements. The CAA has not seen evidence from airlines that the requirements of Annex G have not been met. The CAA also notes that airlines supported the expenditure on snow ploughs if a service level agreement could be reached. The CAA does however consider that if GAL has undertaken this expenditure and it is included in future prices then airlines should be able to rely on the outputs from these projects for example in terms of increased operational resilience from the snow ploughs and will be taking this into account when assessing any potential shortcomings in this area.

Deriving the depreciation charges and the RAB for Q6

CAA's initial proposals

8.13 The CAA's initial projections for the RAB throughout Q6 were based on GAL's forecast net capex, depreciation of the existing assets and depreciation of forecast capex in Q6. GAL's depreciation of existing assets was in line with GAL's regulatory accounts, and GAL's asset lives and depreciation policy were consistent with those in the Q5 decision.

8.14 The depreciation of new capex for Q6 was calculated on a straight-line depreciation basis. The CAA's initial projections reduced the depreciation of forecast capex by around £34 million by correcting the timing and treatment of depreciation and decreasing depreciation in line with the reduction in capex in the CAA's initial projections compared to GAL's RBP.

8.15 The CAA also excluded GAL's depreciation profiling between Q6 and Q7 by £39 million.

8.16 The CAA's initial projections for GAL's RAB throughout Q6 are set out in figure 8.2.

Figure 8.2: CAA initial projections RAB for Q6

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

Source: CAA

Stakeholder views

8.17 GAL indicated that the forecast depreciation of existing assets were immaterially different to GAL's RBP although there were some small changes to the forecast deprecation of post Q5 capex as a result of changes in project mix and phasing. GAL did however remove its proposal for depreciation profiling with had shifted some of the allowance for depreciation from Q6 to Q7. GAL's updated depreciation schedule is shown in figure 8.3.

Figure 8.3: GAL's updated depreciation schedule for Q6

£m (2011/12 prices)	2014/15	2015/16	2016/17	2017/18	2018/19	5 yr total
Depreciation - existing assets and Q5 additions	141	134	124	107	104	610
Depreciation - new additions	2	19	29	37	53	140
Total depreciation	143	152	153	145	158	750

Source: GAL

8.18 The ACC's projection of depreciation was 7% lower than the CAA's initial proposals reflecting a smaller capital plan. BA proposed the depreciation charges for Q6 was £671 million in total, also reflecting a smaller capital plan.

Figure 8.4: ACC's assessment of depreciation for Q6

£m (2011/12 prices)	2014/15	2015/16	2016/17	2017/18	2018/19	5 yr total
Depreciation	142	143	137	123	127	671

Source: ACC

CAA's final projections

8.19 The CAA has carefully reconsidered the regulatory depreciation allowance. The CAA's review of the estimated depreciation charge on Q6 capex:

- validates the depreciation charges for the existing assets and GAL's projections for the value of capex spent in Q5 - the depreciation charge deducted from the RAB during Q5 is the same as that included in the Q5 decision.
- increases depreciation by £7 million each year to adjust for the pensions commutation payment, which was based on a depreciation period of 15 years, which is longer than GAL's 10 year deficit recovery period to account for the size of the payment.
- reduces depreciation in line with the reduction in capex in the CAA's final projections compared to GAL's revised capex plan; and

- removes the depreciation profiling between Q6 and Q7, as it does not see merit in this case of moving value from one period to another.

8.20 Figure 8.5 sets out projected depreciation charge on this basis.

Figure 8.5 CAA's forecast for depreciation charge

£m (2011/12 prices)	2014 /15	2015 /16	2016 /17	2017 /18	2018 /19	5 yr total	2019 /20	2020 /21	7 yr total
Depreciation - existing assets and Q5 additions	141	134	124	107	104	610	98	90	798
Depreciation - new additions	1	16	22	27	40	106	47	56	209
Depreciation-pensions commutation payment	7	7	7	7	7	35	7	7	49
Regulatory depreciation profiling	0	0	0	0	0	0	0	0	0
Total depreciation	149	156	153	142	151	751	152	152	1,056

Source: CAA

CAA's final projection

8.21 The CAA's final projection for the Q6 RAB is set out in figure 8.6 below.

Figure 8.6: CAA forecast RAB for Q6

£m (2011/12 prices)	2014 /15	2015 /16	2016 /17	2017 /18	2018 /19	5 yr total	2019 /20	2020 /21	7 yr total
Opening RAB	2,474	2,480	2,521	2,556	2,554	2,474	2,514	2,513	2,474
Net capex	155	198	188	139	111	791	151	202	1,144
Depn	(149)	(156)	(153)	(142)	(151)	(751)	(152)	(152)	(1,056)
Closing RAB	2,480	2,521	2,556	2,554	2,514	2,514	2,513	2,562	2,562
Average RAB	2,477	2,501	2,539	2,555	2,534	n/a	2,513	2,538	n/a

Source: CAA

CHAPTER 9

Cost of capital, Calculation of the fair price and Financeability

9.1 This chapter:

- sets out the WACC calculated in the CAA's initial proposals;
- sets out the CAA's final proposals for GAL's WACC following the CAA's consideration of responses to the initial proposals;
- summarises the CAA's analysis of the fair price, including comparison to its initial proposals with respect to GAL's price cap;
- sets out the CAA's final proposal for the fair price for GAL for Q6; and
- assesses the extent to which price at this level would enable GAL to finance its projected investment in Q6.

9.2 The CAA's analysis of the components of WACC, a summary of the responses to its consultation and its calculation of the total WACC from those components is set out in full in 'Estimating the Cost of Capital: a technical appendix to the CAA’s Final Proposals for economic regulation of Heathrow and Gatwick after April 2014'[85]

WACC

CAA's initial proposals

9.3 The CAA's initial proposal for GAL's WACC was 5.65% on a pre-tax real basis. This equated to a vanilla[86] WACC of 4.83%.

CAA's final proposals

9.4 Based on the evidence and analysis contained in the Technical Appendix on WACC published alongside this document, the CAA's

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

[86] The vanilla WACC is the pre-tax cost of debt and the post tax cost of equity weighted by gearing. It therefore excludes any adjustments for tax.

final projections for GAL's WACC is 5.95% on a pre-tax real basis. This equates to a vanilla WACC of 5.10%.

9.5 The main reasons for the change from the initial proposals as set out in the WACC Technical Appendix are:

- an increase in the cost of debt arising from, amendments to PwC's calculation methodology and greater emphasis on longer-run market data and averages; and
- an increase in the cost of equity arising from a better reflection of the effect of a lower gearing.

9.6 Combined with the forecast RAB derived in chapter 8, the stream of allowed returns for GAL over Q6 is shown in figure 9.1 below.

Figure 9.1: WACC charge included within the final projections for GAL's Q6 price cap

£m (2011/12 prices)	2014 /15	2015 /16	2016 /17	2017 /18	2018 /19	5 yr total	2019 /20	2020 /21	7 yr total
Average RAB	2,477	2,501	2,539	2,555	2,534	n/a	2,513	2,538	n/a
Cost of capital	147	149	151	152	151	750	150	151	1,051

Source: CAA

Price cap calculation

Initial proposals

9.7 The CAA's initial proposal for GAL was to set a price cap equivalent to a maximum increase in average airport charges of RPI+1.0% per year over a 5 year Q6 period, and RPI+0.0% per year, if the initial projections are extended to 7 years.

9.8 Figure 9.2 shows each building block component which contributed to the CAA's initial price cap proposal.

Figure 9.2: CAA's initial price cap proposals

£m (2011/12 prices)	2013 /14	2014 /15	2015 /16	2016 /17	2017 /18	2018 /19	5 yr total	2019 /20	2020 /21	7 yr Total
Opex		283	280	277	274	271	1385	271	272	1928
Depreciation		142	149	147	136	146	721	152	161	1034
Cost of capital		135	137	139	140	139	688	139	141	968
Total revenue requirement		560	566	562	550	556	2794	562	574	3930
Other revenues		(242)	(240)	(251)	(257)	(267)	(1,257)	(271)	(273)	(1,800)
Net revenue requirement		318	326	311	293	289	1,537	291	301	2,130
Passengers (no. millions)		35.0	35.5	36.1	36.8	37.6	180.9	38.5	39.3	258.6
Unprofiled yield per pax (£)	8.31	9.09	9.19	8.63	7.96	7.69	n/a	7.57	7.67	n/a
Year-on-year change	n/a	9.42 %	1.11 %	(6.07 %)	(7.72 %)	(3.39 %)	n/a	(1.61 %)	1.38 %	n/a
5 year smoothed price cap (RPI +1.0%)										
Profiled yield per pax (£)	8.31	8.41	8.50	8.55	8.60	8.68	n/a	n/a	n/a	n/a
Year-on-year change	n/a	1.24 %	1.04 %	0.60 %	0.59 %	0.98 %	n/a	n/a	n/a	n/a
7 year smoothed price cap (RPI +0.0%)										
Profiled yield per pax (£)	8.31	8.33	8.34	8.31	8.28	8.28	n/a	8.28	8.28	n/a
Year-on-year change	n/a	0.29 %	0.09 %	(0.35 %)	(0.36 %)	0.03 %	n/a	0.03 %	0.03 %	n/a

Source: CAA

9.9 The resulting yield per passenger in figure 9.2 is profiled across the Q6 period. It equates to a price change of no more than RPI+1.0% per year over a 5 year Q6 period. This compares to GAL's RBP of

RPI+6.9%. If the initial projections are extended to 7 years, the price change is no more than RPI+0.0% per year. This was below GAL's commitment proposal at the time of RPI +4% per year.

9.10 The CAA's assessment of the financeability of its Q6 initial proposals for GAL indicated that the notionally financed airport operator would meet a solid investment grade credit rating.

Stakeholder views

9.11 Figure 9.3 summarises GAL's, the ACC’s, BA's and easyJet's views on the proposed Q6 settlement. These are compared to the price paths in the commitments based on: a 'blended yield' - which is the maximum average charges across published prices and bilateral contracts; and a 'core yield' - which assumes all airlines are paying published prices in the same way as the current price cap.

Figure 9.3: Comparison between the CAA's initial proposals and stakeholders' views (£ million unless stated)

Totals over Q6 period (2011/12 prices)	**CAA**	**GAL**		**ACC**	**BA**	**easyJet**
Opening RAB	2,370	2,370		2,370	2,370	2,370
Capex	794	1,064*		434	434	na
WACC	5.65%	7.1%		4.9%	4.8%	4.9%
Depreciation	721	686*		671	677	na
Opex	1,385	1,481		1,323	1,282	1,323
Other revenues	1,257	1,180		1,352	1,352	1,352
Passenger forecasts (millions)	181	180*		191	191	191
Proposed price per year	**5-year: RPI+1.0% 7-year: RPI+0.0%**	**RPI+6.9%**	**'Blended yield' : RPI+0.5% 'Core yield' :RPI+1.5 %**	**RPI-9%**	**RPI-10%**	**RPI-8.5%**
Regulatory approach	RAB based approach	RAB based approach	Commit-ments	RAB based approach	RAB based approach	RAB based approach or Commitments

Source: CAA, GAL, ACC, BA and easyJet

Note: GAL's proposed prices are based on a commitment period of 7 years. GAL has indicated that it would hold to the price level submitted in RBP despite updating its forecasts of capex, depreciation and traffic in its response to the initial proposals.

Deriving a Q6 fair price

9.12 The CAA’s view of a fair price, in terms of the maximum average level of airport charges, is based on a RAB-based 'building block' approach. The main assumptions in its financial modelling for each of the ‘building blocks’ relevant to the calculations are set out in the figures below.

9.13 Figure 9.4 sets out the CAA's projections for the calculation of the RAB and associated depreciation and WACC charge.

Figure 9.4: CAA's projections for the RAB

£m (2011/12 prices)	2014 /15	2015 /16	2016 /17	2017 /18	2018 /19	5 yr total	2019 /20	2020 /21	7 yr total
Opening RAB	2,474	2,480	2,521	2,556	2,554	2,474	2,514	2,513	2,474
Net capex	155	198	188	139	111	791	151	202	1,144
Depn	(149)	(156)	(153)	(142)	(151)	(751)	(152)	(152)	(1,056)
Closing RAB	2,480	2,521	2,556	2,554	2,514	2,514	2,513	2,562	2,562
Average RAB	2,477	2,501	2,539	2,555	2,534	n/a	2,513	2,538	n/a
Cost of capital	147	149	151	152	151	750	150	151	1,051

Source: CAA calculations

9.14 Figure 9.5 sets out the depreciation and WACC charges alongside all the other building blocks required to calculate a fair price.

Figure 9.5 Components of the RAB-based calculation

£m (2011/12 prices)	2014 /15	2015 /16	2016 /17	2017 /18	2018 /19	5 yr total	2019 /20	2020 /21	7 yr total
Opex	283	279	276	272	269	1378	267	266	1912
Depreciation	149	156	153	142	151	751	152	152	1056
Cost of capital	147	149	151	152	151	750	150	151	1051
Total revenue requirement	579	584	580	566	570	2880	569	569	4018
Other revenues	(245)	(244)	(254)	(261)	(270)	(1,274)	(273)	(273)	(1,820)
Net revenue requirement	334	340	326	305	300	1,605	297	296	2,198
Passengers	35.8	36.6	37.2	37.9	38.5	186.0	39.2	39.8	265.0
Yield per pax (unprofiled) £	9.35	9.29	8.74	8.05	7.80	n/a	7.56	7.44	n/a

Source: CAA calculations

9.15 In the initial proposals, the CAA smoothed the yield per passenger to avoid unnecessary fluctuations and to simplify the price control. Such smoothing or profiling is done in a Net Present Value (NPV) - neutral manner, i.e. the NPV of the net revenue requirement is the same under both unprofiled and profiled prices.

9.16 The CAA is aware that a significant difference between the profiled and unprofiled prices may in some circumstances lead to a short-term mismatch between revenues and costs and thus create liquidity issues for GAL. These issues can have implications for the financeability assessment.

9.17 If the resulting yield per passenger is smoothed across a five year Q6 period, it equates to a price change of no more than RPI+1.6%[87] per year (see figure 9.6). This compares to GAL's Business Plan of RPI+6.9%. Under the CAA's final projections a fair price (in 2011/12 price base) is expected to be £8.97 per passenger in 2018/19 which is £2.60 (or 22%) lower than using GAL's projections.[88]

87 In the formula RPI±X, RPI is the change in the index and can be negative or positive.

88 The CAA notes that GAL included a P0 adjustment in its RBP, which would reduce the

9.18 If the projections are extended to 7 years, the price change is no more than RPI+0.3% per year, see figure 9.6. This is almost the same as GAL's blended price commitment of RPI+0.5% per year and below its core price commitment of RPI+1.5% per year.

Figure 9.6: Profiled and unprofiled prices

£ (2011/12 prices)	2013 /14	2014 /15	2015 /16	2016 /17	2017 /18	2018 /19	2019 /20	2020 /21
Yield per pax (unprofiled)	8.31	9.35	9.29	8.74	8.05	7.80	7.56	7.44
Year on year change	n/a	12.6%	-0.6%	-5.9%	-7.9%	-3.2%	-3.0%	-1.6%
5 year smoothed price cap (RPI+1.6%)								
Yield per pax (profiled)	8.31	8.43	8.58	8.70	8.78	8.97	n/a	n/a
Year on year change	n/a	1.5%	1.8%	1.4%	0.8%	2.2%	n/a	n/a
7 year smoothed price cap (RPI+0.3%)								
Yield per pax (profiled)	8.31	8.32	8.36	8.37	8.33	8.41	8.43	8.45
Year on year change	n/a	0.2%	0.5%	0.1%	-0.5%	0.9%	0.3%	0.3%

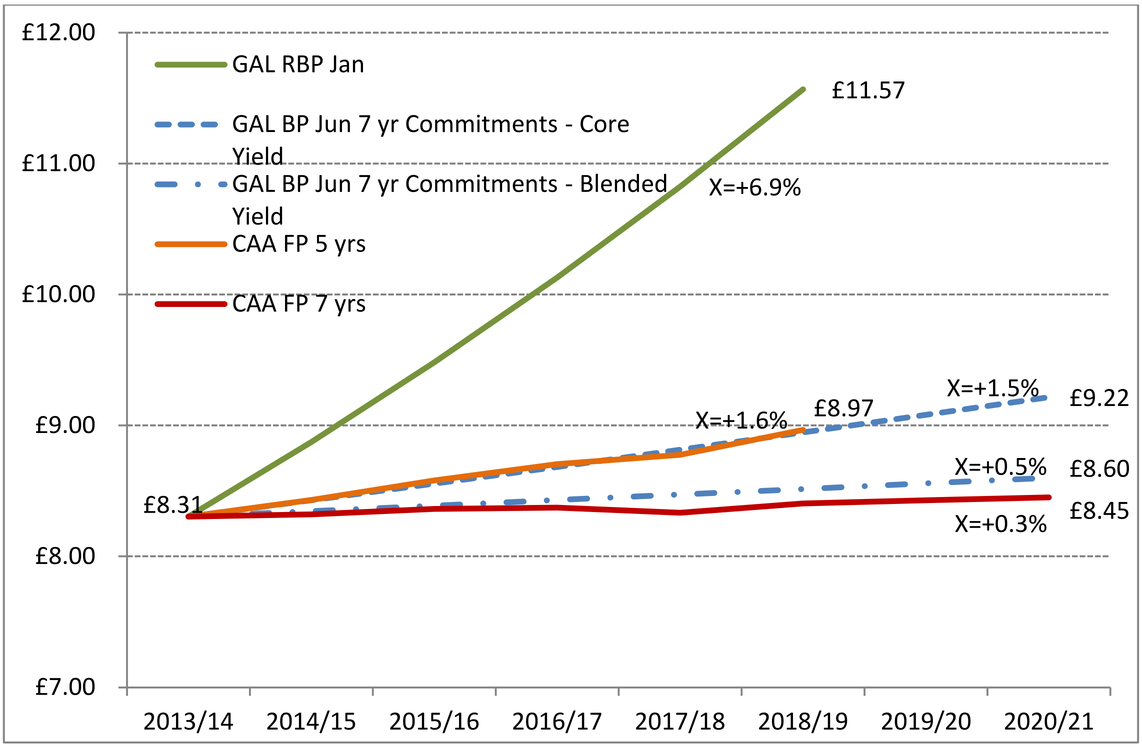
Source: CAA calculations

Note: The CAA has used the inflation forecast from Oxford Economics and assumed a long-run inflation rate of 3.1%.

9.19 Figure 9.7 shows how the CAA's projections compare to GAL's view of a RAB-based price cap using a simple average of the yield in each of the five years. Figure 9.7 also compares GAL's view of price commitments and CAA's projections based on a RAB-based price cap over a seven year period.

difference at the end of the period but increase it at the start of the period.

Figure 9.7 Yield per passenger (smoothed)



Source: CAA and GAL

9.20 Figure 9.8 compares the CAA's final projections with GAL's January RBP, the CAA's initial proposals and GAL's responses to the initial proposals. The main changes from the initial proposals are as follows:

- The WACC has increased from 5.65% to 5.95%. This is due to the CAA’s revised assessment of the cost of debt. This partly reflects changes in market conditions since the publication of the initial proposals in April 2013, and partly technical changes in response to points raised by stakeholders. The gearing and tax assumptions remain unaltered, while the cost of equity has marginally increased to reflect a slightly riskier position of GAL since it was divested from BAA.
- Traffic forecasts have increased by 2.8% over five years resulting from more up to date traffic data and the likely use of larger aircraft from easyJet's purchase of Flybe's slots.

- The opex efficiency assumption has increased from 1.1% per year to 1.2% per year based on removing costs associated with GAL's ✂ wage growth assumption, offset by an allowance for the CAA's higher traffic forecasts.
- Forecast core capital expenditure has been reduced very slightly from £794 million to £791 million from a combination of:
  - including additional schemes in the core plan following additional proposals from GAL, airline support, further assessment of the technical and passenger justification (north terminal coaching bays, stands 551/552/553, minor projects);
  - removing some schemes from the core plan: South Terminal International Departure Lounge reconfiguration (now a renewals project), business systems transformation (now a development project); and
  - cost changes for individual schemes from both GAL and the CAA's consultants.
- Projected commercial revenues have increased by around 1% per passenger from higher outturn data car parking revenues per passenger slightly offset by lower per passenger retail and property revenues. Overall total commercial revenues increased by 3.5% to £1,015 million largely driven by the increase in traffic forecasts.
- Forecasts for ORCs have decreased, from £276 million to £259 million, or 6.1%, due to the inclusion of the CAA's projections for increased opex efficiency in the ORC projections.
- The opening RAB has increased by £105 million due to the inclusion of the pension commutation payment. The changes to the opening RAB and capital expenditure have increased regulatory depreciation by 4.2% to £751 million.

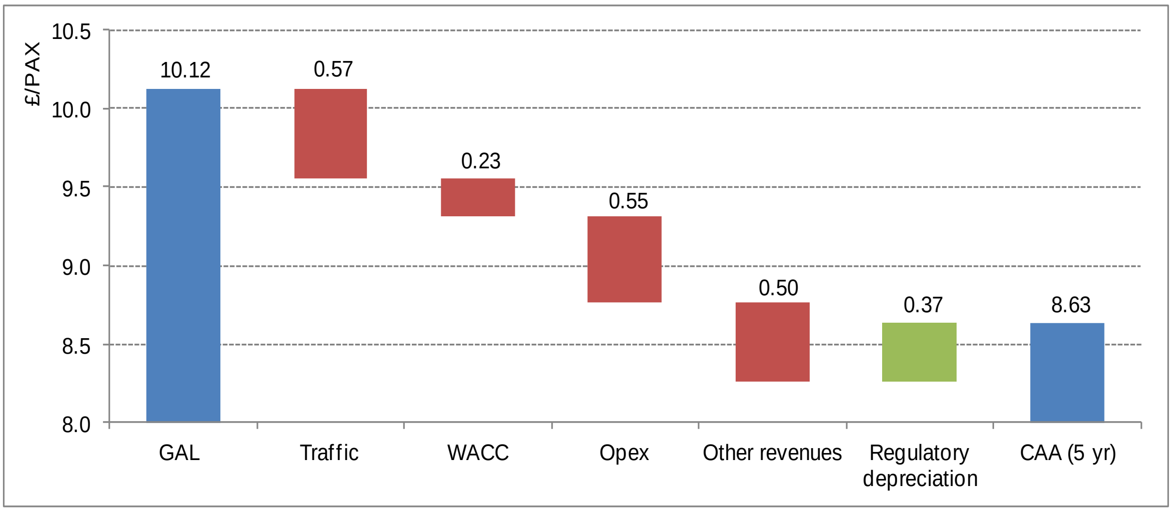
Figure 9.8: Comparison of building block assumptions

	CAA's final proposals	GAL's revised business plan January 2013	CAA's initial proposals	GAL's response to CAA's initial proposals
	£000	**% increase (+) or decrease (-)**		
Opening RAB	**2,474**	4.4%	4.4%	4.4%
Capital Expenditure	**791**	-13.2%	-0.4%	-25.7%
WACC	**5.95%**	-0.6%	0.3%	-1.2%
Operating Costs	**1,378**	-7.0%	-0.5%	na
Regulatory Depreciation	**751**	10.2%	4.2%	0.1%
Commercial revenues	**1,015**	12.2%	3.5%	na
Other regulated charges (ORCs)	**259**	-6.1%	-6.1%	na
Traffic	**186**	6.0%	2.8%	3.2%

Source: CAA and GAL

9.21 Figure 9.9 shows the average yield between GAL's and CAA's projections on average over a 5 year period. CAA's projected depreciation is higher than that of GAL's, because the CAA has removed the depreciation profiling between Q6 and Q7. In the RBP GAL profiled depreciation between Q6 and Q7, in effect reducing the depreciation charge and therefore price in Q6 and increasing them in Q7. The CAA does not see merit of moving value from one period to another.

Figure 9.9 Comparison of average annual yield over a 5 year Q6 between GAL's proposal and CAA's projections



Source: CAA and GAL

Final projections

9.22 The CAA's October final projections fair price for GAL is RPI+1.6% per year over five years and RPI+0.3% per year over seven years.

Financeability

9.23 In addition to proposing maximum levels of airport charges, the CAA has assessed the financeability of its final projections for Q6. The CAA must have regard to the need to ensure that licence holders such as GAL can finance its provision of airport operation services when it comes to the exercise of the CAA's functions such as setting price caps. This cannot override the CAA's primary duty. However, the CAA considers that the setting of a price control condition that is aligned with an efficient operator being able to finance its business is consistent and not in conflict, with present and future passengers' interests.

9.24 The CAA considers it appropriate to establish whether the Q6 final projections would enable an efficient GAL to finance its operations including the capex programme in Q6 on reasonable terms in the banking and capital markets through some combination of debt and equity.

Maintaining solid investment grade credit

9.25 A key assumption in determining the appropriate level of gearing in the CAA's estimation of the WACC is that GAL should be able to obtain and maintain a solid (sometimes known as 'comfortable') investment grade rating at an assumed gearing level of 55%.

9.26 A solid investment grade rating is interpreted as in the region of BBB/BBB+ (using Standard & Poor's (S&P) and Fitch Ratings Limited's terminology) and Baa2/Baa1 (using Moody's Investor Service terminology). This is a couple of 'notches' above the bottom of investment grade of BBB– or Baa3. The aim of the financeability assessment is for GAL to be in a position to absorb reasonable unanticipated downside risk and still retain an investment grade credit rating.

9.27 The CAA has gathered evidence directly from three credit rating agencies; S&P, Moody's Investor Service and Fitch Ratings. In determining a credit rating, an agency typically considers both qualitative evidence (e.g. business risk and corporate governance) and quantitative evidence (e.g. financial risk and credit ratios).

9.28 In forming a view on the business risk of an airport operator, an agency will consider, among other things:

a) the competitive position of the airport compared with airports owned by competitors, which in turn may include:

   i) location (catchment area, local transport links); and

   ii) customer airlines and the passenger mix, (hub airlines, alliances, destinations of those airlines);

b) the regulatory regime, and in particular the rigour and predictability of the regime;

c) the diversity of the airports owned or operated by the company;[89] and

d) charges (for example landing, passenger and security charges).

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[89] The CAA considers the airports on a standalone basis, so while this factor might be important for the credit rating agencies, the CAA's analysis ignores other airports in the same corporate group of companies.

9.29 GAL would appear to have a stable position from a credit perspective. Gatwick is the world's busiest single runway airport and the second busiest airport in the UK. It has an attractive catchment area, convenient transport links and diversified revenue streams in terms of destinations and airlines. On the other hand, GAL is exposed to the prospect of continued sluggishness in the UK economy and the potentially volatile UK leisure market.

9.30 One of the key assumptions of the CAA's financeability assessment is that the CAA's review will not affect GAL's business risk; therefore, the CAA assumes that the regulatory risk of GAL is unchanged from credit rating agencies' current views. However, the CAA recognises that the fair price could affect the financial risk of GAL.

9.31 In forming a view on the financial risk of a business it is rating, an agency may consider matters such as:

a) historical and forecast financial performance, including:

   i) cash flow and profitability;

   ii) revenue diversity and stability;

   iii) liquidity and financial flexibility;

   iv) capital structure of the company (including gearing);

   v) covenants and security including securitisation; and

b) financial policy and strategy of management (including merger & acquisition activity, dividend policy, etc).

9.32 The rating agencies place different emphasis on the various ratios. Some of the agencies also differ in their benchmarks (e.g. the value the ratio needs to be for a certain credit rating).

CAA analysis of credit ratios

9.33 The CAA has considered whether the forecast performance of GAL under the CAA's Q6 final projections is consistent with a solid investment grade based on assumed gearing of 55% and considered six ratios used by the various agencies.[90]

[90] These ratios and some of the terms used in them do not have agreed definitions.

a) interest cover;[91]

b) funds from operations (FFO[92]) interest cover;[93]

c) post-maintenance interest cover ratio (PMICR);[94]

d) adjusted interest cover (adjusted ICR[95]);

e) FFO to debt;[96] and

f) regulatory asset ratio (RAR[97] or gearing) (debt divided by RAB).

9.34 The CAA has used a separate section in GAL's financial model, which was created to provide illustrative calculations of the above financial ratios. These are set out in nominal terms[98] as this tends to be the basis used by rating agencies.

9.35 The CAA has undertaken the analysis on the basis of the notional capital structure consistent with the CAA's cost of capital proposals. This assumes:

a) a constant gearing level of 55%, with the level of dividends being the balancing item used to keep gearing at this level;[99]

b) a nominal cost of debt of 5.8%. This is based on a real cost of debt of 3% (excluding fees) and an inflation rate of 2.8%;

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91 ICR = (EBITDA – tax paid – 2% of total RAB)/interest paid. NB: the rating agencies using this metric assume that 2% of total RAB is required to maintain the regulatory assets.

92 FFO= Net income from continuing operations adding back depreciation, amortisation, deferred income taxes and other non-cash items, less any changes to operating components of working capital.

93 FFO/interest expense = FFO (as above) + gross interest paid on debt/gross interest expense on debt.

94 PMICR = (EBITDA – corporation tax paid – regulatory depreciation)/interest paid.

95 Adjusted ICR is FFO + interest expense – regulatory depreciation + profiling adjustment divided by interest expense.

96 FFO/net debt, where FFO is as defined above and net debt = closing RAB x gearing ratio.

97 RAR = debt less cash and authorised Investments/total RAB.

98 In contrast, the rest of the GAL model used for the price control was specified in real terms.

99 The CAA relaxed this assumption and after allowing for a modest dividend yield, gearing was in the range of 55% to 56%.

c) index-linked debt making up 35%[100] of the total debt balance; and

d) a cost of index-linked debt of 3%.[101]

9.36 The CAA has made some additional assumptions and adjustments in order to derive the financial ratios in figure 9.10.

9.37 Based on these results, the CAA considers that a notionally financed and efficient GAL would be likely to achieve and maintain a solid investment grade credit rating.

[100] Ofgem assumes 25% of each network company's debt is index-linked. In the Q5 price control review, the CAA assumes that the proportion of index-linked debt is 25%. The CAA has also calculated the actual proportion of GAL's index-linked debt, based on GAL's financial statements. The calculated proportion is approximately 55%. Taking into account all the available evidence, the CAA takes the conservative point of 35% in the range of 25 per cent to 55 per cent.

Ofgem, 17 December 2012, '*RIIO-GD1: Final Proposals - Finance and uncertainty supporting document*', p. 25.

GAL, 'Report and unaudited interim financial statements for the six months ended 30 September 2012', p. 15.

[101] The cost of index-linked debt of 3% is consistent with the CAA's point estimate of 3.32% less fees of 20bps (excluding fees). The nominal cost of debt includes inflation of 2.8%.

Figure 9.10: CAA financial ratios for GAL in Q6

Key financial ratios: benchmarks and calculations[102]								
	Benchmark		CAA 5yr			CAA 7yr		
Key financial ratios	Moody's (Baa2)	Fitch (BBB+)	Ave.	Min	Max	Ave.	Min	Max
PMICR	n/a	1.5 - 1.6	1.89	1.86	1.93	1.89	1.86	1.93
ICR	1.4 -1.6	n/a	3.4	3.3	3.4	3.4	3.3	3.4
RAR - Net debt/RAB	68% - 75%	n/a	55%	55%	55%	55%	55%	55%
Other financial ratios								
FFO interest coverage	2.25 - 3.0	n/a	3.4	3.3	3.5	3.4	3.3	3.5
FFO to net debt	6-10%	n/a	20%	19%	20%	20%	19%	20%

Source: CAA analysis

9.38 The CAA notes that its ratio analysis suggests that the notionally financed airport operator would meet a solid investment grade credit rating. In addition, the CAA has assessed the ratios for a 7 year period, and conducted analysis by incorporating a variable dividend payout ratio. The CAA considers that its conclusions are not sensitive to changes in these assumptions.

9.39 The CAA has used GAL's financial model to calculate the Q6 price cap proposals and analyse price cap profiling and financeability. GAL's model, including assumptions, logic, internal consistency and formulae has been externally audited.

9.40 The CAA's Q6 price cap calculations have been internally audited and the excel model has been checked by calculating the price cap using alternative models.

CAA final forecast fair price

The CAA's final forecast fair price is RPI+1.6% per year over five years and RPI+0.3% per year over seven years.

[102] Unfortunately Standard & Poor's does not share the details of key financial ratios which they consider important.

PART C – FORM OF REGULATION

CHAPTER 10

Form of regulation

10.1 The overall model or form of economic regulation for GAL should be designed in a manner that furthers the CAA’s duties and reflects GAL's market power and the potential for abuse.

10.2 The current GAL price control is based on a RAB-based framework. As an alternative to licence regulation, GAL has put forward proposals for airport commitments to airlines. These commitments, which GAL is proposing to include in its Conditions of Use, set out limits on airport charges, a service quality regime and commitments on consultation, investment, and operational and financial resilience.

10.3 This chapter discusses the merits of GAL's proposed commitments and alternative forms of licence regulation that could apply from April 2014 for GAL.

Process to date

10.4 In November 2009, the CAA commenced work with stakeholders to identify and assess alternative forms of regulation.

10.5 In March 2011, the CAA issued a stock-take on this work and narrowed down the options and identified a number of potential improvements to regulatory design within, and beyond, a standard RAB-based framework. The CAA consulted on the merits of these options in its July 2011 setting the scene document.

10.6 In the May 2012 Q6 policy update, the CAA consulted on a further narrowed down set of potential options.

Initial proposals

10.7 The initial proposals assessed each of the regulatory options, including GAL's commitment proposals against an appraisal framework based on the CAA’s statutory duties under the Act. The key points from this assessment were as follows.

- GAL's commitment proposals could have benefit over a licence approach in that it would avoid the direct costs of a regulatory review, increase flexibility and could avoid some of the distortions from RAB-based regulation such as management distraction or perverse incentives. The CAA was concerned with the enforceability of the commitments as GAL appeared able to make unilateral variations and the commitments would be enforced by airlines whose interests may not be aligned with passengers. The CAA was also concerned that the terms in the commitments would not operate in passengers’ interests.
- Commitments backed by a light touch licence would address the concerns with the enforceability of the commitments, although the concerns with the terms in the commitments would remain.
- A RAB-based framework was well understood and widely used, including by the CAA. The CAA acknowledged the drawbacks of a RAB approach in that it can be costly and time consuming, rigid and distort incentives but considered that some of the problems of distortions to investment incentives and rigidities could be overcome through a more flexible RAB approach.
- A long run incremental cost (LRIC) approach would have conceptual benefits from being linked to a notion of future competitive prices, however the input assumptions required significant judgement and could lead to starkly different pricing profiles.
- Linking prices to a benchmark index of peer group airport charges has the potential advantage of a linkage to what might be considered a market based competitive price, but suffered from considerable debate over the composition of the index, the equivalence of comparators, the frequency of adjustment etc.
- A default price cap based on a price for a minimum level of service where airlines are able to negotiate variations would still require a price cap to be calculated and so would suffer from the same pros and cons as other options to the extent that its calculation was based on a complex calculation such as RAB or LRIC.

- A price monitoring and transparency regime would not provide a price cap but would provide a backstop for regulatory action if behaviour was out of line with expectations. The CAA considered that this would have the advantage of encouraging greater discussion between airlines and GAL but raised concerns that, given the degree of market power held by GAL, that significant passenger detriment could occur if GAL abused its market power before tighter controls could be reintroduced.
- A price monitoring and commitments regime would have benefits from the additional protection provided by the commitments but, given this, much would rest on the commitments themselves and a commitments and licensing regime would have benefits from greater enforceability.

10.8 The initial proposals concluded that "the CAA hopes that a commitments and limited licensing framework could be the preferred form of regulation for GAL. This would be on the basis that the enforcement concerns about the commitments concept were addressed through enforcement under the licence; and that the commitments were amended to address the other concerns ..., so that they are reasonable and effective. In the absence of a satisfactory proposal for commitments, and due to the concerns raised around the other potential options, the CAA considers that it would be most appropriate to base its initial proposals on a RAB-based framework."

Key issues

10.9 The CAA has considered the issues raised in the initial proposals and the consultation responses in three groups:

- the evaluation criteria;
- the weight given to the promotion of competition in the assessment of alternative forms of regulation;
- the assessment of alternative forms of regulation.

Evaluation criteria

Key issue

10.10 In the initial proposals the CAA developed a set of evaluation criteria based on its statutory duties under the Act.

Stakeholder views

10.11 GAL was the only stakeholder to comment directly on the evaluation. While GAL stated that the criteria appear reasonable as they were based on the CAA's statutory duties, GAL raised concerns on the implementation of the framework in four areas.

- The CAA focused on the protection against the potential harm against market power and not on the promotion of competition. The CAA has considered this issue in the section on the promotion of competition and regulatory precedent.
- The CAA mis-specified the concept of price protection, which should focus on passengers and not airlines.
- The concept of "regulatory activity to be transparent, accountable, consistent and targeted" in the Act was more clearly directed on regulatory outcomes as well as process.
- The criterion "practical implementation, stakeholder confidence" did not have a direct link to the CAA's statutory duties.

Discussion

10.12 The CAA welcomes GAL's view that it considered the criteria reasonable.

10.13 The CAA agrees with GAL that the focus on price protection should focus on the benefits to passengers. As set out in paragraph 2.12 the CAA considers reductions in airport charges will benefit passengers through reduced air fares and hence the CAA does not accept GAL's argument that it has mis-specified the concept of price protection.

10.14 When performing its general duty the CAA must have regard to the better regulation principles that:

- regulatory activities should be carried out in a way which is transparent, accountable, proportionate and consistent; and

- regulatory activities should be targeted only at cases in which action is needed.[103]

10.15 The CAA considers that the requirement that "regulatory activities should be carried out in a way that is transparent, accountable, proportionate and consistent" is inherently focused on the *way* that the CAA carries out its activities rather than the *outcomes* from those regulatory activities. Proportionality will also have an incidental effect on the substance of the measure. While this approach is likely to lead to outcomes that are transparent, accountable, proportionate and consistent, the CAA does not consider that this is the primary focus of this part of its duties.

10.16 The CAA considers that for regulatory activities to be transparent, accountable, proportionate, consistent and targeted the CAA needs to take into account the practical implementation issues and stakeholder confidence in any proposals. For example if stakeholders do not have confidence in licence protections then this could lead to numerous cases under the Airport Charges Regulations 2011 (ACR) or competition law as stakeholders seek to protect their rights, which could lead to greater uncertainty, more adhoc regulation and more regulatory intervention overall.

CAA final proposals

10.17 Taking into account the discussion above the CAA continues to consider that the set of evaluation criteria set out in the initial proposals is appropriate. These criteria are set out in figure 10.1.[104] The primary criterion is protection of the interests of users (passengers and those with rights in cargo) regarding the provision of airport operation services, and, where appropriate, to do this by promoting competition.

10.18 Other criteria include allowing efficient businesses to finance their licensed activities, operational efficiency, and the better regulation principles (within which the CAA has considered the need not to impose unnecessary regulatory burdens).

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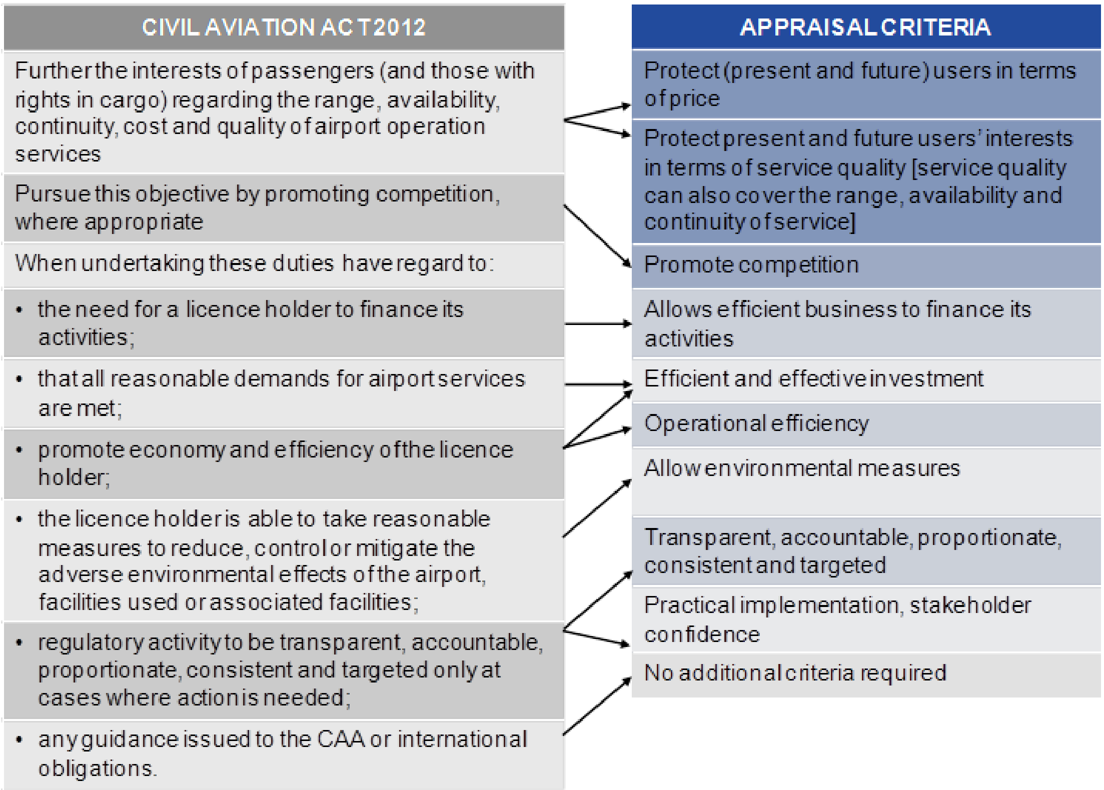
[103] Section 1 (3) and (4) of the Act.

[104] The CAA had similar evaluation criteria for its May 2012 Policy Update document, however these were based on the latest draft of the government's Bill before it full parliamentary scrutiny and its subsequent Royal Assent.

Figure 10.1: Appraisal criteria for assessing regulatory design



Source: CAA

Promotion of competition in the assessment of alternative forms of regulation

Key issue

10.19 GAL raised concerns that the CAA has given too little weight of the need to, where appropriate, promote competition in its assessment of alternative forms of regulation.

Stakeholder views

10.20 GAL raised a number of issues related to the promotion of competition and the CAA's initial proposals.

10.21 First, while Parliament expressed a preference for competition over regulation, the CAA had not explained how it would determine whether the promotion of competition was appropriate to further passengers' interests and how it had balanced the different interests of users, where some may benefit from an onerous price control whereas some might not.

10.22 Second, while there was substantial evidence that competition had increased following the break-up of BAA, the CAA's initial proposals did not promote competition and increased rather than reduced the regulatory burden.

10.23 Third the CAA's initial proposals prevented key elements of a competitive market, in particular:

- pricing flexibility to incentivise different use of facilities and to meet the different requirements of customer types;
- flexibility to adjust the investment programmes and delivery timescales in response to changing circumstances;
- incentives for innovation in operation and service delivery; and
- incentives to target and attract new customers.

Discussion

How has the CAA taken account of the duty to further passenger interests, where appropriate by promoting competition?

10.24 The CAA has considered its duty, where appropriate, to promote competition as one of the key criteria when evaluating alternative forms of regulation. When undertaking that assessment the CAA is aware that, while competition has increased since the break-up of BAA, the CAA is minded to conclude that GAL has SMP and there is a continued need for licence regulation. Consequently on this basis without licence regulation there is a risk that GAL could abuse its SMP, for example through excessive prices, poor service quality, a lack of investment or a lack of efficiency. The CAA is also conscious of its duty not to impose or maintain unnecessary regulatory burdens and that regulatory action should be targeted only at cases where this is needed.[105] Consequently, the CAA has sought to promote competition while ensuring that there is sufficient protection for users against the risk of abuse of SMP without undue side effects. The CAA has balanced these requirements when assessing alternative forms of regulation. It should be emphasised that the CAA considers that as the duty includes the term "where appropriate", the promotion of competition is subsidiary to the general duty to further the interests of passengers. Consequently, the CAA considers that the promotion of

[105] Section 1(4) and section 104 of the Act.

competition should be pursued in circumstances where it will achieve outcomes that further the interests of passengers.

10.25 There are a number of examples where the promotion of competition in airport operation services (the promotion of competition between airport operators rather than airlines) has impacted on the CAA's approach. For example the CAA sets a price cap based on average published charges. This allows the airport operator flexibility to price below this level should it wish. GAL has used this flexibility to offer incentives to new long haul routes in some circumstances. The price cap also allows GAL to adjust the structure of charges, which GAL has used to make better use of capacity by increasing landing charges relative to passenger charges and summer charges relative to winter charges. Under service quality regulation the CAA regulates a minimum level of quality for the basic bundle of services used by airlines and their passengers, while allowing airlines to purchase higher quality airport operation services above this minimum, for example airport lounges.

10.26 GAL queried how the CAA has balanced the different elements of passengers' interests mentioned in the general duty: the range, availability, continuity, cost and quality of airport operations services. When considering the balance of its duties in the assessment of the form of regulation the CAA has considered the relative risks of abuse of SMP identified in the minded to market power assessment for GAL. The CAA considers that the greatest risk of abuse is excessive prices and so has placed most weight on the cost of airport operation services in its evaluation of different forms of regulation. The CAA also considers that there are risks of abuse in terms of service quality and investment and so has placed some weight on these elements. The CAA considers that the availability and continuity of airport operation services, are to a certain extent satisfying factors, and as long as it ensures that the airport operator is able to finance its activities and there is financial and operational resilience then these issues would be met.

10.27 GAL queried how the CAA has balanced the needs of different users where their interests may not be aligned: for example GAL stated that some users may benefit from an onerous price control, whereas other users may not. Under section 1(5) of the Act the CAA should carry out its functions in a manner which it will further passengers as it thinks best. When balancing the needs of passengers' interests the CAA is conscious of the need to protect against the risk of abuse of SMP. Consequently where an airport operator has SMP over all passengers (as identified in the minded to assessment), albeit the requirements of different groups of passengers differ, the CAA has focused regulation where the risk of abuse of market power and potential detriment to passengers is greatest. As set out above the CAA considers the greatest risk to passengers is likely to be excessive prices and consequently considers that the requirements for protection are likely to be greatest in this area. The CAA recognises that this is likely to benefit some passengers more than others, although the CAA considers it will minimise distortions by focusing this protection on the cost of a minimum bundle of common services. This approach allows passengers that have higher service quality requirements to purchase this additional quality, rather than impose these higher costs and quality on all passengers. The CAA considers where an airport operator has SMP over all passengers, and there are trade-offs between different groups, the CAA should seek the outcome that provides the greatest overall benefit.

Impact of increasing competition on the CAA's initial proposals

10.28 GAL stated that, while competition has increased since the break-up of BAA, the CAA's initial proposals increase rather than reduce the regulatory burden. In particular GAL cited the example of the CAA's proposals under a RAB-based framework for core and development capex.

10.29 As stated above, when developing its proposals the CAA has been conscious of the need to protect against the risk of abuse of SMP, while promoting competition where it is appropriate to do so. To this end the CAA stated that GAL's proposed commitments, together with a limited licence would be its preferred form of regulation, provided the concerns with the individual terms could be addressed so that they were reasonable and effective. However in the absence of this the CAA took forward proposals for a RAB-based settlement.

10.30 One of the criticisms of the Q5 regulatory regime has been that it attempted to set the capex programme too far in advance. The CAA's proposals for a core and development capex programme are aimed to increase flexibility of the RAB approach by allowing GAL to change the projects in the development programme so that they best suit the emerging needs of users. In addition, following criticism of the burden of existing capex consultation arrangements, the CAA invited proposals from stakeholders to reduce this burden, while providing adequate protection to users. GAL's main criticism of the core and development capex approach is the need to obtain agreement from the airlines or CAA for the transfer of funds from the development to the core programme.

10.31 GAL raised concerns over the scope of CE that was entered into for Q6 and the inference that this was a form of commercial negotiation. As part of the Q6 review GAL commissioned consultants Oxera to review the regulatory regimes at seven international airports, which it considered to be comparable to Gatwick. The regimes varied from price monitoring type arrangements in Auckland and Sydney to price cap regulation, generally based on some form of building block approach, with varying levels of airport-airline negotiation and single/dual till cross subsidy at Brussels, Copenhagen, Dusseldorf, Paris-Orly, Rome-Fiumicino. Oxera suggested that Gatwick was subject to the greatest regulatory constraints while having the greatest potential for passenger and airline substitution. Oxera noted that the assessment was based on a qualitative judgement and did not reflect the outcome of a MPT.

10.32 As part of this assessment Oxera highlighted the importance of commercial negotiations and made a clear distinction between these and a requirement to consult. These negotiations varied from negotiations on the overall level of charges (for example Brussels, Dusseldorf and Copenhagen) and negotiations over individual price and service level agreements (for example Sydney). Oxera noted that at many airports there was the potential default to a more intrusive regime or dispute resolution should agreements not be reached. The CAA notes that in some ways this is similar to CE for Q6, which was widened to cover all elements of the price control. Within CE there was scope for GAL and airlines to agree on key elements for example on the capex plan or service levels or even the overall level of charges. Subject to agreements reflecting the interests of passengers, the CAA stated it would be minded to incorporate agreements into the Q6 settlement. In many ways this is a similar approach to that used at other airports mentioned by Oxera, for example at Copenhagen the airport operator reveals details of costs and revenues in its multilateral negotiation with airlines, with a fall back regulatory settlement if agreement was not reached. The CAA also considers that Oxera's analysis downplays the flexibilities already within the regulatory regime over the structure of charges, individual price service propositions above the minimum and the scope for bilateral agreements.

More flexible approaches to pricing

10.33 GAL stated that the CAA's proposals would prevent flexibility with regards to pricing as the binding price cap would make it difficult for Gatwick to compete, particularly given capacity constraints where prices would be expected to rise. GAL also stated that a RAB approach would crowd out incentives to reach commercial agreements.

10.34 In previous quinquennium the CAA has set a price cap on the average revenue yield from published charges and so providing GAL flexibility to alter the structure of charges (within the constraints of the ACR) and allows GAL to provide incentives for growth. GAL appears to be stating that a binding cost based price cap prevents it from raising prices to what GAL considers to be the competitive level. For the reasons set out in the fair price chapter, the CAA does not consider that allowing GAL to raise prices unilaterally would benefit passengers and it appears strange if increasing competition led to higher rather than lower average prices.

10.35 GAL stated that a RAB-based approach would crowd out incentives to reach commercial agreements. The CAA has acknowledged that bilateral contracts might be more difficult under a RAB-based approach, for example due to the risk for GAL and the airlines concerned that the terms offered in a typical 10 year bilateral might not be consistent with regulation over more than one control period. However a RAB-based approach does not entirely preclude bilateral contracts and the CAA notes that GAL itself has provided discounts for new long haul routes within a RAB approach.

10.36 The CAA has considered GAL's argument that the prospect for airlines agreeing to bilateral contracts or bilateral contracts are frustrated by the CAA's regulatory process. The CAA does not accept this. GAL indicated at the start of 2011 that it wanted to agree bilateral contracts in that year. The CAA subsequently structured its process so as to allow time for these negotiations to take place. The CAA said it would take into account any progress in reaching bilateral agreements. Over two years have now elapsed and no bilateral contracts have been concluded. (This contrasts with the rapid progress that Manchester Airports Group has made in reaching agreement with easyJet and Ryanair at Stansted). The CAA therefore does not consider it is in passengers' interests to delay issuing its final proposals. Nothing in these proposals rules out GAL continuing to negotiate and secure bilateral contracts both in the lead up to April 2014 and after this date.

10.37 GAL stated that the CAA proposals are an outlier in regulatory design. Where there has been increasing competition regulators had either removed controls in their entirety (e.g retail energy, retail telecoms and some wholesale telecoms markets) or based prices on forward looking costs (such as LRIC in telecoms) or loose safeguard caps (e.g. for retail telecoms and postal services). GAL stated that these approaches have been justified on a number of bases which include that static interpretation of competition of price equal to cost is not appropriate in a market with competition, and the risks of the regulator setting inappropriate price/service outcomes.

10.38 GAL stated that, in general, regulators have removed or reduced regulatory controls where they expect competition to increase. While the CAA expects some forms of competition in airport operation services to increase in the short term (for example in terms of quality), in the longer term the overall level of competition will depend on the tightness of capacity constraints. This is consistent with the view of the CC in the BAA market inquiry as set out in chapter 3.

10.39 In his report for Gatwick, Professor Littlechild states that under separate ownership the operators of Heathrow, Gatwick and Stansted will have an incentive to make more capacity available. He states, for example, that HAL could alter the structure of charges to encourage the use of larger planes. As set out above, the CAA notes that GAL has changed its structure of charges in this regard and this might well have contributed towards the sale of the Flybe slots to easyJet. While this may contribute towards the provision of additional capacity this is unlikely to eliminate the severe capacity constraints at Heathrow and to a lesser extent Gatwick. In addition, changing the structure of charges to incentivise the use of limited runway capacity could have unintended consequences for a hub airport where the viability of long haul services can depend on the feeder traffic provided by short haul routes.

10.40 GAL also stated that competition authorities have been reluctant to introduce ex ante controls due to risk of creating artificial distortions in markets. The CAA considers this suggests a systematic difference between competition authorities and regulators that does not in fact exist. Regulators are also alive to the dangers of artificial distortion, while competition authorities recognise the need sometimes to impose ex ante controls. The UK approach in the last 10-15 years has been to empower regulators also to enforce competition law (as the Act has done for the CAA) and so enable an unfettered choice between ex ante and ex post measures.

Flexibility to adjust the investment programme

10.41 GAL stated that regulatory controls would hold it back from the delivery of its vision for the airport and that this was aggravated by the CAA's reduction in the capex programme. The CAA notes that, in a competitive market, airport operators will only deliver capex if they consider that this would produce a financial return and so any increases in costs would need to be more than offset by increasing of income whether through additional passenger volumes or improved quality that passengers are willing to pay for. For example a competitive airport is unlikely to commit to a major capacity expansion unless it is confident that it can generate sufficient traffic so that it can make a return.

10.42 If an airport operator has SMP then there is a risk that, absent some form of controls, capex could be delivered to simply improve its market position, for example from getting existing users to pay for a reorientation of the airport, or not to be delivered at all. When assessing alternative forms of regulation the CAA has been conscious of the need to provide adequate protections to users, and where possible allowing GAL the flexibility to alter the programme where this better suits the needs of users. This lay behind the thinking of the CAA in the core/development capex proposals set out in the initial proposals.

Scope for innovation

10.43 GAL stated that the CAA's initial proposals could significantly reduce both the motivation towards and rewards from innovation (in terms of service delivery, operations management and product development) and competitive rivalry and therefore undermines the incentives for innovation. GAL state that this is contrary to the previous views of the CC and the CAA.

10.44 GAL stated that improved incentives for innovation would be provided by a more flexible approach to pricing and investment project delivery. GAL also raised concerns over the CAA proposals for setting service metrics, while stating that the structure of the service quality regime was broadly acceptable (in particular as the same structure of regime was included in GAL's proposed commitments). In particular GAL raised concerns that the rebasing of the service quality proposals to reflect performance as at December 2012 would penalise GAL for past successful delivery (and could lead to failures in some areas) and would undermine incentives to outperform in the future. The CAA notes that the current RAB-based regime has not prevented some innovations in airport operation services, for example self service check-in.

10.45 The CAA has always been clear that regulation can have an impact on the development of competition. The development of service quality standards for GAL followed a Public Interest finding from the CC which found that service quality performance was operating against the public interest. This was confirmed in Q5 and the regime was extended and strengthened. Since that time service quality performance has improved, although it is difficult to judge whether this reflects the impact of regulation or competitive pressures (although the CAA notes that service quality has also improved at Heathrow which it might be argued is subject to less competitive pressure). Nevertheless regulation does not appear to have prevented GAL from improving performance. Given that a service quality regime could be included under any of the forms of regulation, when developing proposals, the CAA will take into consideration the potential impact on competition.

10.46 GAL's concerns over pricing and investment flexibility have been dealt with in paragraphs 10.33 to 10.42 above.

Incentives to attract and retain customers

10.47 GAL stated that the CAA’s proposals would reduce GAL’s ability to attract and retain new airlines in particular as: charges would be set in relation to costs; the process by which capex would be included into the regulatory settlement would be dominated by incumbent airlines; and there would be reduced incentives to improve service. The CAA's response to these issues is provided above.

Assessment of alternative forms of regulation

10.48 The CAA has assessed each of the alternative forms of regulation against its evaluation criteria, focusing on the protection against the potential harm from the abuse of market power and, where appropriate to do so, the promotion of competition. The evaluation has taken into account the CAA's assessment of GAL’s market power and the risks of abuse. The assessment builds on the initial proposals and draws on consultation responses from stakeholders and a number of CAA commissioned consultancy studies. The assessment of GAL's proposed commitments has also been summarised against the same criteria.

10.49 A separate appraisal has not been carried out for a default price cap. The price cap within a default settlement would need to be based on a RAB, LRIC or alternative approach and so would be subject to many of the same considerations as these measures.

GAL's commitment proposals

Initial proposals

10.50 GAL set out its airport commitment proposals in detail in Appendix 1 of its RBP, and subsequently provided further detail on the service quality regime and the incorporation of the commitments into the Conditions of Use.

10.51 In the initial proposals the CAA stated that GAL's commitment proposal could have benefit over a licence approach in that it would avoid the direct costs of a regulatory review, increase flexibility and could avoid some of the distortions from RAB-based regulation such as management distraction or perverse incentives. The CAA was concerned with the enforceability of the commitments as GAL appeared to be able to make unilateral variations and the commitments would be enforced by airlines whose interests may not be aligned with passengers. The CAA was also concerned that some of the terms in the commitments then offered would not operate in passengers' interests.

10.52 The CAA considered that the commitments backed by a light touch licence would address the concerns with the enforceability of the commitments, although the concerns with the terms in the commitments would remain.

10.53 The initial proposals concluded that the CAA hoped that a commitments and limited licensing framework could be the preferred form of regulation for GAL. This would be on the basis that the enforcement concerns about the commitments concept was addressed through enforcement under the licence; and that the commitments were amended to address the other concerns, so that they are reasonable and effective. However in the absence of acceptable commitments the CAA took forward proposals for a RAB-based price control.

Responses to the initial proposals

10.54 While GAL continued to maintain that it did not pass the test for a licence, GAL substantially revised its commitments proposals to address the concerns set out in the initial proposals. GAL stated that it had not reflected the CAA's concerns in some areas, for example on capex outputs (as it wanted to maintain flexibility to compete) and service quality (as this would increase rather than maintain standards). GAL also raised a number of concerns with the CAA's proposals for a licence to be associated with the commitments.

10.55 Professor Littlechild raised three concerns on the CAA's consideration of commitments within a licensing framework:

- it was not clear that the CAA's additional demands were consistent with what a competitive market would provide and may unduly constrain the development of competition;
- there are alternative ways of enforcing the commitments without a licence, for example via bilateral contracts with users or undertakings to the CAA; and
- the licensing of GAL would encourage the CAA and other parties to intervene more frequently, which again would not be conducive to the development of competition.

10.56 The ACC’s and airlines' comments on commitments were in general, based on the version of the commitments in the January RBP, rather than the version included in GAL’s response to the initial proposals. The ACC stated that it had had relatively limited discussions with GAL over the commitments.

10.57 The ACC set out concerns in six areas: the legal status was inadequate; the price cap was too high; there was too much uncertainty over future charges; the commitments did not encompass all charges paid at the airport; the service proposals did not reflect the ACC’s concerns and the commitments did not remedy GAL’s substantial market power.

10.58 The ACC broadly supported the CAA’s position on the proposed licence conditions with an additional concern over whether the commitments would be part of the licence and consequently whether the terms within the commitments would be appealable to the CC. On this basis the ACC considered that commitments backed by a licence were questionable as a matter of law.

10.59 On the terms of the commitments, the ACC generally supported the CAA’s comments while raising additional concerns over uncertainty over future charges from the pass through of runway 2 costs; the commitments do not cover all charges paid at the airport and so exposing passengers to residual risk; the level of rebates being insufficient to incentivise GAL performance; an unwillingness to pay bonuses and a concern that airline service standards would distort competition. In general the ACC considered that they required considerably more detail on the commitments than included in the initial proposals to make a full assessment (the initial proposals did not include GAL's proposed commitments, although these were included as an appendix to the market power assessment).

10.60 easyJet, BA, Virgin, Thomson and Thomas Cook all supported the ACC position. Each of these airlines also noted the limited discussions that they had had with GAL over the commitment proposals. easyJet stated that it was open to discussions on the commitments but noted little progress had been made on its concerns with the terms and enforceability of the commitments. easyJet supported the CAA's proposed conditions set out in the initial proposals but stated that these conditions needed to be set with greater precision to allow an ex-ante determination of whether they had been met.

10.61 BA considered that the essential weakness of the commitments was that they were drafted by GAL on the basis that it had little or no market power and so the constraints need to be much greater than a precautionary backstop. BA stated that, while it welcomed the CAA’s proposed changes, even the draft shared by GAL on 7 June 2013 (which was similar to that included in GAL's response to the initial proposals apart from the exclusion of a price), had not overcome these concerns, and therefore BA continued to consider a RAB-based approach should be used for Q6. BA provided a number of detailed comments on the perceived weaknesses in the commitments framework and in particular the CAA's proposed licence conditions. The CAA has sought to resolve the licence issues in the draft licence that it consulted on in July 2013.

10.62 Norwegian Air Shuttle separately wrote to the CAA expressing support for the commitments but emphasised the importance of a transparent price structure and that the commitments price should be lower than the price put forward by the CAA.

10.63 GATCOM stated that the current price cap regulation was inflexible and costly and supported the CAA's view that a commitments and limited licensing framework could be the preferred form of regulation if this properly protects passengers. GATCOM expressed concern that the ACR and the Act did not include a requirement to consult the statutory airport consultative committees (GATCOM and its Passenger Advisory Group (PAG)), and hoped that that a licence condition could be introduced requiring consultation with GATCOM/PAG on investment priorities and service quality to ensure that passengers’ interests were better represented. GATCOM encouraged the CAA to continue to negotiate with GAL over the price cap to ensure that this allows the acceleration of investment, where appropriate. GATCOM and PAG also supported setting standards on airlines (possibly through the introduction of performance bonuses), the publication of UKBF performance, the introduction of an outbound baggage measure, monitoring airport PRM performance and a requirement to review the effectiveness of contingency plans following periods of disruption.

10.64 In September 2013 GAL provided a further note from Professor Littlechild on the regulation of the airport sector. Professor Littlechild considered the concerns raised by the airlines at the CAA Board stakeholder meeting in July 2013 in the context of GAL's proposed commitments. Professor Littlechild queried whether GAL's commitments were so unsatisfactory that it required GAL to be licensed to facilitate enforcement of possibly more onerous commitments or a conventional price control. To support this he cited airline comments noting current good airport service quality and improvements and, while the airlines were interested in principle in the commitments, the main concerns centred around the price, service quality and enforcement of the commitments. To Professor Littlechild this did not seem to be a market in crisis that required regulation. In answer to the particular concerns raised by airlines, Professor Littlechild stated the following.

- The difference between the commitments price and the CAA's fair price was small at an average of 5% over seven years based on the initial proposals (or 3.5% if the CAA raised the fair price to RPI+0.5% per year following responses to the initial proposals).[106] If the CAA subsequently introduced regulation then Littlechild considered that the small difference in the price path raised concerns whether a regulator could ever be confident that its own calculations were correct to within this range over a seven year period.
- The revised commitments should have addressed airline concerns on service quality as: the service quality regime was agreed with the airlines, the airlines considered current service quality performance was good and the airlines did not provide any further basis for concluding that GAL would reduce service quality, in particular as the airport operator is proposing investment in the Pier 6 south project which the airlines were resisting.
- Airline concerns that GAL has spent more time speaking to the CAA about commitments rather than airlines were a normal reflection of the regulatory process, which means it makes sense for the regulated company to devote more attention to the regulator than its customers. Littlechild considered that the airlines statement that consultation was better at other airports was, given

[106] GAL has subsequently reduced the price in the commitments to a blended price of RPI+0.5% per year.

the cited problems at Heathrow and Stansted, a reflection that consultation was better at airports that were not regulated by the CAA.

Subsequent development

10.65 As part of its response to the initial proposals GAL put forward revised commitment proposals which attempted to address the CAA's concerns, particularly with the terms of the commitments, and reduced the average revenue yield to RPI+2.5% for the published price and RPI+1.5% for a blended price of commitments and contracts.

10.66 The CAA subsequently consulted on these revised commitment proposals together with a draft licence that it considered would be required to address the concerns over the enforcement of the commitments.[107] The draft licence included terms to:

- allow the CAA to enforce the commitments in passengers' interests by: including the commitments as conditions of the licence and requiring GAL to comply with the commitments in a manner that furthers the interests of passengers;
- allow the commitments to be enforced by airlines by requiring GAL to include the commitments in the Conditions of Use;
- prevent GAL from amending the commitments other than through the processes set out in the commitments;
- allow the CAA to act as an appeal body where GAL and the airlines could not reach agreement on proposed amendments; and
- allow the CAA to introduce a temporary price freeze if it considered that the commitments based approach was not working and that a licence modification was needed to introduce a full price control condition. The temporary price freeze would have effect only during the time it took for the CAA to develop and modify the licence.

Responses to the consultation on the draft licence with GAL's revised commitment proposals

10.67 GAL did not consider that a licence was required with the commitments as it did not consider that it had substantial market

[107] CAA, 8 July 2013, Gatwick Airport Limited – proposed licence conditions under section 18 of the Civil Aviation Act 2012 in relation to price commitments.

power and passed the market power test. GAL stated that the comments provided by GAL on the licence were without prejudice to this position. In general GAL considered that the CAA's proposals for a licence were too interventionist and increased regulatory uncertainty that risked undermining the development of commercial relationships and encouraging investment and improvement. GAL also made a number of specific comments on the proposed licence conditions.

10.68 GAL also responded to a number of the concerns raised by the CAA in the consultation, in particular:

- the pass through of second runway costs did not reflect pre-funding but reflected charges rising to reflect the long run cost of the service delivered;
- the service quality rebates placed a significant incentive on GAL to improve performance;
- capex will be driven through compliance with the service quality regime;
- GAL has committed to a minimum annual capex spend, and transparency over changes to the capital plan;
- GAL will provide the underlying assumptions to the calculations of the asset value to allow other parties to prepare calculations on a different basis if they wished;
- additional financial resilience conditions were not required in a licence given the contractual ring fence in GAL’s debt covenants and the ownership structure of GAL; and
- given the requirements for an aerodrome licence any licence conditions for continuity of service plans should be very light touch.

10.69 The ACC was in general supportive of the proposed licence conditions and considered that this addressed concerns over the enforceability of and modifications to the commitments, although it did raise concerns over the condition that allowed the CAA to make modifications to the commitments without going the process under section 22 of the Act.

10.70 The ACC also raised concerns over the terms in GAL's revised commitments, in particular:

- the price in the commitments was too high, with the price in the commitments above the CAA's proposed price of RPI+0% over seven years, which itself was above the ACC's view of an efficient price;
- the inclusion of a blended price would be difficult to monitor as airlines would not be able to see the contracts of the resulting revenues and monitoring compliance with the commitments would be more difficult than under a regulatory settlement;
- the pass through of second runway costs was inappropriate as it required passengers to pay an open ended sum for the development of a second runway and charges should only be passed on once the second runway is operational;
- GAL's pricing principles were no longer part of the commitments;
- the service quality regime included generous bonus payments;
- the inclusion of the S factor was inappropriate as the ACC expected the risk of tightening or loosening of security policy to be included in the overall price;
- there were significant weaknesses in the service quality regime, in that the rebates were small in relation to the cost of the remedy, and did not cover all facilities that are necessary, for example a rebate was unlikely if a taxiway was congested or needed resurfacing;
- it was not for GAL to set airline service standards, which are set by airlines based on the needs of passengers;
- the modification process for service standards based on 51% of passengers and airlines responding was not workable as it could be discriminatory given the diverse airline base;
- there was no commitment to deliver the capital plan and the rebates in the service quality regime were too low to incentivise delivery;
- there was no commitment to publishing the value of the RAB;
- the operational resilience conditions require airlines to comply with the rules of conduct which should be caveated to prevent the risk of abuse; and

- the airlines remain the insurer of last resort, for example if the runway was unavailable then the airline and not GAL would be liable for the costs.

10.71 On 20 August, following the receipt of comments on the licence, the CAA published the non-confidential responses and asked GAL to submit revised commitments. GAL's revised commitments addressed a number of concerns highlighted by the airlines in that they:

- removed service quality bonuses;
- included a requirement to have regard to CAA policy on the financing of new runway costs;
- increased the threshold for modifications to airlines representing 67% of passengers on published charges; and
- included its pricing principles as an annex to the commitments.

10.72 GAL also reduced the price in the commitments to RPI+1.5% per year based on published charges and RPI+0.5% per year based on the blended published rate and bilateral contracts.

10.73 Virgin and BA responded to GAL's final commitments proposal, highlighting the following issues:

- a licence would still be required and the CAA's proposals in this area should not be watered down;
- the price reduction was not a real concession as prices would reduce in any case due to increased traffic and given the additional flexibilities to GAL the commitment price should be below the RAB price;
- service quality rebates were too low and were not agreed with airlines, although the removal of bonuses was welcomed;
- they welcomed GAL's increase in the threshold for modifications, although they regarded this as still too low;
- there was no commitment to capex meaning that improvements could be delayed unless airlines agreed to increased charges;
- that GAL could increase prices by introducing new premium charges;

- the airlines remain the insurer of last resort in the Conditions of Use which does not reflect standard contractual practice;
- the pricing principles used by GAL still do not form part of the commitments;
- second runway costs were uncapped and could be excessive; and
- the cumulative revenue difference adds complexity and reduces uncertainty.

10.74 Following CAA comments, GAL further revised the commitments in particular to:

- increase the service quality rebates so that they are at the same level for the first six months as the Q5 regime; and
- increase the threshold for the security cost pass through to £1.75 million per year, equivalent to the proposed threshold for the security cost pass through in the initial proposals.

CAA assessment of GAL's commitment proposals in the absence of a licence

GAL's commitments proposals

10.75 The CAA considers that GAL's airport commitments are a positive step. The commitments could potentially provide a number of protections for airlines and passengers against the potential abuse of SMP that are normally found in licence regulation. The key features of GAL's proposed commitments are set out in figure 10.2. The CAA has based its consideration based on GAL's final commitments proposal submitted on 20 September 2013.[108]

[108] GAL, 20 September 2013, Final Airport Commitments, http://www.caa.co.uk/docs/78/20SeptemberFinalCommitmentsProposals.pdf

Figure 10.2: GAL's commitment proposals

Issue	Commitment proposal
Contractual basis	GAL commits to include the commitments in the Conditions of Use
Duration	7 years, with GAL providing 2 years' notice if it wishes to extend commitments
Change mechanism	Ability to change price path profile and service quality regime following consultation and if agreed by GAL and at least 67% of airlines paying published charges and 51% of airlines responding to the consultation
Price	No price cap but the average revenue yield limited to RPI+1.5% per year based on published charges and RPI+0.5% per year based on average charges over the duration of the commitments, with a limit on over or under recovery in any one year. Variations to price cap to pass through increases in security costs and the costs of the second runway and hold baggage screening
Capital Consultation	Publish rolling five yearly capital plan, consult on major projects and report on annual expenditure. Consultation with airlines and the Passenger Advisory Group
Service quality regime	Similar rebate scheme as Q5, with introduction of new outbound baggage measure and reweighting of attributes (both agreed with airlines). Monthly rebates the same as Q5 and would be increased by 25% if service quality failures persist for more than six months. Airline service quality penalties on check-in and arrivals bag performance, which would be funded by netting off airport rebates
Investment	Minimum capex spend of £100m and explain material differences between the latest forecast, the prior year forecast and the forecast included in the CAA's price review
Operational resilience	Develop, maintain and consult on an operational resilience plan and so far as reasonable and practical coordinate and cooperate with all relevant parties to deliver the operational resilience plan
Financial resilience	Provide an annual confirmation of adequate financial resilience, prepare and maintain a continuity of service plan, and not to amend, vary or supplement any of its finance documents in respect of credit rating requirements unless it has given prior written notice to the CAA
Accounts	Publish same information as in the 2011/12 statutory accounts

Source: GAL and CAA analysis

10.76 Under Test C of the MPT, the CAA has to consider whether, for passengers and cargo owners, the (incremental) benefits of licence regulation are likely to outweigh the adverse effects. GAL's commitments could, in principle, be relied on within this legal framework as evidence to support a conclusion that it was not appropriate to introduce licence regulation. For this to be the case the regime created by the commitments would need to be reasonable and effective for passengers in that the overall deal would have to be reasonable compared to a regulatory settlement, so that the benefits of licence regulation would be outweighed by the adverse effects. The following sections set out the potential benefits and concerns with the commitments.

Potential benefits of commitments

10.77 GAL has proposed that these commitments might be combined with bilateral contracts for some individual airlines. GAL considers that the conclusion of bilateral contracts will be more likely with the airport operator's commitments in place than under a traditional price cap as the commitment is longer term (7 years compared to a traditional 5 year price cap). The CAA agrees that bilateral contracts are more likely under commitments as the commitments would:

- reduce the risk for GAL and the airlines concerned that the terms offered in a typical 10 year bilateral might not be consistent with regulation over more than one control period;
- provide a longer period for an early sacrifice of margin to be compensated later; and
- enable a more flexible capital plan which would support differentiated services under bilateral contracts.

10.78 The CAA considers that bilateral contracts are likely to enable price/volume deals which would facilitate growth, increasing choice and value for passengers.

10.79 Airlines and passengers at Gatwick are more diverse than at other airports subject to economic regulation. It is therefore unlikely that one size would fit all and the commitments may provide benefits over a licence in the form of additional flexibility which would allow better tailoring to the needs of individual airlines and their passengers.

10.80 A combination of airport commitments and bilateral contracts could therefore better further the interests of passengers as it could better be tailored to the business needs of individual airlines and their passengers, providing greater flexibility while still providing protection to all passengers. There could also be advantages from a reduction in complexity and a refocus of relationships towards airlines and away from the CAA.

10.81 The commitments would also provide **more certainty** to airlines and GAL as the commitments would last for seven rather than five years, providing GAL with **greater incentives to outperform** assumptions on commercial revenues and efficiency and to grow traffic.

10.82 The CAA considers that the commitments would have benefits over a licence, in that they would avoid the **direct costs** of staff and consultancy associated with a regulatory review. GAL estimates that the costs associated with RAB-based regulation are currently around £10 million per year, although costs may be reduced under other forms of licence regulation. However potential cost savings from commitments would be significantly reduced if there is not effective partnership working between the airport operator and airlines, and consequently there are numerous complaints to the CAA under competition law or the ACRs. Airline feedback on the commitments has been mixed.

10.83 The commitments would also have benefits in terms of: **avoiding management distraction**, as the enforcement of the commitments would be linked to commercial negotiations; and removing **some perverse incentives** that may occur under a regulatory regime, for example potential distortions to capex incentives under a RAB-based framework (which could lead to capex being taken forward that is not in passengers' interests), or the potential for regulatory gaming.

Enforcement of the commitments

10.84 Professor Littlechild has suggested that the CAA should take the commitments as undertakings from GAL and so avoid the need for a licence. The CAA does not have an express statutory power to accept voluntary commitments or undertakings. Consequently the CAA would need to be satisfied that accepting commitments was a suitable exercise of its discretion under the Act. In particular, given the risks of abuse of SMP identified under the minded to market power assessment, the CAA would need to be satisfied that the commitments proposed would better protect passengers' interests than licence regulation. For protection to be better, the commitments would need to be enforceable and the terms would need to provide sufficient protection to users.

10.85 The CAA considered the **enforceability** of the commitments under Test C of the minded to market power assessment for GAL. The CAA has reviewed GAL's latest commitment proposals to identify whether this has addressed its previous concerns over the enforceability of the commitments in passengers' interests:

- The Conditions of Use are in principle capable of amounting to a contract and if this is the case then the commitments are enforceable under normal contract law.
- The balance of obligations in the Conditions of Use, with insufficient assurance that these would be matched by appropriately demanding obligations on GAL. The CAA considers that the inclusion of the commitments in the Conditions of Use goes someway to addressing this issue.
- Unilateral variation or contracting out, with particular concerns over the scope of GAL's ability to introduce new or alter existing terms. GAL has included an obligation in the latest commitments that prevents changes to the commitments obligations included in the Conditions of Use.
- Dispute resolution, where the commitments require parties to follow a dispute resolution mechanism. The findings of the dispute resolution process are now binding until determined by legal proceedings or agreement and do not prevent either party from seeking urgent relief from the Court. This has addressed the CAA's concerns in this area.

10.86 However the CAA continues to have some concerns. Consequently in the absence of a licence, the CAA has concerns over enforceability in two areas:

- The commitments are **enforced by airlines**. While the interests of airlines generally align with those of passengers, this may not always be the case. While GAL states it has included a provision to consult with PAG in the capital plan, this does not address enforcement concerns for passengers for example in relation to the service quality. Consequently commitments would not offer the same level of protection to passengers and cargo owners compared to a licence enforceable by the CAA, which has a statutory duty to protect their interests.

- The commitments do not provide **adequate protection against repeated service quality failures.** The commitments include a requirement to increase service quality rebates by 25% if failures continue for more than six months and to develop an improvement plan. The CAA continues to have concerns in this area, for example as the increased rebates would only apply if failures are spread across two financial years and that rebates reduce to zero if there are six consecutive months of failure in one financial year. This does not appear to be in passengers' interests unless, as with Q5, there was a backstop of a CAA investigation if failures persist for more than six months.

Price of the commitments

10.87 The price in the commitments is RPI+1.5% per year based on published charges and RPI+0.5% per year based on average charges. This compares to a RAB-based fair price of RPI+1.6% over five years and RPI +0.3% over seven years. The CAA has considered whether the commitments price is acceptable.

10.88 The CAA considers that the correct comparison should be between the fair price and the average price under the commitments for the following reasons:

- The fair price is calculated on the basis that this would be the average charge paid by airlines and their passengers.
- The 'minded to' market power assessment identified that GAL had substantial market power across all its passengers, consequently it is important that passengers are protected as a whole from excessive prices.
- The existence of an additional control on published charges provides additional protection against the ability to trade off prices for different passenger groups, although it should be noted that GAL already has scope to vary the structure of charges under the existing RAB-based price cap subject to the requirements of the ACR.

- While it could be argued that bilateral contracts might be possible under a RAB-based approach on which the fair price could be based, for the reasons given above this is less likely than under a commitments approach.

10.89 The CAA has considered whether the five or the seven year fair price is the correct comparison. The five year RAB-based price is based on a detailed bottom up assessment of the individual building blocks and is the basis for the CAA setting a five year price under a RAB approach[109]. The seven year price has been developed for comparison with the commitments, and while the CAA has taken into account the changes forecast by GAL in the first two years of the following control period, the assessment generally pivots off the five year assessment rather than being based on a detailed bottom up assessment. There are also some issues that might point to a higher seven year price that have not been included in the calculations, for example the impact of the greater traffic risk over seven years on the cost of capital. The seven year price can therefore be regarded as less certain. The CAA therefore considers that it is relevant to take into account both comparisons, but to place the greatest weight on the five year price as this is the effective RAB alternative. On this basis the commitments blended price is below the CAA's five year RAB-based price but marginally above the seven year fair price, although it should be acknowledged that the differences are relatively small.

10.90 There are some issues that point in the direction of accepting a commitments price that is below the fair price:

- the greater flexibility to GAL in pricing where it can recoup any previous shortfalls over the seven year period, although the resulting increase in uncertainty to airlines is likely to be relatively small compared to the flexibility GAL has to set its structure of charges within the current price cap;
- the greater flexibility to GAL from being able to flex its capital plan rather than having to deliver projects to meet specific trigger dates; and

[109] In the Q6 policy update the CAA consulted on changing the duration of a RAB-based price control and there appeared to be little appetite to consider changing the existing duration of five years.

- the marginal benefit to GAL from passing through increases in costs from changes in security requirements rather than passing through both increases and decreases in costs.

10.91 The issues pointing towards accepting a commitments price above the fair price are:

- the greater period of certainty to airlines and consequently the greater risks to GAL;
- the commitments would lock in the forecast reductions in prices in the subsequent control period, which often have a tendency of not transpiring, with new cost pressures emerging so the actual price ends up higher; and
- the risk that GAL could walk away from the commitments if the CAA sets a price, removing the other benefits from the commitments in terms of flexibility and greater tailoring to individual airline needs.

10.92 On balance the CAA considers that these issues point towards accepting the commitments price as reasonable.

Other terms in the commitments

10.93 The CAA has also reviewed the other terms in the commitments to assess whether they are in passengers' interests. The CAA recognises that GAL has addressed a large number of concerns highlighted by the CAA in the initial proposals, the minded to market power determination and the consultation on a draft licence to be associated with commitments. However, there are a number of issues with the commitments that remain in the absence of a licence.

10.94 The **pass through of the costs of the planning and development of the second runway.** GAL has caveated the pass through in that it would follow government support and have regard to any policy guidance issued by the CAA in relation to the financing of new runway developments. The CAA has concerns that the commitments would only have regard to CAA policy rather than follow CAA policy. This could allow GAL not to follow CAA guidance if it considered it had reasons not to. Any guidance issued by the CAA for the financing of new runway developments would be consistent with the CAA duties to further passengers' interests and also have regard to the ability of a licence holder to finance its activities. GAL's primary focus is likely to be the profitability and value of the company. GAL has estimated the total cost of the second runway and associated infrastructure to be £5 billion to £9 billion and has indicated that the second runway could be open by 2025. This compares to annual revenue from airport charges of around £300 million. In previous versions of the commitments GAL was seeking to recover the planning and development costs of a second runway spread equally over ten years. This could have led to a substantial increase in airport charges. Given the potential scale of cost pass through the CAA considers that this term imposes risks that would not be in passengers' interests.

10.95 The **service quality regime** in the commitments includes monthly rebates at the same level of those included in the Q6 settlement. The CAA is also concerned that the limits placed in the commitments on the total rebates payable, the absence of rebates if failures continue for more than six months in a financial year and the offsetting impact of airline service quality failures might reduce GAL's liability for repeated service quality failures, which may act against passengers' interests.

10.96 The commitments do not include the core service standards for airfield availability and pier service. The CAA considers that these standards should be agreed with airlines before introduction. Some of the details of the measurement of core service standards are either undefined, for example the details of the scope and location of the monthly publication airport wide service quality measurements, and additional caveats have been introduced for example security queues do not contribute towards the standard if airlines do not comply with stand planning rules. The CAA also notes that only GAL can initiate changes to core and airline standards.

10.97 The service quality regime includes **airline service quality penalties** on check-in queues and arrivals bag performance. The CAA supports coordination on service standards across the airport campus where this does not distort the functioning of an effective market, but the CAA does not have the locus in the Act to set standards on airlines.

10.98 The commitments do not include a commitment to any outputs from the **capital plan** apart from a maintenance of the service quality regime and a commitment to a minimum spend of £100 million per year over the term of the commitments. GAL's proposed spend under a RAB-based framework is around £200 million per year and many of the schemes produce outputs that are not reflected in the service quality regime, for example the early bag store will provide the ability for early check-in; the IDL schemes will provide increased circulation space and new children's and outside areas; the check-in schemes will provide new bag drop facilities; the north terminal arrival scheme provides a much enhanced arrival area etc. While GAL has committed to provide an explanation as to any material differences between the latest Capital Investment Programme (CIP) forecast and both the prior year forecast and the forecast incorporated in the CAA's 2013 price control review, it has not committed to any programme of specific capital expenditure. The CAA is therefore concerned that GAL could significantly reduce capex and not deliver the outputs that the CAA considers are in passengers' interests.

10.99 The **security cost pass through** allows GAL to pass through 90% of the increase in the costs of required changes in security standards, where these costs exceed £1.75 million per year. This compares to the Q5 approach which allowed for either increases or decreases in security requirements to be passed through. This term consequently protects GAL against risks but allows them to benefit if requirements reduce. The CAA does not consider that this would operate in passengers' interests and it could affect the overall price in the commitments.

10.100 The CAA has a number of concerns about the **financial resilience conditions** in the commitments.

- The commitments include a requirement to notify the CAA of any variations in the contractual ring fence that relate to the credit rating requirement. However if the protection in the contractual ring fence changes, in the absence of a licence, there would be nothing the CAA could do to replace that protection. This commitment therefore would only be effective if the commitments were underpinned by a licence.
- The commitments include a requirement for the directors to provide an annual certificate of adequate financial resources. There is no indication of the time period to be covered. Unless the certificate covers a period of at least two years then there is a risk that there would be insufficient time for remedial action to be taken if issues arose.
- The commitments do not include a requirement to obtain a holding

company undertaking. GAL questioned the benefit of a holding company undertaking given the ownership structure of GAL. The CAA considers that a holding company undertaking is required to prevent the airport operator from being open to pressure by a holding company to do something which is not consistent with passengers' interests. The CAA does not consider that GAL's current ownership, which could change during Q6, negates the need for this requirement.

- The commitments do not include a restriction on business activities as GAL stated that the finance documents include a similar restriction. The CAA is concerned that the finance documents could change, and in the absence of licence protection, remove the protections to users.

10.101 The commitments include a requirement to publish the value of the asset base and the underlying assumptions and calculations. This does not constitute the calculation of the **regulatory asset base**, which could be different to the asset base for a variety of reasons. The CAA considers that the continued calculation of the RAB is important should any subsequent re-regulation be required.

10.102 The commitments include **operational resilience** conditions. However the CAA has concerns in two areas:

- The commitments include a requirement to have regard to, rather than comply with, any guidance issued by the CAA when developing operational resilience plans. The CAA considers that this could allow GAL to develop operational resilience plans that are not in passengers' interests;

- The operational resilience conditions require airlines to comply with GAL's rules of conduct. The CAA considers that this could allow GAL to exert its substantial market power over airlines where this may not be in passengers' interests, for example by imposing inappropriate costs.

10.103 The CAA has considered the airlines' concerns that GAL could introduce additional **premium charges**. The CAA considers that for most airport operation services any premium charges would be covered by the non-discrimination provisions in the ACRs and the Groundhandling Regulations or the fair, reasonable and non-discriminatory provisions for ancillary services under the commitments. However the CAA acknowledges that the scope of premium service is unclear and in the absence of a licence there may be potential for GAL to introduce charges that act against passengers' interests.

10.104 The CAA does not consider that the commitments raise issues in the other areas identified by airlines in particular:

- That it will not be possible for airlines to **monitor prices**, as the overall revenue from airport and other traffic charges will be available in GAL's statutory accounts. GAL is also committing to publish the cumulative revenue difference (including underlying actuals data) for both the blended and published charge basis. The CAA considers that this, together with reporting requirements under the ACR, will provide airlines with sufficient information to challenge GAL's calculations should they wish to do so.
- The CAA considers that the increase in the **threshold for airline support** to 67% for making changes to the price and service quality regimes would be sufficient to prevent a single airline or one or two airlines being able to push through changes to the regime that would not be in the interests of passengers in general. The CAA considers that the modification provision should therefore not act against passengers' interests.
- The airlines remain the **insurer of last resort**. This is part of the Conditions of Use of the airport rather than the commitments themselves.
- The CAA does not consider that the **pricing principles** need to be included in the commitments, as GAL is required to set out its pricing principles as part of setting its structure of charges under the ACR. In addition if the pricing principles were to be included in the commitments within a licence it could be seen as the CAA standing over those principles where it would be the appeal body.

10.105 Overall, the CAA welcomes GAL's commitment proposals. However, the CAA is not sufficiently convinced that in the absence of a licence the enforcement and the terms of the commitments would provide sufficient protection to be in passengers' interests. Consequently, the CAA considers that the benefits of licence regulation are likely to outweigh the adverse effects. Figure 10.3 summarises the appraisal of GAL's proposed commitments.

Figure 10.3: Appraisal of GAL's proposed commitments

Criteria	Assessment
Price protection	The price in the commitments is reasonable compared to the CAA's consideration of a fair price, particularly given the greater certainty to airlines and their passengers from a longer term deal. However there is uncertainty over the pass through in particular of second runway costs and additional premium charges which might not be in passengers' interests.
Service quality protection	The commitments include much the same Service Quality Rebates (SQR) scheme as used for Q5. In the absence of a licence the commitments do not provide adequate protection against repeated service quality failure.
Promote competition	The commitments could avoid distortions to competition, for example if a price cap is set too low then this could distort charges and investment at other airports and bilateral contracts could be more likely under commitments, although they are not ruled out under licence regulation.
Allows efficient business to finance its activities	GAL is unlikely to propose commitments that would not allow it to finance its activities.
Efficient and effective investment	Investment would be driven by the service quality scheme and GAL's vision for the airport. Commitments would avoid some of the perverse incentives from RAB-based regulation particularly around investment incentives. Consultation arrangements are similar to those in Q5. However there is no guarantee that investments that do not directly impact on outputs covered in the SQR scheme would be taken forwards.
Operational efficiency	Potential benefits to efficiency incentives from the retention of benefits for longer (at least seven years compared to a typical five year RAB-based control).
Allows environmental measures	The commitments do not prevent the introduction of environmental measures.
Transparent, accountable, proportionate, consistent and targeted	The commitments would only be enforceable by airlines and so may not offer the adequate protection to passengers and cargo owners. The terms could allow GAL to make unilateral variations or contract out, and so may make accountability and consistency difficult. There is no direct enforcement or intervention mechanism by the CAA.

Criteria	Assessment
	Commitments could provide substantial cost savings compared to licence regulation, although cost savings would be significantly reduced if there is not effective partnership working between the airport operator and airlines. Given the concerns over enforceability, the process for reintroducing a licence could take two to three years, allowing significant user detriment to occur during this time. The process of reintroducing price controls would be hampered as GAL does not intend to continue publishing the value of the RAB.
Practical implementation and stakeholder confidence	The concerns over the enforceability of the commitments could make practical implementation difficult. Airline feedback on the commitments has been mixed and while some stakeholders have expressed support for commitments, most have raised concerns over the terms of the commitments.

Source: CAA analysis

Commitments backed by a licence framework

CAA assessment

10.106 Given the concerns highlighted above, the CAA considers that there are good grounds for commitments to be backed up by licence regulation. Such a framework could provide clear benefits in terms of enforceability and speed of response. It could also allow the concerns highlighted with the terms in the commitments set out in paragraphs 10.94 to 10.103 to be addressed through a licensing and monitoring regime.

10.107 Under such a framework the CAA considers that as a minimum a licence should include:

- a condition that makes the commitments a licence condition. This would enable the CAA to enforce the commitments;
- a condition that GAL shall comply with the commitments in a manner designed to further the interests of passengers. This would allow the CAA to enforce the commitments in passengers interests; and
- a condition that prevents GAL from unilaterally varying the commitments and prevents modification outside the instances set out in the commitments as it is a requirement under the Act that the type and circumstances of licence condition self modification

provisions are set out in the licence.

10.108 The CAA considers that with the above licence conditions, if the commitments based approach was not working the CAA could undertake urgent enforcement action to prevent passenger detriment while a full price control condition was introduced.

10.109 While the above conditions would address a number of concerns associated with the enforceability of the commitments, they would not address concerns associated with the terms on offer in the commitments themselves. Under a licence there is potential for the CAA to monitor GAL's performance and introduce additional licence requirements if required. This could be used to address the CAA's concerns over the flexibility in the capex plan, service quality performance and the areas where GAL would only have regard to rather than follow CAA policy, for example on second runway costs and operational resilience. The CAA could also continue to calculate a RAB from the information provide by GAL. The one area where the CAA considers that it would require additional licence requirements is financial resilience, given the significant passenger detriment that could occur if problems arise in this area. The CAA would not see a licence associated with commitments covering airline service quality performance, as the licence is for GAL rather than airlines, and GAL's pricing principles as this could fetter the CAA's discretion as the CAA is the appeal body under the ACRs.

10.110 Based on the above analysis the CAA considers that a framework of commitments backed by a licence could provide a suitable form of regulation for GAL and could provide benefits from avoiding some of the perversities that can occur from alternative forms of licence regulation. Figure 10.4 summarises the appraisal of a commitments and licensing framework for GAL.

Figure 10.4: Appraisal of commitments and licensing framework for GAL

Criteria	Assessment
Price protection	The price in the commitments is reasonable compared to the CAA's assessment of a fair price. Under a licence the CAA will be able to prevent increases in charges that are against passengers' interests.
Service quality protection	GAL's good recent track record, combined with service standards in the commitments, should ensure good continued service. The ability of CAA to monitor service quality performance with the potential for introducing additional licence conditions if required should provide adequate protection to users.
Promote competition	The additional flexibility under the commitments approach should promote competition in airport operation services.
Allows efficient business to finance its activities	GAL is unlikely to propose commitments that would not allow it to finance its activities.
Efficient and effective investment	The ability of the CAA to monitor investment and introduce additional licence conditions if required should provide adequate protection to users.
Operational efficiency	Potential benefits to efficiency incentives from the retention of benefits for longer (at least seven years compared to a traditional five year RAB-based control).
Allows environmental measures	The commitments would not prevent the introduction of environmental measures.
Transparent, accountable, proportionate, consistent and targeted	By including licence conditions that allow the CAA to enforce the commitments, prevent GAL from amending the commitments without good reason or withdraw them should ensure that GAL is held properly to account for its actions. These licence conditions are focused on areas of concern and so are proportionate. Even with the changes outlined above a commitments and licence framework should provide cost savings compared to other forms of licence regulation. By sharing information with airlines on costs and revenues, cumulative revenue difference calculations, the transparency of costs of specified activities and investment consultation should provide the necessary transparency.
Practical implementation and stakeholder confidence	Allowing licence enforcement of the commitments should overcome the concerns over practical implementation and increase stakeholder confidence.

Source: CAA analysis

RAB-based approach

Initial proposals

10.111 In the initial proposals the CAA stated that a RAB-based framework was well understood and widely used, including by the CAA. The CAA acknowledged the drawbacks of a RAB approach in that it can be costly and time consuming, rigid and distort incentives but considered that some of the problems of distortions to investment incentives and rigidities could be overcome through a more flexible RAB approach. Given concerns with alternative forms of regulation, the CAA based its initial proposals on a RAB approach.

Stakeholder views

10.112 GAL stated that a tight price cap under a RAB approach would not necessarily benefit passengers (as the CAA had provided no evidence that price reductions to airlines would be passed on in reduced air fares to passengers) and emphasised the potential impact on competition from the distortions created by a RAB-based framework by the additional rigidity and the impact on investment incentives. GAL raised concerns that the additional flexibilities to the RAB approach set out in the initial proposals, for example from a core and development capex programme, would delay capex and increase regulatory intrusion.

10.113 GAL stated that the CAA's assessment of the promotion of competition falls short of fulfilling its general duty to promote competition. GAL also queried how a RAB-based price cap could ensure that any subsequent commercial agreements are fair, in particular what the CAA means by fair and why any counterparty would enter into an agreement that was unfair.

10.114 Given the limited scope for competition identified in the minded to market power assessment the CAA does not consider that a RAB-based price control has reduced the potential for competition at Gatwick.

10.115 GAL state that a RAB-based approach will restrict its ability to attract and retain new customers as capex proposals would be need to be agreed with existing users, charges would be restrained below the market rate and there would be reduced incentives to innovate (citing in particular the CAA's proposal to increase service quality standards so that they reflect current performance).

10.116 The ACC supported the CAA's proposals for a RAB approach.

CAA assessment

10.117 In the Q6 Policy Update the CAA stated that, where it applied a RAB-based approach in the future, it would consider doing so flexibly, which would take advantage of the flexibilities under the Act, for example in terms of duration, capital incentives and flexibility to respond to exceptional circumstances.

10.118 Many regulators use a RAB-based framework to set price caps. A RAB-based framework at Gatwick has advantages in that it is well understood by stakeholders, and supported by airlines (but not GAL). There is also less uncertainty on individual building blocks, in particular traffic, than there is at Stansted. Also unlike Stansted, the historic investment, and consequently the value of the RAB, does not appear to be out of line with the needs of the airlines and passengers that use Gatwick. A RAB-based approach can provide good protection to passengers through a price cap, SQR scheme, efficiency incentives and capex triggers and consultation requirements.

10.119 The CAA acknowledges that there are drawbacks with a RAB-based approach. A RAB-based price cap can be costly and time consuming to calculate as it requires the regulator to have a lot of information to overcome information asymmetries. It can distort investment incentives, either by encouraging too much investment (which will need to be addressed in the periodic review by the regulator) or by distorting investment decisions at airports that potentially compete with Gatwick (although this does not currently appear to be the case in practice). A RAB-based approach can also introduce rigidities into the capital planning approach and from the SQR scheme, although the CAA considers that it may be possible to overcome these, to a degree, through a more flexible RAB-based approach. Since the CAA considers that GAL currently has SMP and this will endure for Q6, the CAA considers that a RAB-based approach could be an appropriate form of regulation for GAL.

Figure 10.5: Appraisal of flexible RAB-based approach for GAL

Criteria	Assessment
Price protection	A RAB-based price cap can ensure that users only pay for efficiently incurred costs, and provides both users and the airport operator with certainty and stability. At Gatwick there is a reasonable level of certainty over key inputs, increasing the robustness of RAB-based calculations.
Service quality protection	Service quality requirements can be specified as part of a decision/licence although care is needed to ensure that they meet the needs of users. This provides a one size fits all approach, which may not be right for individual airlines or their customers. Nevertheless it secures a minimum level of service which can be effectively enforced.
Promote competition	Depending on how it is set, RAB regulation can distort investment incentives at both regulated and unregulated airports which can have an adverse impact on competition. This does not appear to be the case for GAL given the investment plans of airports which potentially compete with Gatwick. A RAB approach could discourage commercial agreements, although it does not prevent such agreements. In cases where the airport operator has SMP, by setting an appropriate price cap, a RAB-based approach can help to ensure that any commercial agreements are fair.
Allows efficient business to finance its activities	The regulated business would receive a preset return on current and future investment although it would be subject to some traffic risk.
Efficient and effective investment	A RAB approach can promote investment as regulated business will earn a return on investment and lead to the promotion of investment over opex based solutions. A more flexible RAB approach may improve incentives for the planning, delivery and efficiency of capex.
Operational efficiency	Some incentive to outperform regulated settlement due to the retention of gains during the regulatory period.
Allows environmental measures	A RAB-based framework would not prevent environmental measures from being introduced.
Transparent, accountable, proportionate, consistent and targeted	Setting of a price cap is transparent and consistent. The focus of regulation can be targeted on areas of harm, although RAB approach can be complex, time consuming and introduce rigidities into processes. Nevertheless a RAB-based framework should provide some certainty and stability for stakeholders and is proven in other markets where operators have SMP.

Criteria	Assessment
Practical implementation and stakeholder confidence	A RAB-based framework is well understood by stakeholders and is used in relation to airports and across a number of other regulated sectors. A RAB approach has strong support from airlines although it is not supported by GAL.

Source: CAA analysis

Long-run incremental costs approach

Initial proposals

10.120 In the initial proposals the CAA stated that a long run incremental cost approach would have conceptual benefits from being linked to a notion of future competitive prices, however the input assumptions required significant judgement and could lead to starkly different pricing profiles.

Stakeholder views

10.121 GAL raised concerns with some of the drawbacks identified by the CAA of a LRIC approach, in particular:

- while LRIC could lead to volatile charges this does not mean that this would limit the protection to users as the CAA has not explained why increasing prices, where there is insufficient capacity, would be detrimental to passengers' interests;
- while LRIC could lead to under or over recovery in particular period, why this under or over recovery is an issue or why LRIC would not be indicative of the competitive price; and
- GAL does not understand the CAA's statement that LRIC is not an effective proxy for competitive prices, where investments are lumpy and for example may not reflect the capacity cycle.

10.122 GAL stated that the CAA's cited drawbacks around the uncertainty over the appropriate increment, the remuneration of investment and volatility are overstated and in any case are based on uncertainty and volatility which are key features of competitive markets.

10.123 GAL stated that for regulation to promote competition it needs to reflect more than a competitive outcome but to also allow the market dynamics to reveal solutions and innovations to meet passengers' needs.

10.124 GAL considered that the reduced incentives towards capex spending from a LRIC approach to be a positive rather than the implied negative factor in the CAA assessment.

10.125 GAL stated that the CAA’s consultants, Europe Economics (EE), had not fully reflected GAL's comments in its revised report. The CAA understands that GAL's concerns around the EE analysis were as follows:

- EE continues to largely dismiss the relevance of increment 2 (a new runway);
- EE continues to assume for increment 3 (the modern equivalent replacement cost of the airport) that the new airport is full from the first day of operation;
- EE estimates continue not to include all material costs, EE has made some adjustments to its input cost assumptions, but these are not fully comprehensive;
- EE recognises the relevance of ranges, however there is focus on the central estimate such that the analysis appears to be focused on a point estimate, and this appears to be the basis on which it has been interpreted by the CAA;
- EE has underestimated the costs associated with new runway capacity and the modern equivalent valuation costs as highlighted by GAL's submissions to the Airports Commission; and
- EE has not reflected quality uplift in its estimates and GAL did not consider that there should be no increase in quality in line with passenger and airline expectations.

10.126 The ACC supported the CAA's assessment and considered that a LRIC approach would be inappropriate given the specifics of airport capacity in the south east, the sensitivity of the calculations to regulatory judgement and data intensive nature of the calculations.

10.127 In his paper for GAL, Professor Littlechild queried whether LRIC reflected a theoretical competitive price and stated that setting prices in relation to long run costs is not what markets do in practice.

CAA assessment

10.128 Price caps based on LRIC have been used by some UK sector regulators. LRIC can be calculated in a number of ways. Typically, these include:

- future incremental costs divided by future incremental demand over the asset life, which can involve a small increment, such as changes to make the maximum use of existing facilities, or a large increment such as a new terminal or runway; and
- using the modern equivalent asset value (MEAV) or replacement cost of the existing assets. Ofcom has used current cost accounting for its review of mobile termination charges. This could also be seen as an amendment to a RAB-based approach.

10.129 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.

10.130 The main potential benefit of a LRIC approach is that, in principle, it could signal the long-term average price that might emerge from a ‘competitive’ market, in that it reflects the costs that a new entrant would have to incur to provide equivalent capacity.[110] Price protection for users is assured by setting a price cap based on LRIC and fixing it for a number of years.

10.131 The CAA’s consultants EE provided advice on the application of LRIC estimates to Gatwick and Stansted.[111] EE suggested that LRIC provides the best indication of the competitive price where it is based on the MEAV.[112] In addition EE suggested a LRIC approach may increase efficiency as the regulated company will only be reimbursed for efficient investment.

10.132 The CAA continues to consider that there are a number of drawbacks from a LRIC approach in the airport sector:

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

[111] Europe Economics, December 2012, *Advice on the application of long run incremental cost estimates for Gatwick and Stansted*, http://www.caa.co.uk/docs/1350/Europe%20Economics,%20Advice%20on%20the%20application%20of%20long%20run%20incremental%20cost%20estimates%20for%20Gatwick%20and%20Stansted%20-%20nonconfidential%20version.pdf.

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

- a LRIC approach is data intensive and requires regulatory judgement to define the increment. This can lead to significant uncertainty over future price profiles and it may be possible to generate large price increases or decreases depending on the assumptions used, limiting the protection to users and introducing variability owing to regulatory judgements;
- as LRIC is a long-term forward-looking measure there is a risk of over and under recovery in a particular period. This means that LRIC may not be well-suited as a benchmark to indicate whether a particular price is proximate to the 'competitive' price at any given time. Though it may be possible to smooth volatility in cost recovery over time, while ensuring changes are cost neutral, this may be difficult if this approach is used in the short term to facilitate a transition to a more competitive sector. Charging a flat LRIC price over time also raises similar issues as any other 'smoothing' effect, for example existing passengers may be asked to pay for future improvements from which they may not benefit;
- it has also been argued that LRIC is not an effective proxy for competitive airport prices where investments are very 'lumpy', for example LRIC may not reflect the capacity cycle which, in a competitive market, could produce significant price volatility. When considering prices it is important to take account of the effects of the capital intensive nature of airports and of the 'lumpiness' of capacity increments.

10.133 In response to GAL's comments:

- The CAA has already set out in the discussion of the fair price (see Part B) why increasing airport charges for capacity constrained regulated airports would be detrimental to users.
- Airport charge volatility can be an issue for airlines and their passengers as uncertainty over costs makes it difficult for airlines to price air fares for future periods, with the associated risks passed on to passengers through higher fares.
- Under or over recovery of costs can be an issue if there is no long term commitment to LRIC pricing which could either leave the company facing large revenue shortfalls or customers paying much more than required.

- LRIC by its nature recovers forward-looking costs averaged over a period of time and consequently it may not fully reflect excess demand over capacity, although the CAA notes its concerns with allowing charges to increase for capacity constrained regulated airports where additional capacity is constrained by government policy.

10.134 EE identified a number of drawbacks from using a LRIC approach for GAL which included the following issues:

- Difficulties in determining the appropriate increment to use. As noted above, EE considered that the most credible increment would be the replacement of an airport (rather than, for example, a small amount of incremental capex or a new runway).
- Greater uncertainty (and loss of accuracy) due to the need to make a judgement as to the efficient levels and types of investment required rather than using historical values that were spent.
- The potential for greater uncertainty of remuneration of investment. As charges are not related to historical investment costs, then this increases uncertainty to the regulated company over the remuneration of investment, particularly if the current configuration of the airport is not ideal.
- Greater potential for volatility, for example if input prices or technology changes.

10.135 EE's analysis identified that any model that is used to estimate LRIC would be sensitive to the inputs and the assumptions that underpin it. In particular, EE's sensitivity analysis indicated that changes to the inputs and assumptions could lead to quite significant changes in a LRIC estimate. More fundamentally, EE questioned the relevance of an estimate of the competitive price obtained through LRIC given the level of government involvement in planning of airport capacity, particularly in the South East of England.

10.136 Following the publication of the EE LRIC study, GAL identified a number of concerns – ranging from conceptual points to issues of principle and approach – that it considered would have a material effect on EE's LRIC estimates.[113] At the broadest level, GAL was

[113] GAL, March 2013, CAA Stansted Market Power Assessment – Europe Economics advice on

concerned that:

- too much emphasis was placed on how government policy (on setting overall airport capacity in the South East) reduced the usefulness of using LRIC to determine prices for airports; and
- the LRIC estimates were 'materially understated', particularly for the airport replacement option – the most preferred option – as various inputs (utility and transport connections, planning and pre-construction activity costs, depreciation and land indexation) had either been omitted or had been set inappropriately.

10.137 To help assess the merits of GAL's concerns, the CAA engaged EE to reconsider its approach and LRIC model.[114] EE considered GAL's concerns and:

- although EE did not agree with the majority of GAL's concerns, EE considered that the model could be improved through a better consideration of depreciation, which would lead to a small increase in the LRIC estimates; and
- re-iterated its view that the value of LRIC was reduced if entry and expansion is driven more by government planning and less by price signals.

10.138 GAL's comments on the EE study largely restate comments made on the EE final report which EE have already considered. Responding to each of the points raised:

- EE considered the relevance of increment 2 (a new runway) to the competitive price and rejected it due to the impact of government planning, the relevance of a new runway to the price of Gatwick overall and concerns over the willingness to pay for extra capacity at particular airports (see section 1.2.2 of the EE response);
- EE continued to consider that a replacement airport should assumed to be full from the first day of operation as the assessment assumes the closure of Gatwick and transfer of all traffic to the replacement airport (see section 1.2.1);

the application of long run incremental cost estimates for Gatwick and Stansted, Reference: Q5-050-LGW54.

[114] Europe Economics, April 2013, *Response to comments from GAL*, http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=14279.

- EE has reviewed GAL's proposed costs and adjusted the model where it considered it appropriate (see section 1.2.3);
- EE provided central estimates but undertook sensitivity tests around these estimates to provide an indication of the range and this is what has been considered by the CAA in its assessment (see section 1.3.3);
- EE considered whether the costs of the replacement airport costs are understated and uplifted the costs to allow for additional depreciation and a 5 year planning period but did not consider an adjustment was appropriate for other factors (see sections 1.3.4 to 1.3.6);
- EE considered whether to uplift for quality as the replacement new entrant would be the one that offers exactly the same experience as the existing airport (see section 1.3.8); and
- EE considered that the economic value of a service was not relevant where an airport had substantial market power as regulators should be concerned with what it costs for a service to be provided.

10.139 In its response GAL made reference to new information on the costs of additional runway capacity, as highlighted by GAL's submission to the Airports Commission. In its submission GAL stated that a second runway and associated facilities would cost between £5 billion and £9 billion (in 2013 prices) benchmarked against the development of Terminal 5 at Heathrow and the detailed cost breakdown made by BAA in its work on a second runway at Stansted.[115] Given these benchmarks this may overstate potential costs and the CAA continues to consider that EE's estimate is reasonable given the uncertainties around this estimate.

10.140 In response to Professor Littlechild's comments, EE stated that a LRIC approach can reflect prices in a normally competitive market as it would reflect the forward looking avoidable costs of supply.[116]

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[115] GAL, July 2013, Airports Commission: Proposals for providing Additional Runway Capacity in the Longer Term http://www.gatwickairport.com/Documents/business_and_community/R2/Gatwick_Airport_Proposals_for_additional_longterm_runway_capacity19Jul2013.pdf, paragraph 8.3

[116] Littlechild, May 2013, Regulation of an increasingly competitive airport sector,

However, for the reasons stated in paragraph 10.134 above, the CAA does not consider that for airports LRIC would necessarily reflect the competitive price.

10.141 The CAA has examined EE's updated approach and considers that its revised approach is reasonable, although the concerns with the usefulness and uncertainty associated with LRIC estimates remain.

10.142 In summary, although the CAA recognises the potential benefits of an LRIC approach, it also acknowledges its drawbacks. The CAA is concerned that a combination of the following will mean that the implementation of a LRIC based control at Gatwick could undermine its primary duty: the practical difficulties in its calculation; the specifics of airport capacity in the South East that may render it inappropriate; the significant sensitivity of the calculation to regulatory judgement; and the data intensive nature of the calculation. On balance, therefore, the CAA considers that this option is not suitable for regulating GAL's airport charges in Q6 given the risk it could undermine, rather than support, protection for users and the promotion of competition.

Figure 10.6 Appraisal of a LRIC approach for GAL

Criteria	Assessment
Price protection	Provides some protection against charges above the competitive level over the long term (although noting for airports it may not reflect competitive prices at a specific time), although calculations are subject to considerable uncertainty.
Service quality protection	Service quality requirements can be specified as part of a decision/licence although need to ensure users' interests are considered.
Promote competition	In theory LRIC better reflects competitive outcomes, although the practical issues highlighted above may limit the extent to which this is the case. A LRIC approach may not reflect the dynamic aspects of competitive prices although, given the constraints on new capacity, this may be less relevant issue for airports in the South East.

http://www.gatwickairport.com/Documents/business_and_community/Public%20Regulation%20Pages/Economic%20regulation/2013/LGW-BQ5-238%20-%20Regulation%20of%20an%20increasingly%20competitive%20airport%20sector%20-%2026%20May%202013.pdf, paragraph 21.4.

Criteria	Assessment
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 inefficient 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 recovery over time. Stakeholders raised concerns whether sufficiently precise results could be obtained and whether the transfer from a RAB to a LRIC control had sufficient benefits to justify it given the long-term horizons.

Source: CAA analysis

Price caps based on pegging tariffs to comparator airports

Initial proposals

10.143 In the initial proposals the CAA stated that linking prices to a benchmark index of peer group airport charges had the potential advantage of a linkage to what might be considered a market-based competitive price. However this approach suffered from considerable debate over the composition of the index, the equivalence of comparators, the frequency of adjustment etc.

Stakeholder views

10.144 GAL criticised the price comparators approach and did not consider it was appropriate to use this work to benchmark airport charges or indicate the competitive price (including within a range). The main issues raised by GAL were:

- the composition and small size of the comparator sample, which did not include GAL's views of obvious comparators (Manchester, Munich, Zurich, Brussels, Dublin or Paris-Orly) and was not consistent with previous work undertaken by Leigh Fisher (LF) for Melbourne airport, which focused on the size of the airport;
- significant variables have been excluded such as service quality, input costs/GDP per capita, regional subsidies and the balance between capacity and demand;
- the assessment of regulation is inadequate;
- the methodology does not include like for like comparisons as characteristics of airports differ and limited checks appear to have been carried out on whether the results are intuitive;
- there are inherent weakness from the practical difficulties of benchmarking aeronautical revenues, for example as the data is 12 to 18 months old and the need to use group data in some circumstances;
- the report fails to bring out clearly the uncertainty in the results, in particular from the exclusion of variables or changes to assumptions and the sensitivity analysis undertaken by GAL indicated a higher benchmark;
- the LF analysis is a prototype analysis and the CAA's use of the analysis to indicate a competitive price is inappropriate;
- there were flaws in the definition of variables including catchment size, access time to principal city, capacity utilisation and requirement regime;
- there were concerns with the regression analysis including the goodness of fit of the regression is poor, with insignificant variables and counterintuitive results and correlation between variables, and

- LF should have placed more weight, and undertaken further work on the regression approach to establishing a benchmark, which GAL considered provided a benchmark between £8.92 and £10.20 per passenger compared to GAL's charges of £7.96. Even if more historical data was not available then a regulatory approach did not have to be based on backwards looking data.

10.145 The ACC supported the CAA's assessment and considered that airport comparators should not be used to set precise price caps but could provide an indication of the competitive price.

CAA assessment

10.146 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.

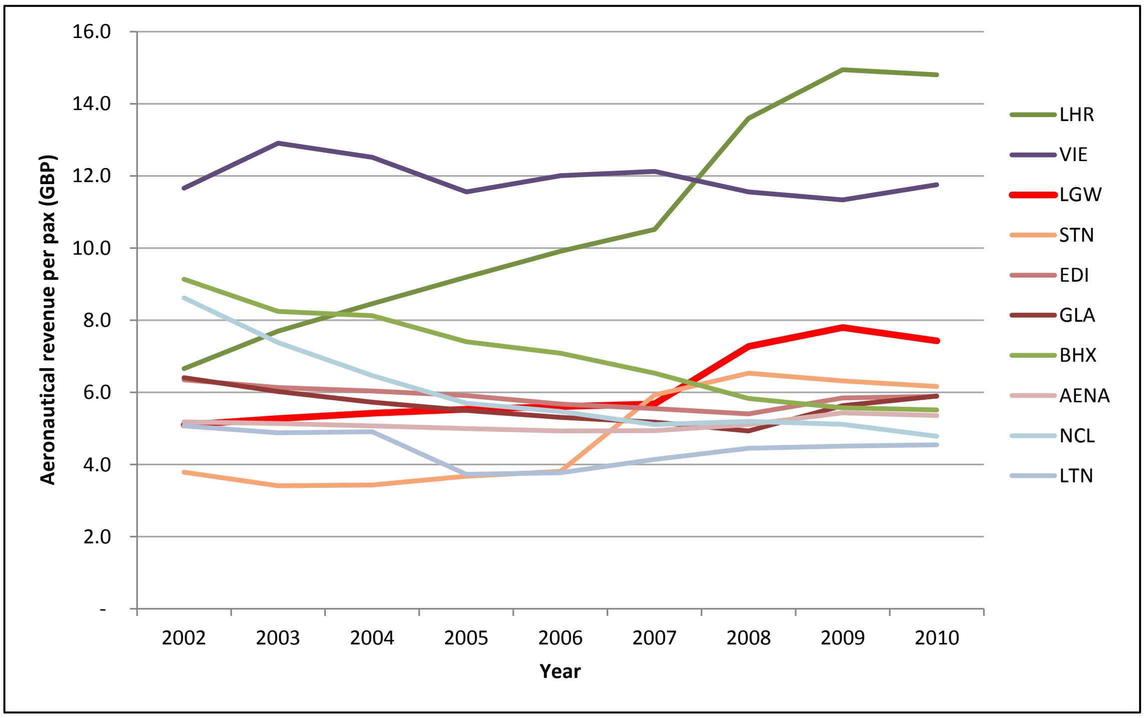
10.147 Pegging tariffs in this way should provide some protection to passengers by setting a direct link between charges and a proxy for the competitive price. It avoids the complexities of scrutinising the bottom up cost and revenue information required by price caps based on RAB and LRIC type methodologies. As well as a price cap, the regime could also include other output requirements such as a SQR scheme and investment requirements.

10.148 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.

10.149 The CAA commissioned consultants LF to identify whether it was possible to benchmark prices at comparable airports in order to regulate airport charges at Gatwick and/or Stansted. LF identified a potential comparator set of airports separately for Stansted, Gatwick and Heathrow. The comparator set for Gatwick reflects the range of airlines that use Gatwick and includes Heathrow, Edinburgh, Glasgow and Barcelona which are used by BA and Luton and Stansted which are predominately used by Low Cost Carriers (LCCs).

10.150 Based on this comparator set, LF benchmarked GAL’s aeronautical revenues over the last ten years. This showed that GAL’s average aeronautical revenues per passenger increased over the period and were now around average for the group. The results however are sensitive to the inclusion or exclusion of Heathrow from the comparator group. If Heathrow was excluded from the group then GAL's charges would be above the average, although still with the 10 to 15% range of uncertainty identified by LF.

Figure 10.7: Aeronautical revenue per passenger for the Gatwick comparator basket



Source: LF: Note: AENA is Spanish airports and includes both Madrid Barajas and Barcelona which are both comparators to Gatwick

10.151 In developing the comparator basket LF found that trends in aeronautical revenue per passenger were robust against variations in the airports chosen (apart from Heathrow) and changes in the way the index was calculated. However, if used for setting a price cap, due to the additional precision that would be required, LF identified a number of issues that would need to be addressed, in particular:

- whether the comparator basket is held constant or is allowed to change over time, depending on how different airports evolve;

- how the comparator basket is chosen, in particular the cut-off for the inclusion of airports, and whether particular parameters are included;
- how the index is calculated, for example whether airports should be weighted and the treatment of exchange rates;
- inherent uncertainties in the accuracy of the data, especially where estimates have had to be made for example in relation to air traffic control costs and freight revenues; and
- ensuring that the precise portfolio of activities that generate revenue is consistent across airports to ensure a like for like comparison.

10.152 In total, LF considered that the resulting range of uncertainty from the benchmarks was ±10 to 15%. LF stated that this range did not reflect the inclusion or exclusion of additional comparator airports. LF considered that potential issues with comparator based price caps could be reduced by averaging across airports and be resolved through agreement on the comparator set and/or parameters between the airport operator and airlines. Nevertheless LF recommended that it may be better for the comparator benchmark to be considered as a range rather than a point estimate.

10.153 The CAA asked LF to consider the concerns raised by GAL. LF responded as follows:[117]

- Size and composition of the comparator sample. LF stated that the comparator sample reflects not only airport characteristics but also the traffic mix and the diverse range of airlines that use Gatwick. The choice of comparators reflects the purpose of the study and so is therefore different to that of Melbourne and that airport size is only one of a range of factors that is important in determining the comparator sample.
- Exclusion of significant variables. LF repeated the points raised in their final report: that different types of airlines have different service quality demands and so the inclusion of traffic mix in the determination of comparators should reflect different customer

[117] Leigh Fisher, August 2013, Addendum Note: Comparing and Capping Charges at Regulated Airports, http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=14279.

demands; that the study was benchmarking prices and not costs and the inclusion of costs could create a circularity where inefficient costs could be used to justify high prices, investment will not impact on prices in any one year but will be spread over time and the benchmarking has been considered over a period of ten years; the balance between capacity and demand is reflected in the criteria through runway utilisation; the impact of affordability of charges has been taken into account by adjusting charges by purchasing power parity exchange rates; and regional subsidies reflect the matching of charges to demand and can often affect costs as well as charges.

- The assessment of regulation was undertaken at a high level to allow the drawing of general conclusions and there are a myriad of different arrangements across airports.
- The assessment is based on like for like comparisons and the revenue data has been normalised across airports based on the experience of publishing airport benchmarks over many years.
- LF acknowledged the practical difficulties in benchmarking aeronautical revenues but do not consider the 18 month timelag is that significant and audited results for all airports were not available for the most recent year. LF also acknowledged the difficulties in using group level data but considered that time series data was required to allow a reliable split of group data and to avoid compromising other parts of the analysis. LF considered that the 15% uncertainty range accounted for these factors.
- LF stated that any approach to benchmarking is open to interpretation and it is easy to assemble a different set of comparators to draw different conclusions. LF stated that this does not mean that the CAA should not use benchmarking as part of its analysis but it should be used carefully and as stated in the final report, definitive conclusions based on spot prices should not be drawn. LF stated that they considered an approach similar to that used at Melbourne but were concerned that this could be criticised as too simplistic. LF considered that the 15% range around the comparator benchmark provides a basis to inform the CAA's work.

- LF considered that outputs from the benchmarking could usefully inform the consideration of the competitive price within a range and noted that during the consultation process there was general support for the use of price benchmarking to inform the regulatory process.
- LF considered that their assessment of catchment areas is appropriate, that runway utilisation is the ultimate constraint on airport capacity and that the consideration of the regulatory environment is necessary broad brush but is appropriate for the purposes of the study.
- LF considered that the goodness of fit of the regression is reasonable for this kind of cross sectional analysis and disagreed that signs of the coefficients were counterintuitive and that the specification of the regression was inappropriate to inform the choice and weighting of variables in the selection of comparators.
- LF considered that they could have introduced more variables into the analysis and greater complexity in the weightings but considered that could add greater uncertainty in the results and considered the simple average approach taken, together with the 15% uncertainty band covered a range of outcomes under different approaches and so would be appropriate.
- LF considered that the multivariant regression approach which calculated a norm for each airport would avoid some of the problems of the simple benchmarking approach used in the report but would require a significant data gathering exercise to produce time series estimates and could also introduce problems associated with the regression itself.

10.154 LF did not change their benchmarks for each of the airports or the conclusions that they drew.

10.155 Based on the above response, the CAA continues to consider that comparator benchmarks provide a useful indicator of the possible range for the competitive price. This is consistent with the purpose of the LF work, which was in part "to identify suitable comparator airports that would provide an indication of the level of airport charges at Heathrow, Gatwick and Stansted in a reasonably competitive market". The CAA does not consider that it would be appropriate to set precise price caps based on comparator benchmarks. The CAA notes that this view is consistent with that of Littlechild in his paper for GAL, who considers that the comparator benchmark could be used as a cross check against the terms offered in the commitments.[118] A summary of the CAA's evaluation against its criteria is given in figure 10.8.

Figure 10.8: Appraisal of pegging tariffs to comparator airports for GAL

Criteria	Assessment
Price protection	In principle the price cap ensures users only pay a proxy for the competitive price, however due to potential measurement and statistical issues the benchmark may not be sufficiently precise to set price caps. There is no guarantee that charges are cost reflective.
Service quality protection	Service quality requirements could be specified as part of a licence although care will be needed to ensure they meet users' requirements. The choice of the comparator group implicitly takes account of the needs of different users by including structural criteria such as the passenger, carrier and destination mix, and airport size in the choice of comparator airports. If higher than typical service quality standards are set then there may be a need for prices to be adjusted. If service quality requirements are not specified then improvements may be avoided if they result in higher prices.
Promote competition	Setting prices in relation to comparator airports could remove distortions from a RAB-based approach as prices would be based on a proxy for the competitive price.
Allows efficient business to finance its activities	Pegging tariffs removes the direct link between charges and costs and so care will 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 to costs then this should create incentives for efficiency as GAL will effectively be a price taker rather than price maker. GAL will therefore retain any gains made from reducing opex

[118] Littlechild, May 2013, Regulation of an increasingly competitive airport sector, http://www.gatwickairport.com/Documents/business_and_community/Public%20Regulation%20Pages/Economic%20regulation/2013/LGW-BQ5-238%20-%20Regulation%20of%20an%20increasingly%20competitive%20airport%20sector%20-%2026%20May%202013.pdf, paragraph 21.7.

Criteria	Assessment
	would extend over the long term and would not be limited to a five year regulatory period.
Allow environmental measures	While it should be possible to pursue environmental measures such as the differentiation of charges according to noise impact, funding specific environmental investment may be more difficult if the same requirements are not present across the comparator set.
Transparent, accountable, proportionate, consistent and targeted	As the price cap is based on tariffs at other airports it should be transparent and the costs of regulation may be greatly reduced. Maintaining the same comparator set across the control period may provide consistency.
Practical implementation and stakeholder confidence	LF has demonstrated it is possible to identify a set of comparator airports for Gatwick, which include a number of airports that operate under light handed regulation. The comparator benchmark is also robust to some changes in the comparator set, although the inclusion or exclusion of Heathrow can have a significant impact. Nevertheless the choice of comparators is likely to be disputed by those parties that do not agree with the resulting benchmark. The benchmark could be vulnerable to unexpected shocks, which might be considered unfair by the airport operator and other stakeholders.

Source: CAA analysis

Price monitoring

Initial proposals

10.156 In the initial proposals CAA stated that a price monitoring and transparency regime would not provide a price cap but would provide a backstop for regulatory action if behaviour was out of line with expectations. The CAA considered that this would have the advantage of encouraging greater discussion between airlines and the airport operator but raised concerns that, given the degree of market power held by GAL, significant passenger detriment could occur if GAL abused its market power before tighter controls could be reintroduced.

10.157 Price monitoring and a commitments regime, would have benefits from the additional protection provided by the commitments but much would rest on the commitments themselves and a commitments and licensing regime would have additional benefits from greater enforceability.

Stakeholder views

10.158 GAL stated that the CAA should have placed more emphasis on the presence of commitments in its assessment of price monitoring, in particular where there are commitments as well as price monitoring, GAL did not share the CAA's view that the CAA would have to rely on commitments and not price monitoring.

10.159 Professor Littlechild, in his paper for GAL, considered that the option C (a light touch approach to monitoring) from the CAA's consultants First Economics (FE) should be preferred for price monitoring as this would have less regulatory involvement, thereby preventing the CAA getting drawn into disputes. Professor Littlechild acknowledged that the Australia price monitoring included annual monitoring which was included in FE's option B.

CAA assessment

10.160 Price monitoring would not involve the CAA setting an explicit price cap to apply from April 2014. Instead, the CAA would expect GAL to exercise self-discipline and self-regulate its actions and take steps to ensure that it does not abuse its market power against a framework of a regulatory backstop to incentivise this behaviour.

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

10.162 In principle, where there is a need for regulation to address a risk of exercise or abuse of SMP but that risk is relatively low, the threat of the regulator intervening may be sufficient to incentivise GAL to act as if it faced effective competition. If monitoring is effective, it would incentivise GAL to act as if it were subject to competitive constraints so as to bring acceptable prices and performance to customers without the need for direct regulatory intervention.

10.163 Monitoring, if effective, has a number of benefits in terms of greater flexibility, reduced regulatory specification and reduction of the regulatory burden. If effective, it would also encourage GAL and the airlines to develop a more cohesive relationship than relying on the regulatory process for setting prices.

10.164 The CAA consultants FE developed and assessed alternative forms of a monitoring regime. FE identified three generic types of monitoring regime.

- Option A: a regulatory regime where the airport operator's charges are monitored against an external price, benchmarked and automatically capped if beyond a pre-defined level.
- Option B: an annual ex-post review of prices and outcomes, without a prescriptive ex-ante price cap but with transparency on a range of monitoring indicators on charges, financial performance, investment and service quality and a set of high level criteria against which CAA would assess performance.
- Option C: a light touch approach, with the airport operator entering into a voluntary code of conduct before the start of Q6 with less frequent reviews of prices and outcomes. Such a code of conduct would go well beyond the requirements of the ACRs and would involve meaningful commitments to cost transparency, information provision, dispute resolution and agreement on charges.

10.165 FE considered that of the three options, option A, would be less beneficial than the other options. FE considered that as option A included an automatic movement to ex-ante price control regulation it would effectively be considered by the airport operator as a price cap. The cap could also be subject to unexpected shocks or changes in charges at individual comparator airports. In addition the time lag to comparative data becoming available would mean that assumptions would need to be made on prices in individual years, with adjustments in subsequent years. This would create uncertainty for the regulated airport operator, its investors and customers.

10.166 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.

10.167 The CAA's market power assessment for GAL indicates that it is likely that it will not face effective competitive constraints across a significant proportion of its revenue base. Given the diverse mix of airline business models at the airport, GAL is more likely to reach bilateral agreements with individual airlines rather than an agreement with all airlines on overall charges as required under option C. Consequently the CAA has focused its assessment on option B, price monitoring based on an annual ex-post review of prices and outcomes.

10.168 FE considered that price monitoring could be an effective form of regulation, if:

- the airport operator accepts and understands the need for self-regulation (within a price monitoring regime);
- there is a credible and understood threat of price control re-regulation, if the airport operator is found to be abusing its market power;
- the reputational consequences to an airport operator of being found to have abused its SMP are unattractive; and
- the financial consequences of ex-ante price control regulation should be unfavourable.

10.169 The CAA has considered two options for price monitoring: price monitoring in the absence of commitments, and price monitoring with commitments. The CAA considers it unlikely that GAL, with its degree of market power, would discipline itself and withstand the temptation to take advantage of the freedoms that the removal of ex-ante price controls and a switch to ex-post monitoring would give it. The CAA notes GAL's behaviour identified in the 'minded to' market power assessment, in particular that:

- GAL has argued throughout the review that its prices are too low, i.e. below, the competitive level, and would need to increase; and
- airlines that represent a significant volume of traffic at Gatwick appear to have little countervailing buyer power, with GAL largely setting the terms that an airline will receive in any negotiations so that the scope for negotiation is limited. In particular, it appears that existing airlines (with a few exceptions) have limited scope for negotiation as evidenced by the fact that bilateral contracts have not been agreed.

10.170 Against this backdrop, it is not clear how a switch to a price monitoring regime, in the absence of reasonable and effective commitments at Gatwick, could work.[119] GAL has clearly set out its reading of the market and signalled its pricing intentions. If the CAA were now to remove GAL's price cap and give the airport operator the freedom to set prices at a level of its choosing, in the absence of reasonable and effective commitments subsequent disagreements between GAL and the CAA about the exercise of market power could be inevitable. This would most likely cause the CAA to challenge GAL's price increases and seek some form of remedy or tighter regulation.

10.171 The CAA is of the view that it is better for all parties to resolve the difference of views that GAL and the CAA have about prices now as part of the Q6 review process rather than in 1-2 years' time as part of an ex-post investigation into actual pricing behaviour under a monitoring regime. This will ensure that avoidable detriment is not imposed on users. It will also give greater certainty to GAL and users about the appropriate price path for the next five years.

Figure 10.9: Appraisal of price monitoring type ex-post licence conditions for GAL

Criteria	Assessment
Price protection	Price monitoring leads to self-regulation of prices. If self discipline is not self evident then there will be a switch to default price caps and more formal price control regulation, although given the issues identified in the market power assessment significant passenger detriment could occur before price controls are reintroduced.
Service quality protection	Service quality could be transparently monitored where poor performance could lead to a switch to default price caps and price control re-regulation. Although given the issues identified in the market power assessment significant passenger detriment could occur before price controls are reintroduced.
Promote competition	The intention of this option is that the airport operator would behave in the same way as airport operators without SMP. From the market power assessment it is not clear that GAL would behave in this manner.

[119] If the CAA considered that GAL's commitments were reasonable and effective in the absence of a licence and therefore in passengers' interests then it is unclear why a licence was required at all.

Criteria	Assessment
Allows efficient business to finance its activities	There is no reason why an airport operator would set prices at a level that does not permit it to finance its activities.
Efficient and effective investment	An airport operator would not be constrained from bringing forward efficient new investment plans, which could be taken into account when setting prices.
Operational efficiency	Cost efficiency would be one of the indicators that could trigger a switch to default price caps and, ultimately, ex-ante price control regulation. Although again this would depend on the level of prices and the incentive they place on being efficient.
Allow environmental measures	There is no reason why environmental measures could not be introduced under a price monitoring regime.
Transparent, accountable, proportionate, consistent and targeted	There should be no reason why the rules in this option would not be understood clearly by all parties, it therefore is capable of satisfying the better regulation principles. Airlines are likely to argue that the controls in price monitoring are likely to be insufficient to control the market power held by the airport operator.
Practical implementation and stakeholder confidence	This option requires stakeholders to believe that an airport operator will behave responsibly. It cannot be guaranteed that stakeholders will have this belief.

Source: CAA analysis

Price monitoring combined with GAL's commitment proposals

Initial proposals

10.172 In the initial proposals the CAA stated that a price monitoring and commitments regime would have benefits from the additional protection provided by the commitments but much would rest on the commitments themselves and therefore a commitments and licensing regime would have additional benefits from greater enforceability.

Stakeholder views

10.173 Stakeholder views on this option are set out under price monitoring.

CAA assessment

10.174 Price monitoring might, if combined with GAL's commitment proposals, be a more effective form of regulation than price monitoring alone. The annual report under price monitoring would allow transparency on the main information that airlines might need to negotiate on behalf of users. It would also allow a quicker enforcement route for airlines compared to the commitments alone.

10.175 Given the points raised above on the potential risks of abuse, much of the burden from preventing abuse of SMP would rest on the commitments rather than the price monitoring regime itself. Consequently it will be important to ensure that the terms in the commitments are reasonable and effective from the perspective of users. In the absence of such requirements, price monitoring with commitments is likely to suffer from as many of the enforceability issues as commitments alone, albeit that the monitoring will improve transparency and the licence will provide some benefits from being able to enforce in the interests of end users and improving the speed of response. Nevertheless, there may be issues with the enforcement of the commitments in the absence of effective licence conditions. It would also not be clear to GAL or airlines whether the CAA considered whether the price or terms in the commitments were consistent with an effective market. This option is therefore likely to be less beneficial than a commitments and licensing framework on grounds of enforceability. There would also be additional costs from the price monitoring regime itself. Consequently, the CAA does not consider that price monitoring with commitments should be taken forward.

Figure 10.10: Appraisal of price monitoring with commitments for GAL

Criteria	Assessment
Price protection	Given the issues identified above, much of the burden for preventing the abuse would rest on the commitments and the terms in the commitments would need to be fair to airlines and users. Price monitoring will not be able to enforce the commitments directly and so is likely to be less effective than a commitments and licensing framework.
Service quality protection	Much of the burden for preventing the abuse would rest on the commitments and the terms in the commitments would need to be fair to airlines and users. As above price monitoring would not be able to directly enforce the commitments and so is likely to be less effective than a commitments and licensing framework.
Promote competition	The intention of this option is that the airport operator would behave in the same way as airport operators without SMP. While the

Criteria	Assessment
	commitments would provide some additional protection they would need to be reasonable and effective for airlines and users.
Allows efficient business to finance its activities	There is no reason why an airport operator would set prices in commitments at a level that does not permit it to finance its activities.
Efficient and effective investment	The commitments or the price monitoring regime would not constrain the airport operator from bringing forward efficient new investment, although consultation arrangements would need to be improved to ensure that this would be in users' interests.
Operational efficiency	Operational efficiency incentives are more likely to be dependent on the terms in the commitments rather than the threat of reregulation through price monitoring.
Allow environmental measures	There is no reason why environmental measures could not be introduced.
Transparent, accountable, proportionate, consistent and targeted	There should be no reason why the rules in this option would not be understood clearly by all parties, it therefore is capable of satisfying the better regulation principles. Airlines may have greater confidence in this regime than in price monitoring or commitments alone, however much of the protection would come from the commitments themselves and licence enforcement of these may be more proportionate response.
Practical implementation and stakeholder confidence	This option requires stakeholders to believe that an airport operator will behave responsibly. The commitments provide an indication of what can be expected from GAL, however as a price monitoring regime would not directly enforce the commitments, concerns with enforceability may remain.

Source: CAA analysis

Conclusions

10.176 The Act provides an opportunity for the CAA to introduce regulation that is better tailored to the risks of abuse of SMP and the interests of passengers. The CAA's minded to market power assessment found that GAL holds SMP.

10.177 While not acknowledging that it has SMP, GAL has put forward airport commitment proposals which offer many of the same protections to airlines and passengers than would be available under a regulatory settlement. The CAA welcomes these proposals, and in particular the changes that GAL has made to the commitments to address the previous concerns raised by airlines and the CAA. However, the CAA remains concerned that the enforceability and some of the terms of the commitments are such that, in the absence of a licensing and monitoring framework, they would not offer sufficient protection against the risk of abuse and/or further passengers' interests.

10.178 The CAA has therefore considered what form of regulation should be implemented under a licence. The CAA considers a seven year commitments and limited licensing framework could be an effective form of regulation for GAL. This is on the basis that the enforcement concerns about the commitments concept was addressed through enforcement under the licence; and that there were additional licence conditions to enforce financial resilience and that there was an effective monitoring framework to ensure that the additional flexibility of the commitments promotes passengers' interests.

10.179 In reviewing alternative forms of regulation, the CAA does not consider that LRIC or airport comparator benchmarks would be sufficiently robust to be used to set price caps. Furthermore, the CAA does not consider that price monitoring, in particular in the absence of reasonable and effective commitments, would offer sufficient protection given the issues identified in the minded to market power assessment. Price monitoring combined with commitments in a licence may be a more effective form of regulation, however much of the burden from preventing abuse would fall on the commitments themselves. Consequently, simply including commitments in a licence is likely to be a more appropriate form of regulation, particularly in terms of enforceability.

10.180 Given the potential improvements that are available under the Act, and the degree of market power held by GAL, the CAA considers that a RAB-based framework could also be an appropriate form of regulation for GAL. A RAB-based framework is well understood and widely used across regulatory sectors. It provides price and service quality protection to passengers, while providing incentives for efficiency and has support from airlines. Unlike Stansted, there is less uncertainty over individual building blocks and the value of the RAB does not appear to be out of line with the investment requirements of passengers.

10.181 On balance, the CAA considers that a commitments plus limited licensing framework and effective monitoring would better further passengers’ interests and, where appropriate, promote competition. In the case of GAL, commitments offer a number of benefits over a RAB-based framework from the additional flexibility and greater potential for bilateral contracts which could allow better tailoring to the needs of individual airlines and their passengers. This would not only enhance choice and value to passengers, but would also facilitate airport competition at the margin. The commitments would also provide other benefits above a RAB-based framework from:

- the greater certainty to airlines and their passengers as they are for seven rather than five years and would lock-in the benefits of lower charges in years six and seven; and
- the strengthening of the airline and airport relationship as the commitments are to airlines rather than the CAA; and
- avoiding some of the direct costs and distortions to incentives that would be present under a RAB-based framework.

10.182 A supporting licence and monitoring regime would ensure that the commitments furthered passengers’ interests by requiring GAL to comply with the commitments in a manner that furthered their interests and allowed the CAA to enforce the commitments so that the additional flexibilities in the commitments were furthering passengers' interests.

10.183 The CAA considers that the commitments, licensing and monitoring regime would be consistent with the better regulation principle that regulation should be targeted only in cases where action is required, while allowing the CAA to increase regulation if GAL cannot develop the good relationships with airlines that would be important for an effective regime. On this basis the CAA considers that its final proposals for the regulation of GAL should be based on commitments and a licensing and monitoring framework, which is set out in the remainder of this document.

10.184 The CAA emphasises that the conclusion that a commitments, licensing and monitoring regime is the most appropriate form of regulation for GAL is based on the specifics of the airport operator and its market position. It is also based on the regime as a whole and there should not be any read across that any elements of the regime, for example the service quality or operational resilience requirements, would be relevant to the specific circumstances of other airport operators or regulatory regimes.

PART D – CAA'S FINAL PROPOSALS FOR A LICENCE

CHAPTER 11

A licensing and monitoring framework for GAL's commitments

11.1 This chapter sets out the CAA's proposals for a licensing and monitoring framework for GAL's commitment proposals. It consists of the following sections:

- process to date: this section outlines the process which has led to the CAA's final proposals, including the development of GAL's commitment proposals and the CAA's consultation on draft licence conditions;
- enforcement licence conditions: this section sets out the licence conditions that the CAA considers are required to deal with concerns over the enforceability of the commitments;
- financial resilience licence conditions: this section sets out the licence conditions that the CAA considers are required to deal with concerns over the financial resilience conditions in the commitments; and
- monitoring framework: this section sets out the CAA's final proposals for a monitoring framework to be associated with GAL's commitment proposals.

Process to date

11.2 GAL's commitment proposals were first set out in its response to the CAA's May 2012 Q6 Policy Update consultation document. GAL developed these proposals in response to airline and CAA feedback and provided revised commitment proposals as part of its June 2013 response to the CAA's initial proposals.

11.3 The CAA subsequently consulted on these revised commitment proposals together with a draft licence regime in July 2013 and received responses from GAL, the ACC, BA and Virgin. .

11.4 Following this consultation, and a consideration of airline and CAA views, GAL put forward its final commitment proposals on 20 August 2013.

Licence conditions to enforce the commitments

Initial proposals and subsequent development

11.5 On 8 July 2013 the CAA consulted on potential licence conditions incorporating GAL's commitments, in four areas which:

- made the commitments licence conditions and required GAL to comply with the commitments in a manner which, so far as reasonably practicable, furthers the interests of passengers and cargo owners;
- prevented GAL from amending the commitments other than through the processes set out in the commitments;
- allowed the CAA to act as an appeal body where GAL and the airlines could not reach agreement on proposed amendments; and
- allowed the CAA to introduce a temporary price freeze if it considered that the commitments based approach was not working and that a licence modification was needed to introduce a full price control condition. The temporary price freeze would have effect only during the time it took for the CAA to develop and introduce the licence modification.

11.6 The CAA has considered stakeholder views on each of these provisions in turn.

Conditions making the commitments part of the licence and requiring GAL to comply with the commitments in passengers' interests

Stakeholder views

11.7 GAL considered that the airlines' ability to enforce the commitments directly through contractual mechanisms, with a clear adjudication process as well as the ability to seek redress through the Courts, is appropriate. It also considered that its own success in a competitive airport market would depend on its ability to operate and develop the airport in the interests of passengers and that any solution to protect passengers' interests where the airlines did not appear to be doing so should be proportionate and have regard to GAL's incentive to ensure the best outcome for passengers. It suggested that, in order to allay any residual concerns, the role of the PAG could be increased so that it is consulted formally on airport development projects to provide a direct passenger voice into the performance of the airport. The CAA notes that a requirement to consult with the PAG does not appear to have been included in the latest version of the commitments.

11.8 GAL was also concerned that the obligation to comply with the commitments in a manner which furthers the interests of passengers and cargo owners would create uncertainty in what were contractually binding obligations, potentially rendering them unenforceable. Furthermore since the obligation was unqualified, unlike the CAA's section 1 duties, GAL considered that it could lead to absurd results with GAL required to make large capital investments or large price cuts without regard to the need to ensure that it is able to finance its provisions of airport operational services.

11.9 GAL also noted that the CAA is not minded to find that GAL has market power in the provision of cargo services so, in line with its duty to target only those cases where action is needed, the CAA should not be concerned about cargo providers who are protected by competition.

11.10 The ACC and Virgin were supportive of the CAA's proposals, commenting that conditions 3.1 and 3.2 together successfully addressed their concerns that it could be considered unlawful to impose obligations in a form that was not capable of being enforced under the Act. A breach of the commitments could be a breach of the Act and thus enforceable under the Act. Requiring GAL to comply in a manner designed to further the interests of users will fill any unintended gaps in the commitments and minimise the risk of unfavourable interpretation of them by GAL. The ACC and Virgin suggested that this should be extended to make it clearer that GAL must comply with the commitments, as well as the licence condition, in this manner.

CAA's final proposals

11.11 The CAA considers that the proposed condition ensures that the commitments remain in the Conditions of Use until such time as the

CAA makes a licence modification under section 22 of the Act and that they are directly enforceable by the airlines through normal contractual processes. By including the commitments in the licence and making it clear that they are also licence conditions means that the CAA is also able to intervene if necessary. The CAA would normally only expect to do so where there was detriment to the interests of users that was not being addressed. The CAA would therefore expect GAL to introduce the commitments as provided on 20 September into its Conditions of Use and would expect to enforce the relevant parts of the Conditions of Use as licence conditions. The CAA would not consider obligations on third parties or GAL's pricing principles to form part of the commitments for the reasons set out in chapter 10.

11.12 The CAA considers that, if GAL is found to pass the MPT, it cannot in the long term rely wholly on GAL’s assertion that it will be incentivised by normal competitive market forces to take account of the interests of the end users. It is therefore important to ensure that the interests of users are explicitly protected in the licence, both to ensure the right behaviours and to ensure that the CAA has the right means to enforce compliance in a targeted and proportionate manner. The CAA acknowledges GAL’s comments that this obligation appears to be more onerous than the CAA’s own duties in section 1 of the Act. However, the CAA has qualified the obligation so that GAL must comply so far as reasonably practicable. The CAA considers that this gives adequate qualification to the obligation and in contemplating any investigations or enforcement action the CAA would also take all relevant circumstances into account including existing contractual arrangements. The CAA agrees with the ACC that it should be clear that this obligation extends to compliance with the commitments themselves and considers this is already explicit in the condition as it specifies that the commitments are licence conditions.

11.13 With regards to cargo owners, the CAA has a duty to further the interests of cargo owners as well as passengers so it is right to continue to have regard to their interests. Section 18(1)(b) of the Act allows the CAA to include conditions it considers necessary or expedient to further those interests as well as conditions relating to protecting against the risk of abuse of market power. However, in light of the minded to market power assessment, the CAA has no plans to use this power at this time, unless issues arise.

A condition preventing GAL from withdrawing or amending the commitments

Stakeholder views

11.14 GAL considered that a licence condition preventing GAL from withdrawing or amending the commitments was not necessary as it would undertake in the commitments not to amend them and this would be enforceable by the airlines. It also noted that altering or withdrawing the commitments would be a material change in circumstances that could lead to a new market power determination.

11.15 The ACC and Virgin were generally supportive of the CAA's proposals to use the provisions in section 21(3) of the Act to allow non-controversial changes to be made to the commitments in accordance with modification processes within the commitments. This view was subject to the final drafting of those processes and, in particular, the percentage of airlines whose agreement would be needed to make the change. They both highlighted some potential problems that could arise if the percentage was based on the number of airlines paying fees under the commitments and suggested that instead the percentage should be based on the number of passengers represented, excluding any airlines unaffected by the change.

CAA's final proposals

11.16 The CAA has not included a provision specifically preventing GAL from withdrawing the commitments. Instead the licence condition requires GAL to include the commitments in the Conditions of Use so if it withdraws the commitments, this would be *prima facie* evidence of a breach of a licence condition.

11.17 The CAA is broadly content that GAL's self-modification proposals set out within the commitments will allow GAL and the airlines to make agreed changes to the commitments efficiently. However, the CAA considers that a self-modification provision is also required in the licence itself to meet the requirements of the Act.

11.18 This is because, as the commitments are licence conditions, the Act requires that any modifications to them must be made either under the modification provisions in section 22 or under a self-modification provision included in the licence condition under section 21(3). The CAA considers that, where changes have been properly debated and agreed already, the procedural requirements of section 22 are unnecessary and would place additional burdens on all parties. The CAA also considers that it is not necessary to retain the right of appeal for changes that have been agreed by all parties.

11.19 The Act is prescriptive about what must be included in the self-modification provision: it must set out the types of modifications that can be made and the circumstances and periods in which they can be made. The provision included in the licence condition fulfils these requirements by allowing any modifications to be made in accordance with the modification provisions set out in the commitments.

A condition allowing the CAA to be an appeal body where GAL and the airlines cannot reach agreement

Stakeholder views

11.20 GAL objected to the CAA's initial proposal to include a right to direct changes to the commitments if there is a dispute where the commitments are operating against the interests of users. It considered that the whole basis of the commitments would be undermined if the airlines could seek further arbitration.

11.21 GAL also objected to the CAA's proposal to allow either GAL or the airlines to seek a determination from the CAA on proposals to amend the commitments if there is no agreement to the amendment. It confirmed its intentions in the commitments that amendments could only happen if the requisite majority of airlines agreed. The adjudication process included in the commitments is not intended to deal with disputes over amendments to the commitments. Therefore GAL considered that if amendments were to be made without the requisite majority of airlines agreeing, those amendments should be made under section 22 of the Act.

11.22 The ACC and Virgin did not agree with the CAA's proposals to allow a determination where the relevant number of airlines did not agree with a proposed modification. They considered that where there was significant opposition, the CAA should use section 22 of the Act to ensure there was proper consultation and rights of appeal.

11.23 The ACC and Virgin also noted that the CAA had appeared to misunderstand GAL's intentions regarding the role of the Independent Arbitrator whose role is limited to disputes of compliance with the commitments rather than disputes over modifications.

CAA final proposals

11.24 The CAA notes GAL's objection to a self-modification provision allowing the CAA to direct changes to the commitments if they were operating against the interests of users. The CAA had discussed this possibility in the initial proposals but decided not to take it forward in the draft condition in its letter of May 2013.[120] The CAA considered that any modifications for this purpose should be made under the modification provisions in section 22 of the Act.

11.25 The CAA accepts the views of both GAL and the airlines that there should not be provision for the CAA to act as arbiter if GAL and the airlines could not agree on modifications to the commitments. The CAA accepts that the arbitration provisions in the commitments should only be used for contractual enforcement purposes and not to assess modifications. Therefore, any modification to the commitments that are not agreed by both GAL and the requisite number of airlines should be made under section 22 of the Act which allows either party to appeal the CAA's proposed modification to the CMA. The CAA has not included this provision in the licence condition.

A condition imposing a temporary price freeze

Stakeholder views

11.26 GAL considered that the proposal to include the ability to introduce a temporary price freeze would undermine the basis of the commitments and would introduce regulatory uncertainty, creating an incentive for airlines to lobby the CAA to open an investigation and freeze charges. It said that by retaining the right to intervene at any time, the CAA would significantly reduce certainty and this would reduce the normal free market incentive to invest.

11.27 The ACC and Virgin were generally supportive of the CAA's proposals regarding a price freeze, but believe this should go further to allow the CAA to reduce prices. As a minimum, the CAA should be able to reverse any recent increase in charges not explicitly approved by the CAA. It considered that the CAA needs to have powers to act quickly and it may not always be in a position to act before an increase is

[120] This letter set out further detail on the CAA's initial proposals and can be found at http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=14782.

imposed.

CAA final proposals

11.28 The CAA acknowledges GAL's comments that the temporary price freeze could reduce certainty but notes that the CAA already has the ability to step in at any time it considers necessary to modify the licence under section 22 of the Act. For example, it could do so if GAL chose not to follow CAA guidance on second runway costs, or if there were repeated airline legal cases trying to enforce the commitments.

11.29 However, the CAA has considered this issue carefully in light of the development of the condition as a whole. The price freeze was intended to provide an interim solution should the CAA need to take the necessary steps to modify the licence significantly, for example to introduce a price control regime. The CAA was concerned that it could take several months to develop and implement the changes and that without the price freeze a known detriment would be allowed to continue.

11.30 As the licence condition clearly incorporates the commitments into the licence itself as well as the Conditions of Use, the CAA considers that a price freeze provision is unnecessary, given the powers the CAA has under section 35 of the Act to take urgent enforcement action if it finds that GAL is not complying with its licence obligations. The CAA may give an urgent enforcement order if it is satisfied that GAL is contravening , or has been contravening, or the CAA has reasonable grounds to believe that GAL is likely to breach a licence condition[121]. The Act allows the CAA to specify the necessary steps that GAL must take to rectify the breach under section 36 of the Act.

11.31 The CAA considers that although this puts a greater evidence burden on the CAA to satisfy itself that GAL is in breach, this is a more proportionate and targeted mechanism in line with its section 1 duties. It also gives greater protection to GAL in that it has a right of appeal against an order once it has been confirmed.

[121] The CAA must also be satisfied that there is, or there is an immediate risk of, an economic or operational problem for passengers or cargo owners or relevant service providers.

A condition relating to other regulated charges

Initial proposals

11.32 The initial proposals included a condition requiring GAL to ensure it informs the CAA of the system it uses to allocate costs to specified facilities.[122] This condition was based largely on the "transparency condition" in Q5.

Stakeholder views

11.33 GAL noted that it had already included a commitment to maintain financial transparency in relation to the specified charges and it has updated this in light of CAA comments.

11.34 The Independent Airport Parking Association (IAPA) commented that the current transparency condition for other charges included facilities for park and ride operators within the definition of facilities for bus and coach operators, and that the CAA should extend the condition to cover facilities for meet and greet operators. IAPA commented that GAL had a monopoly for access to the airport forecourt and, as it competes in a downstream airport parking market, it has an incentive to leverage its position in the upstream market into the downstream market. Its members faced problems at airports relating to the price they paid for access to airport facilities and obtaining access to locations which enabled them to compete fairly with GAL's own park and ride or meet and greet operations.

CAA final proposals

11.35 The CAA considers that GAL's commitment, incorporated into the licence, to ensure that charges relating to the specified activities are set at a level which is fair, reasonable and non-discriminatory provides the right level of protection to users of those activities. The CAA is therefore not proposing to include a separate condition in the licence.

11.36 The CAA notes IAPA's comments about the location of facilities for its members. The CAA considers that, as the airport operates in both the upstream market and downstream markets, there is potential for anti-competitive behaviour. It is not proposing to include a separate

[122] 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.

licence condition but it will be undertaking some research after 1 April 2014 into wider issues of road access and forecourt access at the licensed airports in 2014/2015. Once the CAA has completed this research, it will have a better idea of the scale of any potential problems and the best way of addressing it.[123]

Financial resilience conditions

Initial proposals

11.37 The initial proposals considered the appropriate financial resilience conditions on the basis that GAL was regulated by a RAB-based price cap and a licence.

11.38 The CAA assessed the implications of introducing either a full regulatory ring fence provision or a more tailored one that comprises only those elements that did not cut across GAL's existing financial arrangements. The CAA reached the following conclusions.

11.39 While there are grounds to support the inclusion of a full ring fence[124], the CAA did not consider that it is necessary since the incremental benefits to users could be significantly outweighed by the incremental costs. [125] It was therefore likely to be in passengers' interests that any ringfencing provisions did not cut across GAL's current financial arrangements.[126]

11.40 If the CAA was to rely on GAL's contractual ring fence, there would need to be a licence condition that required GAL to notify CAA of relevant changes before the changes came into effect.

11.41 The CAA proposed that the licence should only include those conditions which did not cut across the current financial arrangements

[123] The CAA notes that under the Act it can either use its concurrent competition powers (with the OFT/CMA to handle allegations of anti-competitive behaviour relating to airport operation services under the Competition Act 1998) or its licensing powers to address any problems.

[124] Financial distress could cause detriment to passengers' interests, reduce expenditure and impact future service quality.

[125] Other reasons include: GAL already has 'strong cash generation' and certain 'highly complex' existing financial arrangements are not compatible with a full regulatory ring fence, GAL's debt covenants already form a contractual ring, a change to GAL's financing structure could require complete re-financing of existing debt (£1.4 billion) the costs of which might be passed on to passengers.

[126] This is consistent with the government's policy.

of GAL. The alternative approach was to introduce a full ring fence provision but derogate those aspects that cut across existing financial arrangements.[127]

11.42 In light of the above, the CAA proposed that the following elements of the standard financial ring fence are included in GAL's licence:

- Certificate of adequate resources[128]
- Restrictions on business activity[129]
- Ultimate holding company undertaking[130]
- Obligation to report changes in the contractual ring fence.

Stakeholder views

11.43 GAL agreed with the CAA that a full ringfence condition was not necessary given the contractual ringfence in its debt covenants but it could see the merit in including an obligation to provide notice of any changes to the debt covenants with regard to credit rating. GAL suggested that the CAA did not need to include a restriction on business activities as a similar restriction is already included in the debt covenants. GAL also queried the benefit of a holding company undertaking, particularly with the ownership structure of GAL. It agreed with the CAA that including a provision on cross-guarantees would be overly intrusive.

11.44 In addition, GAL did not see the need for a continuity of service plan as key operational knowledge is already contained in a combination of its aerodrome licence, aerodrome manual and existing business risk

[127] As these conditions would effectively remain dormant, this would provide greater certainty and clarity by setting out the restrictions on GAL's future financial arrangements.

[128] CAA proposed that company directors annually certify to the CAA whether they expect to have (or not to have) adequate resources (including financial, staff and other resources) to continue to operate for the following 24 months. Where circumstances change, the CAA must be informed as soon as possible. The CAA proposed that this requirement can be designed to reduce any administrative burdens.

[129] The CAA proposed to set the restriction quite widely to cover 'the business activities of Gatwick airport'. The CAA also proposed the inclusion of a de minimis qualification and/or provision for the CAA to grant exemptions, where this would be in passengers' interests.

[130] CAA proposed to place an obligation on GAL to obtain a legally binding undertaking from its ultimate holding company not to do anything that would place the Licensee in breach of the licence.

continuity plans.

11.45 The ACC was concerned that, as proposed, the financial resilience conditions were so watered down that it was not clear how much protection they would provide.

11.46 Virgin noted the various elements of the full ringfence that the CAA was proposing to include and considered these to be a comprehensive list. It supported the proposal to require a continuity of service plan to increase the transparency of GAL's operating and financial structure and assist any insolvency practitioner during a transition period. It considered this would benefit passengers, airlines and the wider economy.

11.47 Virgin thought that including a restriction on business activities would help ensure that GAL concentrated on its main business and its associated obligations to passengers and airlines.

Commitments on financial resilience

11.48 After the initial proposals, GAL has provided commitments on financial resilience. These commitments are discussed in chapter 10 and include:

- a requirement to notify the CAA of any variations in the contractual ring fence that relate to the credit rating requirement; and
- a requirement for the directors to provide an annual certificate of adequate financial resources (although there is no indication of the time period to be covered).

11.49 The commitments do not include:

- a requirement to obtain an ultimate holding company undertaking; or
- a restriction on business activities.

11.50 The CAA has assessed whether these commitments are sufficient or whether they need to be supplemented by targeted licence conditions.

CAA's final proposals

11.51 The CAA considers that the financial resilience conditions as set out in the initial proposals continue to be appropriate in the absence of commitments that can address the CAA's objectives robustly. The

CAA considers that these set the right balance between the benefits and costs of facilitating resilience. However, some of these overlap with the commitments offered by GAL and to the extent that the commitments address the CAA's concerns then the benefits are unlikely to outweigh the costs of duplicating the commitments in the licence.

11.52 The CAA considers that the commitment given by GAL that it will notify the CAA of any changes in the contractual ring fence relating to the credit rating is sufficient to meet the CAA's objective in this respect and does not need to be included in the licence.

11.53 However, for other aspects of financial resilience the commitments given by GAL are not sufficient.

11.54 While the commitments include an adequacy of resources certificate it does not state the future period to which this relates. As noted in chapter 10, this CAA considers that 24 months is appropriate because it gives the CAA adequate time in which to work with stakeholders and take any action that might be appropriate. The CAA proposes that the licence includes a condition requiring a certificate of adequate resources as set out in the initial proposals.

11.55 The CAA proposes to make two changes to its initial proposals in respect of the certificate of adequacy of resources licence condition. First, to make it clear that the CAA is concerned with airport operation services, instead of a certificate in respect of sufficient resources ‘to enable the licensee to comply with its obligations under its licence’, the final proposals include the requirement to provide a certificate of sufficient resources ‘to provide airport operation services at the airport’. Second, consistent with its approach to NERL, the CAA has included a requirement that alongside the certificate the licensee shall also submit a statement of the factors the directors have taken into account in providing that certificate. This will enable the CAA to assess better the certificate provided.

11.56 The commitments do not include an obligation for GAL to obtain legally binding undertakings from holding companies not to do anything that would cause GAL to breach its licence. The CAA considers that this is an important condition which goes wider than just financial resilience. The CAA notes GAL's concerns about the appropriateness because of its corporate structure, but also notes that such an obligation is widespread in other regulated sectors where there is a range of corporate structures. The CAA will work with GAL to identify those companies in its corporate structure which would be required to give such an undertaking. The CAA proposes that the licence includes an obligation for GAL to obtain legally binding undertakings from holding companies not to do anything that would cause GAL to breach its licence.

11.57 The commitments do not include a restriction on the business activities of GAL. Although, it is difficult to tightly define the business activities of an airport operator, the CAA sees merit in restricting GAL to operating Gatwick airport and prohibiting it from clearly unrelated activities. Other group companies would remain free to undertake whatever activities they wished. The CAA proposes to set the restriction quite widely to cover 'the business activities of Gatwick airport'. The CAA also proposes the inclusion of a de minimis qualification and/or provision for the CAA to grant exemptions, where this would be in passengers' interests.

11.58 The proposed licence which includes these conditions is set out in Appendix B.

Continuity of service plan (CSP)

Initial proposals

11.59 This condition would reduce the risk of service disruption whilst issues relating to financial distress are being resolved.

Stakeholder views

11.60 GAL noted the theoretical benefits of a CSP, but was not convinced of its purpose in reality as it is unrealistic to envisage that key operational knowledge would be lost in the event of financial distress. Furthermore, the existing requirements within the aerodrome licence to have an aerodrome manual and a business risk contingency plan, mean that any licence condition requiring a CSP should be very light touch. GAL's proposed commitments include a CSP.

11.61 Virgin supported the inclusion of CSP as it would increase the transparency of GAL's operating and financial structure, as well as assist an insolvency practitioner during a transitional period.

CAA's final proposals

11.62 The CAA notes that a CSP is included in the commitments and this sufficiently addresses the CAA's concerns. The CAA considers that the benefits of including a licence condition in addition to the commitment are unlikely to outweigh the costs. The CAA proposes that the licence does not include a condition in respect of a CSP.

Monitoring framework

11.63 The CAA recognises that GAL has gone a long way to addressing the CAA's concerns with the commitments in other areas. However, as set out in chapter 10, the CAA has some remaining concerns, as follows:

- the pass through of the planning and development costs of the second runway which would only have regard to rather than follow CAA policy. Given the scale of costs in this area this could have significant implications for airport charges and passenger interests;
- the SQR where there are weaker controls if there are repeated service quality failures;
- the capital plan includes no commitments to deliver specific outputs beyond those encompassed in the SQR, subject to a minimum spend of £100m per year, which would provide GAL with considerable flexibility not to deliver outputs that may be in passengers' interests;
- the ability of GAL to introduce new premium service charges which could operate against the passenger interest;
- the pass through of increased security costs to meet new security requirements but not cost savings from relaxations in security requirements;
- the commitments do not include a requirement to publish the value of the regulatory asset base; and
- the operational resilience commitment only 'has regard to' guidance issued by the CAA and the requirement for airlines to comply with GAL's rules of conduct could be used by GAL to exert its substantial market power.

11.64 To address the concerns over a RAB value the CAA intends to require

GAL to continue to undertake a shadow RAB calculation. This calculation will be useful in case tighter price control regulation needs to be reintroduced. It should however be emphasised that there should be no presumption that the CAA would use the shadow RAB number as the basis for any future RAB-based price control. To this end the CAA has included the framework for the shadow RAB calculation in Appendix C. When considering whether to include capex in the RAB calculation for any future price controls the CAA will continue to use the twin test of: efficient project management and consultation in line with the requirements in the commitments.

11.65 The CAA has considered whether it would be appropriate to introduce licence conditions to address concerns in other areas. In some cases this would cut across the flexibilities that are the benefit of the commitments, for example in terms of capex, while in others this could add significantly to complexity, for example if service quality rebate levels were set in the licence but the other price control conditions were in the commitments. Consequently the CAA sees merit in monitoring performance of the commitments to ensure that they are promoting passengers' interests and in particular those issues highlighted above. The CAA notes that it will be important for the regime and airport operator/airline relationships to bed down and would therefore not expect to undertake formal monitoring in the first year of the new regime. Consequently, in the second half of 2016 the CAA intends to ask stakeholders for views and undertake a short and focused assessment of the performance of the commitments and publish its findings.

11.66 In addition to the overall performance assessment the CAA considers that it is important that passengers and passenger groups have ready access to information about the performance of the airport. To this end the CAA would expect GAL to publish its performance against airport wide standards, including any rebates paid, on its website and in the terminal. As rebates reduce to zero if GAL continuously fails an individual metric for more than six months then the CAA will undertake an investigation into the failure. There are also a number of blanks on airport service quality standards where GAL has not put forward a proposition. The CAA would expect GAL to agree standards with airlines on these relevant parameters.

11.67 A further important issue is the method of measurement of the service quality performance. GAL's heads of terms do not include details of how service quality performance will be measured. The CAA has seen GAL's proposed approach to measurement in an earlier version of the proposed Conditions of Use. In chapter 10 the CAA highlighted a number of changes included in the approach to measurement to the Q5 regime. The CAA would expect GAL to measure service quality in a way that furthered passenger interests and to consult airlines on any changes from the approach taken in Q5. The CAA would also expect GAL to honour its commitment to formally consult the PAG on airport development projects.[131]

11.68 One area where the CAA is aware there could be significant risks to passengers' interests if CAA policy is not followed is second runway costs. To this end the CAA will consider further its treatment of the costs of second runway early in Q6 and will consult further at an appropriate time. If GAL does not follow CAA policy lines laid down in this area then the CAA will actively consider a licence amendment, given the scale of passenger detriment that could occur.

11.69 The CAA has a duty to further the interests of cargo owners as well as passengers so it is right to continue to have regard to their interests. The CAA notes the earlier public interest finding by the CC in relation to cargo and that the commitments place no controls over the prices charged to cargo operators. In the light of this the CAA intends to monitor cargo charges to ensure that the commitments are operating in users' interests.

11.70 The CAA would expect the monitoring regime and to some extent the licensing regime to evolve over time. If GAL can develop good relationships with airlines and the flexibilities within the regime are operating in passengers' interests then the CAA considers that this could lead to a scaling back in the CAA's monitoring of the commitments. Conversely if the commitments are not operating in passengers' interests and relationships with airlines are poor then the CAA can impose additional licence requirements through the modification process as set out in the Act. This should address the risks that the flexibilities within the proposed regime are not working in passengers' interests.

[131] GAL, 7 August 2013, Gatwick response to "Proposed licence conditions under section 18 of the Civil Aviation Act 2012 in relation to price commitments", http://www.caa.co.uk/docs/78/GAL_commsresponse.pdf

CHAPTER 12

GAL's licence conditions

Introduction and structure of chapter

12.1 This chapter discusses the structure and content of GAL's licence under the CAA's final proposals.[132] It consists of the following sections:

- structure of GAL's Licence;
- final proposals for Licence Conditions;
- other Licence Conditions;
- summary of final proposals; and
- GAL's Licence.

12.2 In reaching its final proposals, the CAA has considered stakeholders' views in response to its proposed licence conditions.[133] For consistency and where appropriate, the CAA has also taken into account responses to consultations on initial proposals for the operators of Heathrow and Stansted airports.[134]

Structure of GAL's Licence

12.3 The licence is structured as follows:

- Part A: Scope and Interpretation Part B: General Conditions (Payment of fees and licence revocation)Part C: Price Commitment Conditions Part D: Financial Conditions

[132] Earlier chapters set out the final proposals relating to price control and service quality.

[133] As set out in its Initial Proposals (chapters 14 and 17) as well as those conditions that the CAA considered to be necessary or expedient having regard to its duties under the Act.

[134] Such as responses to the initial proposals for HAL and STAL in relation to Revocation Conditions.

Final proposals for Licence Conditions

12.4 The CAA received seven substantive responses[135] to its proposed licence conditions. On further consideration the CAA has re-categorised or not taken forward some of the conditions proposed under 'other licence conditions' in the initial proposals. These are set out at the end of this chapter.

Part A: Scope and Interpretation

Initial proposals

12.5 This part of the draft licence provided details of the airport, the airport operator, and the airport area for which the licence is granted. It also specified the date on which the licence comes into force, and its duration, as well as details on interpreting the licence.

12.6 In the initial proposals, the CAA said that the airport area for which the licence would be granted would be based on those areas where GAL is the operator (that is, has overall control of the area) and has market power in that area. In its May 2013 letter, the CAA also considered whether the licence should go wider than the area covered by the market power determination.

12.7 In determining the airport area the CAA proposed to use the definitions of airport under section 66 of the Act, the qualifying information in section 67 and the definition of airport operation services (AOS) in section 68 as a starting point. The CAA then proposed to consider whether GAL provides AOS at the facilitates listed in section 66 and whether GAL has overall responsibility for the management of the facilities listed based on section 9(4) of the Act.

Stakeholder views

12.8 GAL stated that it did not consider that the area for servicing aircraft or the cargo processing area should be included in the airport area set out in the licence. The ACC made no comments on this.

[135] These are: GAL, Gatwick Airport Consultative Committee, GATCOM, Virgin Atlantic, British Airways, easyJet, and IAPA. Thomas Cook also responded to the consultation but made no specific comments on the individual licence conditions).

Final proposals

12.9 The CAA has considered the issue of the airport area in more detail. It considers that, in line with its duties under section 1 of the Act to carry out its functions in a targeted and proportionate manner, the airport area should be linked to the scope of the relevant market and limited to the area in which GAL is found to have substantial market power.

12.10 As the CAA has not yet published the final market power determination (MPD) for GAL under section 7 of the Act, the CAA is basing the airport area in the draft licence included in Appendix B of this document on the area considered in its ‘minded to’ position. This may change, therefore, depending on the final MPD.

12.11 The CAA’s ‘minded to’ position was that GAL has substantial market power in the market for airport operation services for full service carriers and associated feeder traffic and also for low cost carriers and charter airlines, and that these were delivered from the core area of the airport.[136] The CAA therefore currently proposes to include in the airport area covered by the licence, all those parts of the core area of the airport, unless GAL can show, in line with matters set out in section 9(4) of the Act, that it is not the operator of a discrete area. GAL needs to demonstrate that it does not have control over access to that area, its development or the type and quality of services provided there or the prices charged.

12.12 The CAA notes that, under section 18 of the Act, as well as conditions it considers necessary or expedient to guard against the risk of abuse of the market power it has found in the MPD, it may include other such conditions as it considers necessary or expedient having regard to its duties under section 1. Under section 21(1)(f) it may also include provisions relating to activities carried on outside the airport area for which the licence is granted. These give the CAA the power to go wider than the relevant market and the airport area when including conditions in the licence, such as basing the price control on a single-till RAB-based approach as discussed in chapter 2 of this document.

12.13 The CAA has therefore specified in the draft licence that the airport

[136] These are defined in section 5(4) of the Act as the land, buildings and other structures used for the purposes of the landing, taking off, manoeuvring, parking and servicing of aircraft at the airport, passenger terminals and the cargo processing areas.

area consists of:

- the land, buildings and other structures used for the purposes of the landing, taking off, manoeuvring, parking and servicing of aircraft at the airport excluding the fuel farm and fuel hydrant facilities;
- the passenger terminals; and
- the cargo processing areas. In response to GAL’s comments regarding the aircraft servicing and cargo areas, the CAA notes that these may be included in the airport area covered by the MPD and so could be included in the airport area in the licence if GAL is the operator. The CAA sought further information from GAL to confirm that it was not the operator of these areas for servicing aircraft and cargo processing according to the matters listed in section 9(4). The CAA will review this information in light of its final MPD.

Part B: General Conditions

Payment of fees

Initial proposals

12.14 In common with other regulated sectors, the Act allows the CAA to require the licence holder to pay charges to the CAA in respect of its functions under Chapter 1 of the Act. In addition the CAA has general powers to determine charges under a scheme or regulations made under section 11 of the Civil Aviation Act 1982 (the 1982 Act). Also, in common with other regulated sectors, payment of fees would be enforceable using civil sanctions as well as the enforcement powers in the Act.

Stakeholder views

12.15 GAL made no comment on the condition on fees. Virgin was supportive of the payment of fees condition and the proposals to use civil sanctions as well as the enforcement powers under the Act. The airlines made no other comments on this condition.

Final proposals

12.16 The CAA has not received any evidence through the consultation on the initial proposals to suggest the payment of fees condition needs to be changed. Therefore, the CAA proposes to continue to rely on the current scheme under the1982 Act to determine regulatory charges while, through the licence, placing an obligation on GAL to pay these charges when the licence comes into effect and whilst it continues in force. Under the 1982 Act the CAA has an obligation, before making a charging scheme, to consult persons affected by the scheme and the Secretary of State.

Licence revocation

Initial proposals

12.17 Revocation is the ultimate sanction for a licence breach by a regulated company and should be used only as a last resort when all other channels have been exhausted. The licence must include the grounds on which the licence can be revoked, and specify that revocation must be in accordance with procedures set out in section 48 of the Act. The CAA proposed that the grounds on which it could revoke GAL's licence should be:

- where the licence is no longer required, including:
  - the Licensee requests or agrees to revocation;
  - the Licensee is no longer the operator of all of the airport area, or
  - either the airport and/or airport area is no longer dominant; or
- where the Licensee has materially failed to comply with regulatory requirements. For instance:
  - failure to comply with an enforcement order[137] or to pay a penalty[138] (following any appeal proceedings under the Act and allowing at least 3 months for the Licensee to comply before starting revocation proceedings under section 48 of the Act);
  - failure to comply with relevant orders made under the Competition Act 1998 (CA98) or the Enterprise Act 2002 (EA02);[139]

[137] Within the meaning of section 33 of the Act, or an urgent enforcement order within the meaning of section 35 and 36 of the Act.

[138] Within the meaning of sections 39, 40, 51 or 52 of the Act.

[139] The CAA proposed that it is proportionate for the competition enforcement route to have the

- failure to pay charges to the CAA under Condition 1;[140] or
- failure to supply information in accordance with the Act.

Stakeholder views

12.18 GAL considered that failure to comply with an order made under competition law should not be grounds for revocation; it considered the CA98 and the EA02 contained sufficient enforcement powers and that GAL should not be subject to additional and enhanced remedies that others subject to those Acts did not face. It also considered that revocation for non-payment of fees or non-payment of penalty was also disproportionate as the CAA has enough other remedies to ensure payment.

12.19 Virgin considered that revocation should be used as a last resort and as the ultimate sanction. It considered that revocation on its own would not be enough to compel GAL to close the airport or cease operations and the CAA needs to consider carefully what other steps may be required. The airlines made no other comments on this.

12.20 HAL also commented in response to the consultation on its proposed licence that failure to comply with an order made under competition law should not be grounds for revocation; it considered that the relevant Acts should be enforced by means of their own enforcement powers.

Final proposals

12.21 The CAA is required under section 17(4) to include provisions about the circumstances in which the licence may be revoked. It agrees that licence revocation is a serious matter as the prohibition on charging in section 3 of the Act means it would not be lawful for GAL to charge for any airport operation services if it has no licence. In all likelihood, this means that GAL would have to cease operations. Other than in extreme circumstances, the CAA does not consider that this is likely to be in the best interests of passengers and cargo owners, so there should be several checks and opportunities for GAL to correct any

same ultimate sanction as the route in the Act.

[140] Condition 2.1(e) of the initial proposal's Draft Licence Conditions stated that the CAA may revoke the licence if any amount payable under Condition 1 of the licence is unpaid three months after it becomes due and such failure is not rectified to the satisfaction of the CAA within three months after the CAA has given notice of such failure to the licensee.

failures before such excptional action is taken.

12.22 The CAA agrees with GAL that placing additional sanctions over and above those already included in CA98 and EA02 would be unduly onerous and unfair in relation to other companies subject to those Acts. In addition, the CAA's initial view that there should be similar ultimate sanctions for failures to comply with orders under the Act and CA98[141] does not apply to EA02 in the same way. The CAA has therefore not included failure to comply with orders made under CA98 and EA02 as grounds for revocation.

12.23 The CAA also considers that the inclusion of non-payment of fees as specific grounds for revocation is repetitive and unnecessary as the payment of fees is already a separate condition of the licence. Non-payment of fees would not therefore of itself trigger a revocation process but revocation could follow from failure to comply with an enforcement order and/or non-payment of a penalty. For clarity, the CAA has also amended the drafting of the provision for revoking the licence on the grounds of failure to comply with an enforcement order or a penalty.

12.24 The CAA considers it is not necessary to include the imposition of a penalty under sections 51(1) or (3) in the grounds for revocation as there are already sufficient sanctions in the Act. However, failure to pay a penalty issued under section 52 would remain grounds for revocation.

Part C: Price Commitment Conditions

Price Commitments

12.25 Details of the CAA's initial proposals on Price Commitments Conditions, stakeholder views and the CAA's final proposals were covered in chapter 11 of this document.

[141] Because of its concurrency powers and its obligation to consider whether to use the CA98 at all stages of an investigation.

Part D: Financial Conditions

Regulatory accounts, financial resilience and continuity of service

12.26 Details of the CAA's initial proposals on the financial conditions, stakeholder views and the CAA's final proposals were covered in chapter 11 of this document.

Service Quality

Service quality levels, rebates and bonuses

Initial proposals

12.27 The CAA's proposals for the SQR were set out in chapter 13 of the initial proposals and the CAA's May 2013 letter set out the draft service quality condition.[142] The proposed condition incorporated a Statement of Standards, Rebates and Bonuses setting out the details of the SQR. The condition also included mechanisms for self-modification where all parties agreed or for a CAA determination in certain circumstances.

Stakeholder views

12.28 GAL considered that, under a commitments-based licence, the SQR would sit within the commitments rather than in the licence itself. GAL stated that it would oppose conditions that would allow the CAA to direct changes to the commitments as this would undermine the commercial basis of the commitments.

12.29 The airlines supported a mechanism to adjust the SQR subject to appropriate safeguards and governance but made no other comments on the service quality licence condition itself.

12.30 Virgin responded that it might be appropriate to adjust the SQR in the interests of passengers, and supports the inclusion of such a mechanism. It would like to see how these conditions will be developed to reflect its concerns.

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[142] Please see http://www.caa.co.uk/docs/78/20130531LetterToGatwickStakeholders.pdf for more information.

12.31 easyJet argued that the SQR should be simplified to concentrate on those services that are of most importance to passengers.

Final proposals

12.32 As discussed in chapter 11 of this document, the proposed licence incorporates the commitments as licence conditions as well as requiring them to be included in a schedule to the Conditions of Use. Under this form of regulation, the SQR would be included in the commitments so it can be enforced directly by the airlines. The commitments also allow modifications to the SQR through agreement by GAL and an agreed proportion of airlines. By including the commitments in the licence and requiring GAL to comply with the commitments in passengers' interests would, if issues arise, allow the CAA to enforce the commitments in passengers' interests. The CAA's views on the SQR offered by GAL in its commitments and the monitoring arrangements that the CAA will require are set out in chapters 10 and 11 of this document.

Operational Resilience

Initial proposals

12.33 In the initial proposals, the CAA included a draft licence condition requiring GAL, so far as reasonably practicable, 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 order to achieve this, the CAA proposed that GAL should:

- consult on, develop and maintain resilience plans and processes setting out how it will do this, where appropriate in line with any guidance issued by the CAA (the plans would be limited to the actions where GAL is in control and could flag other actions where GAL relied on the airlines or groundhandlers to take action);
- facilitate a governance forum to foster a more cooperative and collaborative approach to managing disruption;
- lead on coordination and communication between itself, the airlines and the groundhandlers to ensure a more coherent response to disruption, including developing 'rules of conduct' for airlines and groundhandlers, setting out what GAL would expect from those bodies to support GAL in meeting its obligations under this condition; and

- publish information relevant to other service providers and passengers so far as possible to help them plan their response to disruption.

Stakeholder Views

12.34 GAL did not consider that the proposed licence condition would add much to the good progress it has made in this area over the last few years and said that commercial and reputational pressures were likely to render the licence condition unnecessary. However, GAL has included similar provisions in its commitments.

12.35 The ACC was supportive of the CAA's proposal and agreed that GAL is best placed to lead on coordination and collaboration. However, it had not had an opportunity to discuss the proposal during the CE process so would want to engage further with the CAA and GAL on how this would work in practice. In particular, it has concerns about the proposals for any roles envisaged for third parties and the proposal for GAL to publish “rules of conduct”. The ACC did not support the imposition of such rules and stressed that any such arrangements must be tenable and must not cut across existing regulations, particularly the requirements under the EU denied boarding regulations (EU261/2004). The airlines will strongly oppose any measures which will increase liabilities or impose new obligations on them.

12.36 In addition, Virgin was concerned that putting too much emphasis on operational resilience could encourage GAL to over-invest in this area to mitigate any associated risk and it noted that any investment must be made in a fair and transparent manner which best meets passengers' interests. GATCOM also suggested there should be an additional obligation to review disruptive events in relation to the effectiveness of the contingency plans and the service level performance during that event.

12.37 The Consumer Council of Northern Ireland welcomed the use of licences to strengthen airports operators' approaches to planning for service disruption and their responses to passengers in the event of service disruption. It also noted that it is essential that airlines are fully involved in developing service disruption plans as airlines are required to provide passengers with assistance and accommodation in accordance with EU 261/2004 in instances of flight disruption.

Final proposals

12.38 The CAA considers that operational resilience is necessary as part of the wider industry framework for dealing with disruption and that GAL should be required to plan for, and coordinate the wider industry response to, disruption. The CAA considers that, with good collaboration, clear expectations and plans setting out relevant roles and responsibilities, coupled with effective application of the denied boarding regulations, this will be a significant step forward towards a more efficient whole industry response. This is likely to be an on-going process that will need time to develop fully.

12.39 The CAA's views on GAL's commitments in relation to operational resilience commitments are set out in more detail in Chapter 10 of this document. In summary, the CAA is broadly content that GAL's commitments cover the essential elements of the proposed condition and that the CAA will be able to intervene if necessary through the enforcement mechanisms in the Act.

12.40 The CAA does have some concerns that GAL is currently only committing to having regard to any guidance issued by the CAA, but, in the event of an investigation into licence breach in this area, the CAA would take into account the degree to which GAL had incorporated any relevant guidance. The CAA is therefore not including a separate condition in the licence at this stage. However, the CAA will monitor GAL’s activities in this area and may decide to propose a specific condition in the future if it considers it to be necessary.

Other licence conditions

12.41 In its initial proposals, the CAA considered that there may be merit in considering other licence conditions for GAL. These conditions were:

- a provision, possibly in the interpretation section of the licence, to clarify that GAL would not be expected to breach safety or security requirements in order to comply with the licence;
- a reopener for a price control;
- a complaints handling condition;

- revocation upon insolvency;
- a consultation condition; and
- a non-discrimination condition.

Breaching legal obligations

Initial proposals

12.42 The CAA considered including a statement in the interpretation section of the licence to the effect that in meeting the licence condition, the licensee should not be required to breach any other legal obligations (for example in relation to safety and security requirements). This may be required to ensure that the licensee does not consider there is a choice between breaching the licence and breaching those other requirements.

Stakeholder views

12.43 GAL considered that a provision requiring compliance with safety and security obligations, could lead to conflict and inconsistency with the enforcement regimes for those obligations.

12.44 The airlines made no comment on this proposal.

Final proposals

12.45 The CAA has considered this proposal carefully. Whilst it is important to recognise that GAL may have conflicting obligations at times, the CAA agrees that including such provision in the licence could lead to uncertainty and inconsistency between the three sets of obligations and related enforcement regimes. Furthermore, it could have unintended consequences on compliance with the economic licence. The CAA does not therefore consider it would be appropriate to include licence conditions in this area.

12.46 It is for GAL to be aware of all its relevant obligations and to manage its activities to ensure compliance with each one. For its part, the CAA will take into account all the relevant circumstances, including any safety and/or security considerations, in any investigations it may carry out or in enforcement or licence modification decisions that it may make under the Act.

Reopeners for the price control

Initial proposals

12.47 In the initial proposals, the CAA questioned whether it should include a provision allowing the price control to be re-opened within the regulatory period in extreme circumstances.

Stakeholder views

12.48 GAL agreed with the CAA that any reopener for a price commitment or price settlement should only be in extreme circumstances.

12.49 The airlines did not see the need for a specific reopener for price controls.

Final proposals

12.50 The CAA considers that such a provision is not appropriate under the form of regulation proposed as the CAA is not intending to impose a price control. Should the CAA need to make changes to the licence relating to a price control in the future, these should be made under the modification provisions in section 22 of the Act.

Complaints handling condition

Initial proposals

12.51 The CAA questioned whether the licence should contain clear requirements on GAL in relation to how it deals with passenger complaints.

Stakeholder views

12.52 GAL considered that such a provision would be overly intrusive and unwarranted and questioned whether there was a problem that needed to be solved.

12.53 The airlines supported the inclusion of such a condition. Virgin wished to further explore the prospect of including a passenger complaints handling requirement within the licence.

Final proposals

12.54 The CAA agrees that, to date, this has not been raised as a problem that needs addressing and no additional evidence to the contrary has been offered through the consultation on the initial proposals. The CAA considers that the inclusion of a complaints handling condition would not be consistent with its duties to be proportionate and targeted only at cases in which action is needed and would impose an unnecessary burden on GAL. The CAA has therefore not included a complaints handling condition in the final proposals. However, the CAA will keep this under review as the licence framework beds in and may consider including a condition in the future if necessary.

Revocation upon insolvency

Initial proposals

12.55 The CAA questioned whether stakeholders considered insolvency should also be grounds for revocation, as it would most likely be in the interests of any receiver, passengers and cargo owners to keep the airport open and running during insolvency. The CAA clarified its views in its May 2013 letter that it considers including insolvency as grounds for revocation would not be in the interests of passengers or cargo owners. Instead, the CAA proposed that an obligation in the financial resilience condition requiring GAL to notify the CAA if it was seeking advice on insolvency would provide sufficient early warning of any insolvency risk.

Stakeholders views

12.56 GAL welcomed the CAA’s May 2013 clarification of its views on whether insolvency should be grounds for revocation as any risk of revocation for this reason would have significant implications for GAL in terms of ratings, cost of funding and market appetite for debt.

12.57 Virgin commented that it was important that the CAA had the ability to revoke the airport operator's licence upon insolvency.

Final proposals

12.58 The CAA is no longer proposing to include insolvency as grounds for revocation. Following the clarification of its views in the May 2013 letter, the CAA has developed a licence condition for inclusion in the financial resilience condition which requires GAL to inform the CAA if GAL were to seek advice on insolvency. This obligation also requires GAL to inform the CAA if any of its linked companies, whose own insolvency or inability to trade would have an adverse effect on GAL's ability to trade, were to seek insolvency advice.

Consultation condition

Initial proposals

12.59 The CAA questioned whether it should include a condition requiring GAL to comply with a consultation protocol setting out the CAA's expectations on how GAL should consult with airlines.

Stakeholder views

12.60 GAL has suggested an alternative consultation process than that used in the last control period and has incorporated this into its commitments.

12.61 The airlines thought that the inclusion of a consultation provision should be informed by the development of arrangements for capital efficiency and capital governance. GATCOM said there should be a specific requirement to ensure that it and its PAG is consulted on future investment plans and projects, as well as on any service quality performance targets, to help ensure passengers' interests and local environmental concerns are represented. Virgin noted the importance of having clear parameters in place from the outset for information disclosure and consultation.

Final proposals

12.62 The CAA agrees that clear and effective consultation is essential to ensure all interested parties understand relevant proposals, are in a position to make informed responses and that GAL takes those responses properly into account.. The CAA considers that the GAL's processes set out in the commitments are sufficient and it is therefore not including a specific condition in the licence. However, the CAA will monitor GAL's activities in this area and may decide to propose a specific condition in future if it considers it to be necessary.

Non-discrimination condition

Initial proposals

12.63 The CAA proposed a non-discrimination condition designed so as not to cut across existing provisions such as those under section 41 of the AA86, the ACR or the CA98.

Stakeholder views

12.64 GAL considered that non-discrimination is adequately covered in the

ACRs, CA98 and the Groundhandling Regulations (GHRs) and it is therefore not necessary to include it in a licence.

12.65 The airlines supported the inclusion of such a condition

12.66 HAL commented in response to the consultation in respect of Heathrow that there was no basis for a non-discrimination licence condition as there are well established competition laws in existence to which the CAA has access and more general provisions in the ACR, therefore there was no justification for an ex-ante licence requirement.

Final proposals

12.67 The CAA considers that section 41 of the AA86, the ACRs, CA98 and the GHRs each include non-discrimination provisions which, individually or collectively, provide adequate protection against discrimination. The CAA does not consider that including additional protection within the licence will provide any greater benefit and would not be consistent with its duty to be proportionate and to target those areas where action is required or its duty not to impose unnecessary burdens.

12.68 The CAA has therefore not included a non-discrimination condition, but will instead rely on existing legislation.

Summary of Final Proposals

Part A: Scope and Interpretation

12.69 The CAA is proposing to exclude the cargo and aircraft maintenance areas from the airport area covered by the Licence.

Part B: General Conditions

12.70 The CAA has not made any changes to the payment of fees condition. The CAA is removing non-payment of fees and non-compliance with orders made under competition law from the grounds for revocation. It is not including insolvency as grounds for revocation.

Part C: Price Control Conditions

12.71 The CAA is including a licence condition that incorporates the commitments and requires them to be included in the Gatwick Airport

Conditions of Use. GAL must comply with the commitments in a manner designed to further the interests of passengers, so far as reasonably practicable. GAL is restricted how changes can be made to the commitments.

Part D: Financial Conditions

12.72 The CAA has included a financial resilience condition as set out in the initial proposals, and included a requirement to inform the CAA if it is seeking advice on insolvency. The CAA is not including a separate condition requiring GAL to have a continuity of service plan.

Other issues

12.73 The CAA has not included specific conditions in relation to;

- service quality;
- operational resilience;
- non-discrimination;
- a price control reopener;
- safety and security;
- complaints handling; or
- consultation.

Licence for GAL

12.74 Please see Appendix B below.

APPENDICES

APPENDIX A

Glossary

Abbreviations	
AA86	Airports Act 1986
ACC	Airline Consultative Committee
ACD	Airport Charges Directive
ACR	Airport Charges Regulations
ACTM	Airport Commerce and Talent Management
AMD	archway metal detectors
ANS	air navigation services
AOC	Airline Operators Committee
AOS	airport operation services
APH	Airport Parking and Hotels
ASQ	Airport Service Quality
ATMs	air transport movements
ATRS	Air Transport Research Society
BA	British Airways
CA98	Competition Act 1998
CAGR	compound annual growth rates
capex	capital expenditure
CAT	Competition Appeal Tribunal
CC	Competition Commission
CE	Constructive Engagement

Abbreviations	
CEPA	Cambridge Economic Policy Associates
CF	Consensus Forecasts
CIP	capital investment plan
CMA	Competition and Markets Authority
COPI	construction price inflation
CSP	continuity of service plan
DB	defined benefit
DC	defined contribution
DfT	Department for Transport
DL	Davis Langdon
EA02	Enterprise Act 2002
EBITDA	earnings before interest, taxes, depreciation and amortization
EE	Europe Economics
EIU	Economist Intelligent Unit
FE	First Economics
FEGP	fixed electrical ground power
FFO	funds from operations
FPs	final proposals
FTE	Full Time Equivalent
GAD	Government Actuary’s Department
GAL	Gatwick Airport Limited
GATCOM	Gatwick Airport Consultative Committee
Gatwick	Gatwick airport
GDP	Gross Domestic Product

Abbreviations	
GHRs	Groundhandling Regulations
HAL	Heathrow Airport Limited
HBS	hold baggage screening
IAPA	International Airline Passengers Association
IBP	initial business plan
ICR	adjusted interest cover
IDL	International Departures Lounge
IMF	International Monetary Fund
IPs	initial proposals
JSG	Joint Steering Group
LCC	low cost carrier
LF	Leigh Fisher
LGW	London Gatwick Airport
LRIC	long-run incremental costs
MARS	Modular Aircraft Refuelling Systems
MEAV	modern equivalent asset value
MPD	market power determination
MPT	market power test
NATS	NATS Holdings
NERL	NATS (En Route) plc
NPV	net present value
NT	North Terminal
OBR	Office of Budget Responsibility
OECD	Organisation for Economic Co-operation and Development

Abbreviations	
ONS	Office of National Statistics
opex	operating expenditure
ORCs	other regulated charges
PAG	Passenger Advisory Group
pax	passenger
PMICR	post-maintenance interest cover ratio
PRMs	passengers with reduced mobility
PwC	PricewaterhouseCoopers
Q5/Q5+1	the fifth quinquennium
Q6	the sixth quinquennium
QSM	Quality of Service Measure
RAB	regulatory asset base
RAR	regulatory asset ratio
RBP	revised business plan
RPI	retail price index
S&P	Standard & Poor's
SDG	Steer Davies Gleave
SH&E	ICF SH&E
SLA	service level agreement
SMP	substantial market power
SQR	Service Quality Rebate
ST	South Terminal
STAL	Stansted Airport Limited
TDA	Tobacco Display Act

Abbreviations	
TFP	Total Factor Productivity
the Act	Civil Aviation Act 2012
the airlines	the airlines operating at Gatwick airport
UKBF	UK Border Force
URS	URS Infrastructure & Environment UK Limited
Virgin	Virgin Atlantic Airways
WACC	weighted average cost of capital
WDF	World Duty Free
WHO	World Health Organization
WTP	Willingness to Pay

APPENDIX B

Draft GAL Licence

Licence granted to

GATWICK AIRPORT LIMITED

by the Civil Aviation Authority

under section 15 of the Civil Aviation Act 2012

On [date]

Contents

Part A: Scope and interpretation of the Licence

A1 Scope

A1.1 The CAA has made a market power determination under section 7 of the Act on [date] that means, for the purposes of section 3 of the Act, Gatwick Airport Limited (the Licensee) is the operator of a dominant airport area at a dominant airport.

A1.2 The Airport is London Gatwick

A1.3 The Airport Area is those areas, as defined in sections 66 and 67 of the Act that comprise:

a) the land, buildings and other structures used for the purposes of the landing, taking of, manoeuvring, parking and servicing of aircraft at the airport, [excluding the aircraft maintenance facilities];

b) the passenger terminals; and

c) [the cargo processing areas.][143]

A1.4 The CAA, in exercise of the powers conferred by section 15 of the Act, hereby grants to the Licensee this Licence authorising the Licensee and those persons listed in section 3(3) of the Act, to require a person to pay a relevant charge in respect of airport operation services that it provides at the Airport, subject to the conditions of this Licence.

A1.5 This Licence shall come into force on 1 April 2014 and shall continue in force until revoked in accordance with Condition B2 of this Licence.

A2 Interpretation

A2.1 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.

[143] The CAA will make a final decision on the areas to be excluded when it has reviewed the relevant documentation from GAL and undertaken further work on the market power assessment.

A2.2 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.

A2.3 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.

A2.4 In construing the provisions of this Licence, the heading or title of any Condition, Schedule or paragraph shall be disregarded.

A2.5 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.

A2.6 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.

A3 Definitions

A3.1 In this Licence:

a) the Act means the Civil Aviation Act 2012;

b) the CAA means the Civil Aviation Authority.

Part B: General Conditions

B1 Payment of fees

B1.1 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.

B2 Licence revocation

B2 The CAA may revoke this Licence in any of the following circumstances and only in accordance with sections 48 and 49 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 all of the Airport Area; or

(ii) the Airport Area ceases to be a dominant area; or

(iii) the Airport ceases to be a dominant airport;

c) if the Licensee fails:

(i) to comply with:

1. an enforcement order (given under section 33 of the Act); or

2. or an urgent enforcement order (given under section 35 which has been confirmed under section 36); or

(ii) to pay any penalty (imposed under sections 39, 40, 51 or 52 of the Act) by the due date for any such payment,

where any 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:

1. the proceedings relating to any appeal under section 47 of the Act brought in relation to the validity or terms of an

order or the CAA's finding or determination upon which it is based are finally determined; or (as the case may be); or

2. the proceedings relating to any appeal under sections 47 or 55 of the Act brought in relation to the imposition of a penalty, the timing of the payment of the penalty or the amount of the penalty are finally determined.

Part C: The price commitment conditions

C1 Price commitments

C1.1 The Commitments are conditions of this Licence and shall be set out in a Schedule to the Conditions of Use.

C1.2 Obligations placed on third parties in the Commitments, and the Licensee's pricing principles set out in the Commitments, shall not be treated as conditions of this Licence.

C1.3 In complying with this Condition C1 the Licensee shall, so far as reasonably practicable, do so in a manner designed to further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of airport operation services.

Modification of the Commitments

C1.4 The Licensee shall not modify the Commitments otherwise than in the circumstances set out in the modification provisions of the Commitments.

C1.5 The modifications that can be made under Condition C1.4 are modifications set out in the modification provisions of the Commitments.

C1.6 Modifications can be made to the Commitments under Condition C1.4 at any time.

Definitions

C1.7 In this Condition C1:

(a) the Commitments means the commitments made by the Licensee to providers of air transport services at Gatwick Airport as agreed by the CAA from the date this licence comes into force and amended from time to time under Conditions C1.3 to C1.5 of this Licence. The Commitments do not include any obligations placed by the Licensee on third parties or the Licensee's pricing principles; and

(b) the Conditions of Use means the Gatwick Airport Conditions of Use, published by the Licensee.

Part D: Financial Conditions

D1 Financial Resilience

Certificate of adequacy of resources

D1.1 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 provide airport operation services at the Airport.

D1.2 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 and shall include a statement of the factors which the directors of the Licensee have taken into account in preparing that certificate. 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 provide airport operation services at London Gatwick Airport of 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 provide airport operation services at London Gatwick Airport of 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 provide airport operation services at London Gatwick Airport 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 provide airport operation services at London Gatwick Airport 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."

D1.3 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 D1.2(a) or (b).

D1.4 The Licensee shall obtain and submit to the CAA with each certificate provided under Condition D1.2 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.

D1.5 If the Licensee or any of its linked companies (or, where applicable the Directors and Officers of any of those undertakings) seeks, or is advised to seek, advice from an insolvency practitioner or any other person relating to

(a) the Licensee's financial position or ability to continue to trade; or

(b) that linked company’s financial position or ability to continue to trade, only to the extent that it would affect the Licensee’s financial position or ability to continue to trade,

the Licensee must inform the CAA within 3 working days.

Restriction on activities

D1.6 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.

Ultimate holding company undertakings

D1.7 The Licensee shall procure from each Covenantor a legally enforceable undertaking in favour of the Licensee in the form specified by the CAA that that Covenantor will:

(a) refrain from any action, and procure that every subsidiary of the Covenantor (other than the Licensee and its subsidiaries) will refrain from any action, which would then be likely to cause the Licensee to breach any of its obligations under this Licence;

(b) promptly upon request by the CAA (specifying the information required) provide to the CAA (with a copy to the Licensee) information of which they are aware and which the CAA reasonably considers necessary in order to enable the Licensee to comply with this Licence.

D1.8 Such undertaking shall be obtained within seven days of the company or other person in question becoming a Covenantor and shall remain in force for so long as the Licensee remains the holder of this Licence and the Covenantor remains a Covenantor.

D1.9 The Licensee shall:

(a) deliver to the CAA, within seven days of obtaining the undertaking required by Condition D1.8, 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.

Definitions

D1.10 In this Condition D1:

(a) the Covenantor means a company or other person which is at any time an ultimate holding company of the Licensee.

(b) a linked company means any company within the Licensee's Group where the financial position of that company or its inability to continue to trade would have an adverse effect on the Licensee's financial position or ability to continue to trade;

(c) Permitted Business means:

(i) any and all business undertaken by the Licensee and its subsidiary undertakings as at 1 April 2014;

(ii) to the extent that it falls outside Condition D1.10(c)(i), 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

(iii) 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% of the value of the RAB at the start of the financial year.

APPENDIX C

Rolling forward the Regulatory Asset Base

Purpose and basis of the calculation

This Annex specifies the detail of the formulae that GAL will use for tracking the regulatory asset base.

The equations set out below are based on the projections made by the CAA in reaching its final decision on the charge conditions for the control period after 1 April 2014.

Each year, each RAB is expressed in actual end year price levels. The modelling used fixed 2011/12 price levels and the figures below must be uplifted to current price terms each year.

Retail Price Index ("RPI") Growth t from 2011/12	=	The RPI (as defined in the Condition) at the end of the financial year t divided by the average of the monthly RPI figures for the financial year 2011/12,which (based on the All Items index[144] and based on 13 January 1987 = 100) equals 237.3
Annual RPI Growth t	=	The RPI at the end of the financial year t Divided by The RPI at the end of the financial year t-1
Within Year RPI Growth t	=	The RPI at the end of the financial year t divided by the average of the monthly RPI figures for the financial year t

[144] All Items (CHAW) index, source: National Statistics.

This section describes how the Gatwick Airport RAB will be rolled forward from one year to another.

Opening RAB t	=	For the financial year 2014/15, this figure will be set according to the following formula: £ 2474.418 million x RPI Growth from 2011/12
	+	Actual Capex 2013/14 x RPI Growth from 2013/14
	-	£189.215 million x RPI Growth from 2011/12
	-	(Actual proceeds from Disposals 2013/14) x RPI Growth from 2013/14)
	=	For the remaining financial years, this figure will be set according to the following formula: Closing RAB t-1 x Annual RPI Growth t
Closing RAB t	=	Opening RAB t
	+	(Total Actual Capex t x Within Year RPI Growth t)[145]
	-	(Proceeds from Disposals t)
	-	(CAA's Assumed Depreciation t x RPI Growth from 20011/12)

Assumed Depreciation t in 2011/12 prices	=	For each financial year this figure will be fixed at the following values:	
		Financial year 2014/15:	£149.460 million
		Financial year 2015/16:	£156.124 million
		Financial year 2016/17:	£153.258 million
		Financial year 2017/18:	£141.742 million
		Financial year 2018/19:	£150.908 million
		Financial year 2019/20:	£152.309 million
		Financial year 2020/21:	£152.029 million

[145] Accrued capital expenditure with no adjustment for movements in working capital.